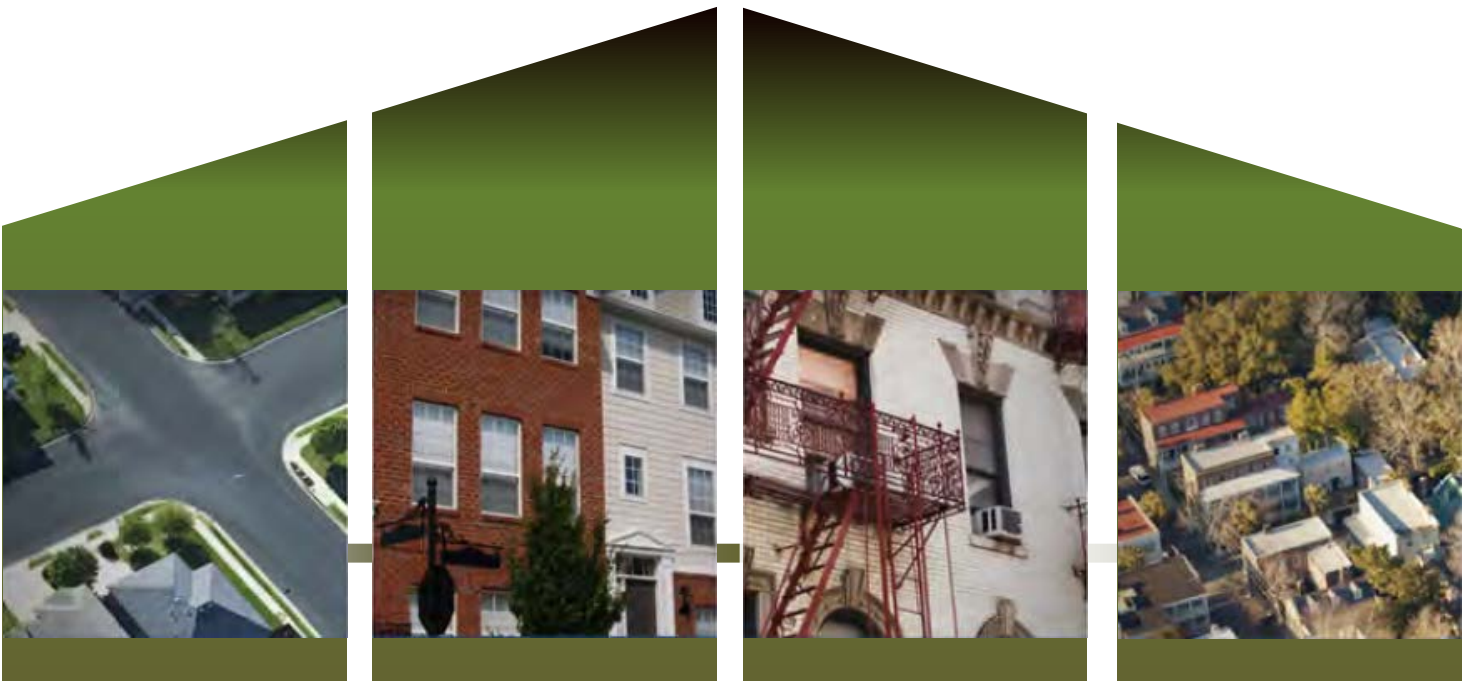




# HOME and the Low-Income Housing Tax Credit Guidebook





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# INTRODUCTION

## Purpose of this Guidebook

When developers seek financial resources for affordable rental housing development, many combine funds generated through the Low-Income Housing Tax Credit (LIHTC) offered by the Internal Revenue Service with housing block grant funds provided through the HOME Investment Partnerships (HOME) Program administered by the U.S. Department of Housing and Urban Development (HUD). This publication, *HOME and the Low-Income Housing Tax Credit Guidebook*, provides technical guidance to HOME Program Participating Jurisdictions (PJs) on how to assess these HOME-LIHTC applications, and how to comply with the requirements of both programs for the successful development of affordable multifamily rental projects.

*While HUD has made every effort to describe the requirements of the Internal Revenue Code accurately, HUD does not have oversight of the LIHTC. PJs are cautioned that they must consult with legal and tax counsel or the Internal Revenue Service when providing HOME funds to a project funded with LIHTC to ensure that they understand the most accurate and up-to-date tax code requirements. PJs should also contact their state's Low-Income Housing Tax Credit allocating agency.*

## Overview of the Programs

The HOME Program and LIHTC originate with different legislative histories and program purposes. As such, each program has relative strengths and limitations in addressing a variety of local housing conditions or needs.

The HOME Program was created in 1990 by the Cranston-Gonzalez National Affordable Housing Act. Each year, Congress allocates approximately \$2 billion by formula among the states and hundreds of localities nationwide. HOME is the largest Federal block grant designed exclusively to create affordable housing for low-income households in the nation. Among other things, HOME funds may be used by PJs to provide incentives to develop rental housing through acquisition, new construction, reconstruction, or rehabilitation of non-luxury housing.

Congress created the Low-Income Housing Tax Credit in 1986 as **Section 42 of the Internal Revenue Code (IRC or “the Code”)** to develop a financial incentive to generate private capital for the development of affordable rental housing. LIHTCs are administered by the Internal Revenue Service (IRS) because they are tax credits, not direct funding, for affordable rental housing development. Congress gives the states authority to allocate a certain number of tax

credits to eligible affordable housing ventures annually. Therefore, while Section 42 of the IRC regulates certain aspects of the LIHTC, each state also establishes certain priorities, policies, and procedures for the allocation of its housing tax credits.

LIHTC is not the only Federal tax credit that can be used for affordable housing. The IRS also offers tax credits for historic preservation (tax benefits to the project owner for maintaining the historic character of a building) and energy (tax benefits to the project owner for making energy-saving investments). In addition, several states offer their own low-income housing tax credits and/or historic preservation tax credits, which serve as a credit against the investor's state income tax liabilities. This guidebook provides guidance *only* on the use of the Low-Income Housing Tax Credit based on Section 42 of the IRC. It does not provide guidance on how to use these other tax credit programs with HOME.

## Why Use HOME and LIHTC Together?

HOME and LIHTC are often used together to finance affordable rental housing development. In order to establish affordable rents in many markets, a project's rents may not adequately support sufficient conventional mortgage debt. The equity raised from the LIHTC may not be sufficient to provide all of the additional capital required by the project. Often, HOME funds can be used to finance the remaining gap.

Combining HOME and LIHTC funding also enables the developer and investors (including the PJ) to:

- Leverage scarce resources
- Develop mixed-income housing
- Reach a diverse clientele (such as very low- and low- income residents) with the same program activity.

When combining these two sources of funds, the projects must comply with the requirements of both programs. Generally, this can be achieved by complying with the most restrictive requirement. This guidebook illustrates how to do this.

## Stakeholder Motivations

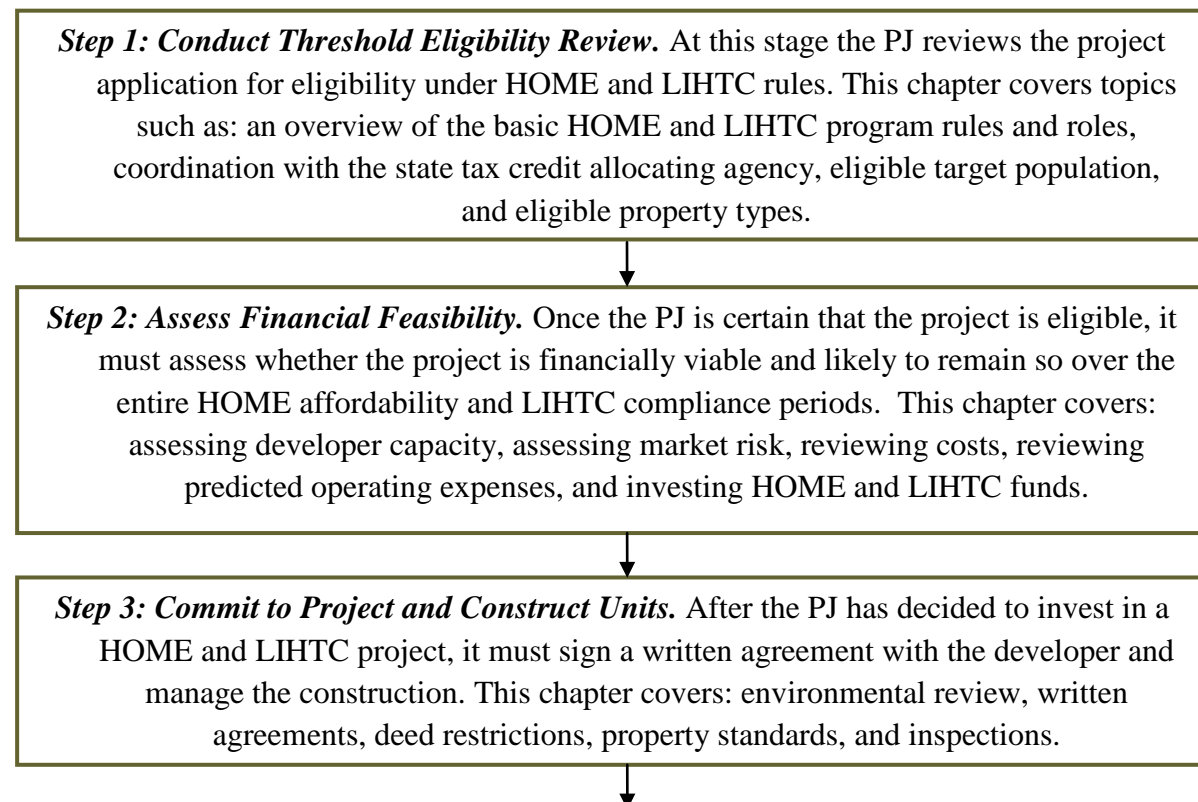
Generally, HOME PJs and LIHTC investors are not motivated by the same goals. The typical LIHTC investor is motivated by its financial interests. Project and investment decisions are made in the context of the tax implications and the financial impact on the investor. The investor purchases a 99.9 percent interest in the ownership entity awarded LIHTCs for which it receives a tax credit. This is a dollar-for-dollar credit against the investor's tax liability for ten years, along with other financial benefits generated by the project such as:

- 
- Operating losses resulting from the depreciation of the property
  - Sharing of any net cash flow generated from the Net Operating Income of the project
  - Benefits that may result when the investor exits the project.

PJs, on the other hand, are generally motivated by public policy objectives to provide affordable housing to meet the needs of low-income families in their communities who are rent burdened or living in substandard housing. PJs must be involved with the LIHTC project sponsors from the beginning of the development process to ensure that their policy objectives are met, to ensure long-term compliance with HOME affordability restrictions, and to negotiate the best return on the HOME investment.

## Organization of this Guidebook

The organization of this guidebook mirrors the development process for an affordable rental project that uses HOME and LIHTC, from application and underwriting to project commitment and construction to lease-up and ongoing compliance during rental property management. The following chart describes these key HOME and LIHTC development steps and the associated guidebook chapters.





**Step 4: Lease Up and Complete Project.** Once the construction is complete the PJ can close-out the project and the owner can lease-up the units. This chapter covers: income targeting and determinations, rents, leases, tenant selection, and project completion procedures.



**Step 5: Ensure Long-term Compliance.** All HOME and LIHTC rental projects have an affordability or compliance period during which the PJ must monitor for ongoing regulatory compliance. This chapter covers: affordability period; ongoing property quality; rent, income, and unit mix during the affordability period; and consequences of noncompliance.



**Step 6: Address Long-Term Affordability.** At the end of the HOME affordability period or the LIHTC compliance period, owners are free to convert units to non-affordable uses. This chapter discusses steps that PJs may take to preserve affordable units.

As noted above, this guidebook discusses the HOME and LIHTC rules in the context of the development process.

A glossary of key terms and concepts is provided as an attachment to this chapter. These terms are identified throughout the guidebook in ***bold italics***.

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## GLOSSARY OF KEY TERMS

**4 percent tax credits:** 4 percent of the eligible basis is allowed as a tax credit per year for 10 years. 4 percent tax credits are available for existing housing or federally subsidized housing and are generally used in conjunction with tax-exempt bond financing. 4 percent tax credits are also referred to as 30 percent present value LIHTCs.

**9 percent tax credits:** 9 percent of the eligible basis is allowed as a tax credit per year for 10 years. 9 percent tax credits are also referred to as 70 percent present value LIHTCs. 9 percent tax credits are available for new construction and rehabilitation.

**Absorption rate:** The number of units per week or month that is projected to be leased once the property begins accepting residents. This number is expressed as a percentage of the total number of units in the property.

**Accessibility for persons with disabilities:** The Fair Housing Act requires accessibility for newly constructed housing. In properties with more than four units, the public and common areas, as well as all the ground floor units, and units served by an elevator must meet the Fair Housing Act accessibility guidelines. For people with sensory impairments, accessible also means that a property makes reasonable accommodations to ensure their equal access and use. HOME-assisted units are also required to meet the accessibility requirements of Section 504 of the Rehabilitation Act of 1973, which for some projects, requires that a certain number of units be made to be accessible in accordance with the Uniform Federal Accessibility Standards, for persons with mobility and sensory impairments. Generally, UFAS is a higher level of accessibility than the Fair Housing Act.

**Affirmative marketing procedures:** For properties of five or more HOME-assisted units, PJs must develop marketing procedures to ensure that special outreach and advertising efforts are made to communicate the availability of HOME-assisted units to those groups and individuals least likely to apply for them.

**Affordability period:** The period of time during which a property must comply with the HOME rules and regulations, including income and rent restrictions.

**Applicable fraction:** The share of the property that is LIHTC-assisted. It is based on the lesser of either: (1) the number of tax credit units to the total number of units, or (2) the square footage of the tax credit units to the total square footage of the property.

**Basis boost percentage:** Projects located in HUD-designated qualified census tracts or state housing finance agency-designated difficult development areas can be allocated up to 30 percent additional LIHTCs, at the discretion of the state LIHTC allocating agency. If the full 30 percent addition is allocated, the basis boost percentage is 130 percent.

**Capital needs assessment:** A projection of the likely timing and cost of replacement of building systems (roofing, siding, mechanical systems, appliances, etc.) Often referred to as a CNA, the analysis is expressed annually, over a 5-, 10- or 20-year period; it estimates the cost of replacements in each year.

**Capture rate:** The share of renter households seeking housing of that type, in that location, and at that price range, that need to be “captured” (i.e., leased) by the proposed property in order for it to succeed. For example, a capture rate of 5 percent would indicate that 5 percent of the potential, eligible renters in that market would need to become tenants.

**Carryover Requirement:** LIHTC projects must spend at least 10 percent of their projected total basis as of the end of the second calendar year following the year of allocation. This is sometimes referred to as the 10 percent test.

**Cash flow waterfall:** The priority ranking of the distribution of any surplus cash flow generated by a multifamily rental property.

**Community Housing Development Organization (CHDO):** A private, nonprofit organization that meets a series of qualifications prescribed in the HOME regulations at 24 CFR Part 92.2.

**Comparable units:** Under the HOME Program, units that are equivalent in terms of size, amenities, and number of bedrooms. Units must be comparable in order to use them as replacement units when maintaining unit mix. The LIHTC Program uses the concept of “next available unit” for replacement units. LIHTC replacement units may be any unit in the same building, as long as the LIHTC-eligible basis square footage is maintained.

**Compliance period:** See LIHTC compliance period.

**Cost allocation:** The process used to establish the allocation of costs and the minimum number of HOME-assisted units in a HOME-assisted project, based on the amount of HOME investment.

**Cost certification audit:** Financial audits required by funders (including the state’s LIHTC allocating agency) to certify actual project development costs. An initial audit may be used to ensure that 10 percent of the project’s then-projected costs have been expended to meet the carryover requirement. At the completion of the project a cost certification is required to confirm the total development costs and the amount of LIHTC eligible basis in the project.

**Debt service coverage ratio (DSCR):** A calculation to determine the relationship between the Net Operating Income (NOI) of a project to the amount of debt service the NOI must be used to pay. To calculate DSCR divide Debt service (principal, interest, and credit enhancement payments) by NOI. The DSCR is also referred to as “DSC,” or “cover.”

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***Deed restriction or covenant:*** A legal document that restricts the use of a HOME-assisted property during the affordability period for use as affordable housing for low- or very low-income households as required at 24 CFR 92.252(e).

***Deferred developer fee:*** The portion of the agreed-upon developer's fee that the developer is not paid as a development expense, and instead remains in the rental project to cover development costs. The deferred developer fee may be recovered from the developer's share of operating cash flow.

***Developer:*** A for-profit or nonprofit entity responsible for initiating and managing the development of real estate, including the arrangement of financing, construction, and the ownership structure.

***Development budget:*** The cost estimate for all of the costs (or "uses") that the developer will incur to complete and lease-up or sell a project.

***Direct investment:*** The simplest form of LIHTC investment in which a large corporation purchases the entire investor interest in the project.

***Eligible basis:*** In LIHTC developments, certain costs may be included in the calculation on which the tax credits are based. These costs are referred to as "basis eligible" costs, and the total of these costs is "eligible basis." Eligible basis does not include land, financing fees, syndication costs, or reserves, but does include the acquisition cost of existing buildings, construction and/or rehabilitation, and most soft costs.

***Environmental Assessment (EA):*** A concise public document required under the National Environmental Policy Act (NEPA) regulations, for which a Federal agency (or an entity authorized to assume HUD's environmental review responsibilities) is responsible that provides sufficient evidence and analysis to determine whether to prepare an environmental impact statement or issue a finding of no significant impact (FONSI). See 24 CFR 58.36 and HUD CPD Notice 01-11.

***Environmental Impact Statement (EIS):*** The environmental impact statement serves as an action-forcing device to ensure that the policies and goals defined in NEPA are infused into the ongoing programs and actions of the Federal Government. It provides full and fair discussion of significant environmental impacts and informs decision makers and the public of the reasonable alternatives which would avoid or minimize adverse impacts or enhance the quality of the human environment. An EIS may be triggered as a result of an EA, but this is not common among tax credit projects. See 24 CFR 58.37.

***Environmental review:*** The appropriate level of environmental analysis for a project or activity. This may include a Compliance Determination, Environmental Assessment, or Environmental

Impact Statement. It is completed in accordance with 24 CFR Part 58 (known as a “Part 58 review”) to ensure that the proposed project does not negatively impact the surrounding environment and that the property site itself is safe for development.

***Exit strategy:*** An LIHTC investor’s plan for exiting their ownership position at the end of the 15-year tax credit compliance period.

***Extended use period:*** In LIHTC projects, the period of affordability following the initial 15-year period. (This is also referred to as the “LIHTC use period.”) All LIHTC projects must comply with an initial use period of 15 years, during which time the investor limited partner must maintain its ownership position. At the end of the initial 15-year period, there must be an extended use period of an additional 15 years or longer (as required by the state allocating agency) during which time the property continues to be restricted to affordable low-income housing.

***Fair Housing Act:*** See Federal Fair Housing Act.

***Federal requirements:*** Broad Federal requirements that PJs must adhere to when administering the HOME Program. These requirements include but are not limited to fair housing, lead-based paint, Davis Bacon, accessibility standards, and the Uniform Relocation Act (URA).

***Federal Fair Housing Act:*** Title VIII of the Civil Rights Act of 1968 (Fair Housing Act), as amended, prohibits discrimination in the sale, rental, and financing of dwellings, and in other housing-related transactions, based on race, color, national origin, religion, sex, familial status (including children under the age of 18 living with parents or legal custodians, pregnant women, and people securing custody of children under the age of 18), and disability.

***Financing gap:*** The shortfall in permanent financing sources that occurs when the total projected development costs exceeds the total of all committed sources.

***Fixed HOME units:*** Specific rental units that are designated as HOME-assisted initially, and that retain the HOME-assisted designation throughout the HOME affordability period.

***Floating HOME units:*** Rental units that are designated HOME-assisted initially but throughout the period of affordability the designation is allowed to change or “float” among all comparable units in the project in order to maintain the original unit mix of assisted and non-assisted units.

***High HOME rent limits:*** The HUD-published High HOME rent limit. Current HOME rent limits are available at <http://www.hud.gov/homeprogram/>.

***HOME written agreement:*** A legally binding document executed between the PJ and the owner of a project that clearly states the HOME requirements, common expectations, roles and responsibilities of the parties, and the PJ’s enforcement provisions.

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***Housing and Economic Recovery Act (HERA):*** Effective July 30, 2008, HERA primarily provides emergency assistance for the redevelopment of abandoned and foreclosed homes. HERA also amends certain key LIHTC requirements and provisions.

***HUD's Office of Affordable Housing Programs (OAHP):*** The HUD Department that administers three separate programs: the HOME Investment Partnerships, Self-Help Homeownership (SHOP), and Homeownership Zone. These programs are designed to address the nationwide shortage in affordable housing through the development of affordable housing units and the provision of assistance to income-eligible households in the purchase, rehabilitation, or rental of safe and decent housing.

***Income recertification:*** The requirement that the owner/developer determine tenant incomes for income-restricted units to ensure that such households' incomes do not exceed the current income limits. The income recertification requirements for HOME and LIHTC are slightly different.

***Income targeting:*** The process of designating units by the income of their occupants. These requirements apply to the HOME- assisted and LIHTC-assisted units of a property.

***Labor standards:*** The federally-regulated labor standards that apply to HOME-funded projects. Davis-Bacon requirements apply to projects with 12 or more HOME-assisted units. Projects funded solely by LIHTC are not subject to the labor standards.

***Lead-based paint:*** Prior to 1978, lead-based paint was used in residential construction. Pre-1978 properties that are being rehabilitated using HOME and LIHTC must comply with the lead-based paint regulations at 24 CFR Part 35 and meet the HUD Uniform Property Conditions Standards (UPCS)

***Lien position:*** The order of priority in which lenders' claims and rights are recognized on a property.

***Limited liability corporations (LLCs):*** A legal ownership structure of two or more owners. Typically one owner (known as a "member") is designated as the "managing member" who makes most day-to-day decisions. In an LIHTC project, the tax credit investor member(s) typically is not involved in day-to-day decision-making, but is involved in major decisions such as sales or refinancing.

***Limited partnerships:*** A legal ownership structure similar to LLCs, except that the managing owner is called the "general partner" and the investor(s) owner is called a "limited partner." Some limited partnerships have more than one general partner, in which case one of the general partners is usually the managing general partner who makes most of the day-to-day decisions.

***Low HOME rent limits:*** The HUD-published Low HOME rent limit. Current HOME rent limits are available at <http://www.hud.gov/homeprogram/>.

***Low-income household:*** A household with a gross annual income that does not exceed 80 percent of area median income (AMI), as adjusted by household size. Current HOME income limits are available at <http://www.hud.gov/homeprogram/>.

***LIHTC basis:*** See Eligible basis.

***LIHTC compliance period:*** The initial use period of 15 years, during which time the investor limited partner must maintain its ownership position, and during which time the failure to comply with certain LIHTC requirements may result in the cancellation or retroactive recapture of allocated low-income housing tax credits.

***LIHTC period:*** The 10-year period over which the investor may claim the LIHTCs. This is also sometimes referred to as the “credit period.” This is *not* the same as the 15-year compliance period.

***LIHTC rent limits:*** The maximum rent that can be charged to tenants in an LIHTC-assisted unit. It is limited to 30 percent of the applicable income limitation less utilities.

***Market study:*** An analysis of a specific housing market to determine the demand for housing units of a particular type and at a particular rent.

***Maximum per unit subsidy limit:*** The upper limit restriction on the amount of HOME funds that may be invested in a project; it is usually capped at the 221(d)(3) limit. These limits are available at <http://www.hud.gov/homeprogram/>.

***Mortgage (or a deed of trust in some states):*** The legal document executed between a lender and an owner to subject a property to a claim or obligation.

***National Affordable Housing Act of 1990:*** Title II of the Cranston-Gonzalez National Affordable Housing Act (the HOME Investment Partnerships Act) which helps to expand the supply of decent, affordable housing for low- and very low-income families by providing grants to states and local governments called participating jurisdictions or “PJs.”

***Net Operating Income (NOI):*** The amount of income remaining on a property after payment of all operating expenses.

***Net Syndication Price:*** The amount the investor pays for the low-income housing tax credits that will be generated by the operation of the property. Price is expressed as an amount of one dollar in credit allocation, so that an investor willing to buy \$1 million of credits over ten years for \$750,000 is said to be paying \$0.75 (seventy-five cents), or 75/100, or 75 percent.



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**Net Syndication Proceeds:** The total dollar amount that the LIHTC investor pays the LIHTC project sponsor. It is based on the total project allocated credit amount multiplied by the net syndication price.

**Note:** A written promise to pay a legal debt.

**Onsite inspection:** A physical inspection of a unit and/or property in order to determine that the property complies with HOME and/or LIHTC property standard requirements.

**Operating pro forma:** A year-by-year projection of a project's income and expenses.

**Over-income tenant:** A designation for a tenant when their household income exceeds the income limits of the HOME and/or LIHTC programs. The definition of "over-income" differs between the programs.

**Owner:** A for-profit or nonprofit entity that holds title to the property after rehabilitation, construction, or acquisition.

**Pari passu:** Contribution of funds during development at an equal rate or pace, among all funders. Pari passu is often relied upon in complex financial structures with more than one major lender, to ensure that all funders have proportionately equal risk during construction.

**Participating Jurisdiction (PJ):** Any state, local government, or consortium that HUD has designated to receive HOME funds and administer a HOME program. HUD designation as a PJ occurs if a state or local government meets the funding thresholds, notifies HUD that it intends to participate in the program, and has a HUD-approved Consolidated Plan.

**Payment priority:** The sequence in which payments of net cash flow from the operations of a property are made to lenders, investors, and owners. See also "cash flow waterfall."

**Placed in service:** Also referred to as the "placed in service date" or "PISD." Placement in service occurs when the first unit in an LIHTC building is certified as suitable for occupancy under state or local law. Placement in service requirements differ for newly constructed and rehabilitated buildings, and dictate the beginning of the compliance period in an LIHTC project. Projects must be placed in service by the end of the second calendar year following the year of allocation.

**Program income:** Gross income received by the PJ, state recipient, or a subrecipient directly generated from the use of HOME funds or matching contributions.

**Program Rule:** At initial occupancy, 90 percent of the households served across all of the PJ's HOME-assisted rental programs must have annual gross incomes that are at or below 60 percent of area median income. For each project, the PJ needs to determine how this rule applies. Many



PJs restrict initial occupancy of High HOME Rent units to tenants that have annual gross incomes that do not exceed 60 percent of area median income.

***Project control:*** The entity with decision-making authority for the project.

***Project Rule:*** At initial occupancy and throughout the period of affordability, in projects with five or more HOME-assisted units, 20 percent of the households that occupy HOME-assisted units must be very low-income (that is, have annual gross incomes that are at or below 50 percent of area median income) and be charged rents that do not exceed the applicable low-HOME rent.

***Property standards:*** Both the HOME and LIHTC programs require that units be constructed, rehabilitated, and maintained to meet specified physical standards. The standard requirements differ slightly for the two programs.

***Qualified Allocation Plan (QAP):*** The annual plan developed by each state allocating agency to document how it plans to make tax credits and tax-exempt bond financing available to developers.

***Qualified basis:*** The result of multiplying the amount of Eligible Basis (total tax credit eligible costs) by the Applicable Fraction (the percentage of the property actually restricted to income-qualified households). In LIHTC properties, the qualified basis is the amount used for determining the credits that will be generated by the property.

***Reservation (of credits):*** The notification from the state's LIHTC allocating agency that a rental project has been approved for an allocation of credits, and that those credits will be held for the project pending construction and other requirements.

***Reserves for Replacement:*** Funds held in a property's restricted account to pay for its future capital replacement needs. The term may apply to the amount held in the restricted account, or the amount required to be periodically deposited to that account from the operations of the property.

***Right of First Refusal:*** The right to purchase a limited partners' interest in a property, which supersedes the rights of other potential purchasers.

***Section 42 of the Internal Revenue Code (IRC or "the Code"):*** The section of the Internal Revenue Code that regulates the LIHTC.

***Sources and uses statement:*** A financial statement that projects and itemizes all of the uses of funds needed to complete a project (development costs) and all of the sources of funds available to cover those costs.

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**Source documentation:** Third party verification of income provided by independent sources that is used to verify/determine tenant income-eligibility.

**Sponsors:** Under HOME, a for-profit or nonprofit entity that works with other organizations—such as other nonprofits—to assist them to develop and own housing. At project completion, the sponsor turns over title to the property to the sponsored organization. Under LIHTC, developers are referred to as “project sponsors.”

**Subordinate:** To place below the rights of another set of requirements.

**Subrecipient:** A public agency or nonprofit organization selected by a PJ to administer all or a portion of its HOME program.

**Subsidy layering analysis:** A financial review conducted by PJs when HOME funds are used with other public funds in a project. It is done to verify that the project meets the underwriting and cost guidelines established by the PJ and to ensure that no more HOME funds are invested than are necessary to develop the housing.

**Surplus cash:** Cash that is not needed to meet operational requirements.

**Syndicated transaction:** The investor interest purchased by a fund or investor pool composed of many corporations.

**Syndication Fees:** A fee the owner of an LIHTC project pays a syndicator to serve as a broker between the equity investor and the developer.

**Syndicator:** An entity who arranges the housing credit investment, and represents the investors’ interests in the terms of the financial and legal structure of the investment.

**Technical Guide for Determining Income and Allowances for the HOME Program:** A HUD guidebook in its Third Edition (HUD 1780-CPD, issued January 2005) that provides instructions and forms to determine tenant income for the HOME Program. This guide is available at no cost from the HOME Program website at <http://www.hud.gov/homeprogram/>.

**Temporarily out of compliance:** A situation in which an assisted unit is otherwise in compliance with the provisions of the HOME regulations and written agreement except that increases in the household’s income have exceeded the allowable limit, and a replacement income-restricted unit has not become available. In the HOME and LIHTC programs, the definition of “over-income” differs.

**Threshold review:** Preliminary screening of a project to ensure it meets all of the HOME and/or LIHTC eligibility requirements.

***Total development cost:*** The total development cost (projected or actual), representing all costs necessary to produce a completed, occupied project.

***Total LIHTCs:*** This is the total dollar value of LIHTCs that the owner is expected to receive over the ten-year credit period. It is based on the project's qualified basis multiplied by the applicable LIHTC percentage multiplied by ten years.

***UFAS standard:*** The Uniform Federal Accessibility Standards are Federal accessibility design requirements that apply to facilities that are designed, built, or altered with Federal funds. Section 504 of the Rehabilitation Act of 1973 imposes the UFAS standard on certain HOME-assisted units.

***Unit mix:*** The range of unit types, sizes, rent, and occupancy restrictions of all rental units at a property.

***Utility allowances:*** In both the HOME and LIHTC programs, the maximum rent amount allowed in both programs includes utilities. In projects where the tenants pay for some or all of the utilities, a utility allowance is deducted from the rent limits to determine the maximum lease rent that can be charged for the unit. LIHTC and HOME may use different utility allowances. The PJ can choose to adopt the LIHTC utility allowance for its tax credit projects, to simplify this process.

***Very low-income household:*** A household with an annual gross income that does not exceed 50 percent of the area median income, as adjusted by household size.

# CHAPTER 1: CONDUCT THRESHOLD ELIGIBILITY REVIEW

This chapter describes the initial steps the HOME *Participating Jurisdiction (PJ)* should take when it receives a request for HOME funding for a project that has (or expects to have) an allocation of Federal Low-Income Housing Tax Credits (LIHTCs). It highlights the key areas that a PJ should assess when undertaking a basic eligibility threshold review before proceeding to underwrite the project. Specifically, this chapter:

- Explains the general HOME Program rules
- Explains, in general terms, how the LIHTC program works
- Identifies the key eligibility criteria for a HOME-LIHTC project.

## 1.1 Overview of the HOME Program

Created by the *National Affordable Housing Act of 1990 (NAHA)*, HOME is the largest Federal block grant available to communities to create affordable housing. The intent of the HOME Program is to:

- Increase the supply of decent, affordable housing to *low- and very low-income households*
- Expand the capacity of nonprofit housing providers
- Strengthen the ability of state and local governments to provide housing
- Leverage private sector participation.

### CHAPTER 1: CONDUCT THRESHOLD AND ELIGIBILITY REVIEW

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### CHAPTER 2: REVIEW FINANCIAL FEASIBILITY

### CHAPTER 3: COMMIT TO PROJECT AND CONSTRUCT UNITS

### CHAPTER 4: LEASE UP AND COMPLETE PROJECT

### CHAPTER 5: ENSURE LONG-TERM COMPLIANCE

### CHAPTER 6: ADDRESS LONG-TERM AFFORDABILITY

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Every year, the U.S. Department of Housing and Urban Development (HUD) determines the amount of HOME funds that states and local governments — the PJs — are eligible to receive using a formula designed to reflect relative housing need. The HOME regulations may be found on *HUD's Office of Affordable Housing Programs* website at <http://www.hud.gov/homeprogram/>, and in the Code of Federal Regulations at 24 CFR Part 92.

### HOME Program Partners

To ensure success in providing affordable housing opportunities, the HOME Program requires PJs to establish new partnerships and maintain existing partnerships. Partners play different roles at different times, depending upon the project or activity being undertaken with HOME funds. Key program partners include:

- **Participating Jurisdiction.** A *Participating Jurisdiction (PJ)* is any state, local government, or consortium that has been designated by HUD to administer a HOME program.
- **Community Housing Development Organization.** A *community housing development organization (CHDO)* is a private, nonprofit organization that meets a series of qualifications prescribed in the HOME regulations at 24 CFR 92.2. Each PJ must use a minimum of 15 percent of its annual allocation for housing that is owned, developed, or sponsored by CHDOs. PJs evaluate organizations' qualifications and designate them as CHDOs.
- **Subrecipient.** A *subrecipient* is a public agency or nonprofit organization selected by a PJ to administer all or a portion of its HOME program.
- **Developers, owners, and sponsors.** *Developers*, *owners*, and *sponsors* of housing developed with HOME funds may be for-profit or nonprofit entities. Developers are the entities responsible for putting the housing deal together. Owners are the entities that hold title to the property after rehabilitation, construction, or acquisition. Sponsors work with other organizations—such as other nonprofits—to assist them to develop and own housing. At project completion, sponsors turn over title to the property to the other organization.
- **Private lenders.** Most HOME projects leverage or involve other financing, from for-profit lenders or other entities such as foundations or community groups.
- **Third-party contractors.** Third-party contractors include a range of other entities that might work on the HOME program, such as architects, planners, construction managers, real estate agents, or consultants.

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## HOME-Eligible Program Activities

HOME funds can be used to support four general affordable, non-luxury housing activities:

- **Homeowner Rehabilitation.** HOME funds may be used to assist existing owner-occupants with the repair, rehabilitation, or reconstruction of their homes.
- **Homebuyer activities.** PJs may finance the acquisition and/or rehabilitation, or new construction of homes for homebuyers.
- **Rental housing.** Affordable rental housing may be acquired and/or rehabilitated, or constructed.
- **Tenant-based rental assistance (TBRA).** Financial assistance for rent, security deposits, and, under certain conditions, utility deposits may be provided to tenants. Assistance for utility deposits may only be provided in conjunction with a TBRA security deposit or monthly rental assistance program.

## Prohibited Activities and Costs

HOME funds may not be used to support the following activities and costs:

- **Project reserve accounts.** HOME funds may not be used to provide project reserve accounts (except for initial operating deficit reserves) or to pay for operating subsidies.
- **Tenant-based rental assistance for certain purposes.** HOME funds may not be used for certain mandated existing Housing Choice Voucher Program (formerly known as Section 8) uses, such as Housing Choice Voucher rent subsidies for troubled HUD-insured projects.
- **Match for other Federal programs.** HOME funds may not be used as the “nonfederal” match for other Federal programs except to match McKinney Act funds.
- **Development, operations, or modernization of public housing.** HOME funds cannot be used alone or in conjunction with HUD-funded public housing program funds (e.g., Public Housing capital programs such as Development, Comprehensive Improvements Assistance Program (CIAP), or Comprehensive Grant Program (CGP)) to acquire, rehabilitate, or construct public housing units.
- **Double-dipping.** During the first year after project completion, the PJ may commit additional funds to a project. After the first year, no additional HOME funds may be provided to a HOME-assisted project during the relevant period of affordability, with the following exceptions:
  - PJs can renew tenant-based rental assistance to families.
  - PJs may provide tenant-based rental assistance to families that will occupy housing previously assisted with HOME funds.

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- PJs may assist a homebuyer with HOME funds to acquire a unit that was previously assisted with HOME funds.
  - **Acquisition of PJ-owned property.** A PJ may not use HOME Program funds to reimburse itself for property in its inventory or property purchased for another purpose. However, in anticipation of a HOME project, a PJ may use HOME funds to:
    - Acquire property
    - Reimburse itself for property acquired with other funds, specifically for a HOME project.
  - **Project-based rental assistance.** HOME funds may not be used for rental assistance if receipt of funds is tied to occupancy in a particular project. Funds from another source, such as a Housing Choice Voucher, may be used for this type of project-based assistance in a HOME-assisted unit. Further, HOME funds may be used for other eligible costs, such as rehabilitation, in units receiving project-based assistance from another source—for example, Housing Choice Voucher or state-funded project-based assistance.
  - **Pay for delinquent taxes, fees, or charges.** HOME funds may not be used to pay delinquent taxes, fees, or charges on properties to be assisted with HOME funds.

### HOME Project Requirements

The HOME Program is designed to provide affordable housing to low-income and very low-income families and individuals. Therefore, the program has some key restrictions that are designed to foster HUD’s commitment to long-term affordable housing, quality units, and reasonable costs. These key restrictions include:

- Income eligibility and verification
- Occupancy and rent requirements
- Subsidy limits
- Affordability periods
- Property standards.

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## *Income Eligibility and Verification*

Beneficiaries of HOME funds—homebuyers, homeowners, or tenants—must be *low-income* or *very low-income*. A “low-income household” has an annual gross income that does not exceed 80 percent of area median income (AMI), as adjusted by household size. A “very low-income household” has an annual gross income that does not exceed 50 percent of AMI, as adjusted by household size.

## *Occupancy and Rent Requirements*

In projects assisted with HOME funds, the HOME-assisted units must meet the occupancy and rent requirements of the HOME Program. These requirements are explained in detail in [Chapter 2](#).

## *Subsidy Limits*

HOME establishes minimum and maximum amounts of HOME funds that may be invested in any project. The minimum amount of HOME funds is \$1,000 multiplied by the number of HOME-assisted units in the project. The minimum relates *only* to the HOME funds, and *not* to any other funds that might be used for project costs.

The maximum per unit HOME subsidy limit varies by PJ. Annually, HUD determines the maximum amounts, which are based on HUD’s Section 221(d)(3) program limits for the metropolitan area. These limits are available at the HOME Program website at <http://www.hud.gov/homeprogram/>.

## *Affordability Periods*

To ensure that HOME investments yield affordable housing over the long term, HOME imposes rent and occupancy requirements for the duration of an *affordability period*. For homebuyer and rental projects, the length of the affordability period depends on the amount of HOME assistance to the project or buyer, and the nature of the activity funded. Throughout the affordability period, income-eligible households must occupy the HOME-assisted housing.

## *Property Standards*

HOME-funded properties must meet certain minimum property standards:

- **State and local standards.** State and local codes and ordinances apply to any HOME-funded project regardless of whether the project involves acquisition, rehabilitation, or new construction.



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- **Model codes.**<sup>1</sup> For rehabilitation or new construction projects where there are not state or local building codes, the PJ must use one of the following three national model codes:
    - Uniform Building Code (ICBO), National Building Code (BOCA), Standard Southern Building Code (SBCCI)
      - Council of American Building Councils (CABO) one or two family code
      - Minimum Property Standards (MPS) in 24 CFR 200.925 or 200.926.
  - **Housing quality standards.** For acquisition-only projects, if there are no state or local codes or standards, the PJ must enforce Housing Choice Voucher Housing Quality Standards (previously Section 8 HQS).
  - **Rehabilitation standards.** Each PJ must develop written rehabilitation standards to apply to all HOME-funded rehabilitation work. These standards are similar to work specifications, and generally describe the methods and materials to be used when performing rehabilitation activities.
  - **Uniform Federal Accessibility Standards.** The UFAS standards apply to new construction and substantially altered rehabilitation, in accordance with Section 504 of the Rehabilitation Act of 1973.
  - **International Energy Conservation Code and Site and Neighborhood Standards,** for new construction projects.

### HOME Administrative Requirements

HOME imposes certain administrative requirements related to the eligibility of administrative and planning costs, match, and commitment and expenditure deadlines.

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<sup>1</sup> Since the promulgation of the HOME Program regulations, these code issuing agencies have merged to form the International Code Council (ICC). The model codes used for the HOME Program are no longer being updated. In their stead, the ICC has issued the International Building Code. HUD will consider whether changes to the HOME regulations incorporating the International Building Code are appropriate. The HOME Program website provides updated information on all HOME requirements. (See <http://www.hud.gov/homeprogram/>.) For more information about the International Building Code, see [www.iccsafe.org](http://www.iccsafe.org).

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## ***Administrative and Planning Costs***

Each PJ may use up to 10 percent of each year's HOME allocation for reasonable administrative and planning costs. In addition, up to 10 percent of **program income** deposited in a PJ's local HOME account during a program year may be used for administrative and planning costs. PJs, state recipients, and subrecipients may incur administrative and planning costs.

## ***Match***

The HOME Program requires that PJs contribute an amount equal to no less than 25 percent of the total HOME funds drawn down in a year for project costs as a permanent contribution to affordable housing. PJs incur a match obligation only for project funds, not for administrative, operating, or capacity-building expenditures. Although the obligation is incurred per dollar expended in the project, match credit can be invested in any HOME-eligible project, whether the project receives HOME funds or not. Match funds can be contributed in many different forms, including cash; value of waived taxes or fees; value of donated land or property; or donated goods, services, materials, or equipment.

## ***Commitment and Expenditure Deadlines***

The HOME Program encourages PJs to expend their affordable housing funds expeditiously by imposing two deadlines. HOME funds for a given program year must be committed to HOME projects within two years of signing the HOME Investment Partnerships Agreement. For CHDO set-aside funds, PJs must reserve funds for use by CHDOs within that 24-month period. In addition, generally HOME funds must be expended within five years of receipt of funds. FY 2012 HOME funds must be spent within four years, in accordance with the *Consolidated and Further Continuing Appropriations Act of 2012* (P.L 112-55).

*This section contains only a brief overview of the HOME requirements. For additional information, PJs are encouraged to consult the HOME regulations and the HOME Program website at <http://www.hud.gov/homeprogram/>.*

## **1.2 Overview of the LIHTC Program**

Before considering a HOME funding request for a project that has, or is expected to have, LIHTCs, PJ staff should become familiar with what LIHTCs are and how the LIHTC program works.

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## What is a Low-Income Housing Tax Credit?

The U.S. Congress authorizes each state to allocate a certain number of Federal low-income housing tax credits (LIHTCs) and issue up to a specified amount of tax-exempt bond financing annually. The state's allocation threshold is based on its population. Internal Revenue Service rules found at Section 42 of the Internal Revenue Code (IRC, or "the Code") govern the LIHTC program. Each state establishes additional requirements and program priorities for the credits it administers.

The state reserves LIHTCs for approved affordable housing projects that meet certain affordability criteria for up to 30 years. These Federal tax credits are sold to investors as a way to raise cash equity for eligible affordable housing projects. In exchange for cash up-front, the investor receives a tax credit (dollar for dollar reduction in its Federal tax liability) each year for a period of ten years. The IRS enforces compliance with the LIHTC affordability restrictions for 15 years. The *LIHTC compliance period* is the 15-year period during which a project must continue to comply with the various LIHTC requirements to avoid any tax credit recapture. The compliance period begins with the first taxable year in the credit period. The *extended use period* is a date specified by either the LIHTC allocating agency or 15 years after the close of the compliance period. During this extended period, the use of the property is restricted to affordable low-income housing.

There are two forms of Federal LIHTCs, known as *9 percent* and *4 percent tax credits*. 9 percent tax credits, also referred to as "70 percent present value LIHTCs," are available for new construction and rehabilitation. 4 percent tax credits, also referred to as "30 percent present value LIHTCs," are available for existing housing or federally subsidized housing and are generally used in conjunction with tax-exempt bond financing. In an acquisition and substantial rehabilitation project; the 4 percent credit is applied to the acquisition of the existing buildings and the substantial rehabilitation qualifies for the 9 percent credits.

The LIHTC program has rent and occupancy standards that vary from those of the HOME Program. The requirements for rents and occupancy under both the HOME and LIHTC programs are detailed in [Chapter 2](#).

## State's Role in the LIHTC Program

Each state allocating agency is required to issue a *Qualified Allocation Plan (QAP)* to document how it plans to make the tax credits and tax-exempt bond financing available to developers. The QAP is published annually. It contains vital information on the LIHTC program requirements and the state's funding preferences, in terms of the types of projects and locations in which it

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wishes to invest. Further, it explains the funding process, and identifies application deadlines and when funding decisions (called *reservations of credits*) are made. Each state's QAP typically contains separate sections discussing the allocation procedures and requirements for 9 percent LIHTCs and 4 percent LIHTCs.

Each state is required to conduct public hearings in the process of developing the QAP.

*One key source of information for the PJ about the state allocating agency's funding priorities is the state LIHTC Qualified Allocation Plan (QAP). When PJs know and understand the state's LIHTC priorities, they can better target HOME funds to projects that are the most fundable. Local PJs may also wish to discuss rental housing priorities with state staff, through the formal public hearing process on the QAP, and through other informal opportunities that arise.*

### Typical LIHTC Ownership Structures

Virtually all LIHTC projects are developed as single-asset entities, meaning that the ownership entity has a single property in which all revenues, expenses, assets, and liabilities are accounted for together.

LIHTC projects are typically owned by one of the following two types of legal entities:

- **Limited liability corporations (LLCs).** *Limited liability corporations* are similar to partnerships. Typically one partner (or "member") is designated as the "managing member" who makes most day-to-day decisions. The tax credit investor member(s) typically is not involved in day-to-day decision-making, but is involved in major decisions such as sales or refinancing.
- **Limited partnerships.** *Limited partnerships* are similar to LLCs, except that the manager is called the "general partner" and the investor(s) is called a "limited partner." Some limited partnerships have more than one general partner, in which case one of the general partners is usually the managing general partner who makes most of the day-to-day decisions.

PJs should be aware of certain special conditions of ownership that apply if HOME CHDO set-aside funds are being used in an LIHTC project. If the CHDO is applying and the ownership structure is a limited partnership, the CHDO must be the managing general partner. If the ownership is an LLC, a HUD waiver is required to allow for this ownership structure and the CHDO must be the managing member of the LLC. Other ownership structures are possible in theory, but are rarely seen in practice.

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## Role of the LIHTC Investor

The state's reservation of credits is not money from the state LIHTC allocating agency to the developer. Instead, the allocation gives the owner the right to sell the reservation of LIHTCs to an investor. The investor purchases the LIHTC allocation at a price determined by the market for the credits for which the investor receives a 99 percent plus interest in the LLC or limited partnership that will own the project. In exchange for the infusion of cash equity, the investor receives its 99 percent ownership share plus the annual tax credits (a dollar for dollar reduction against its Federal income tax liability) over the first ten years, followed by an additional five-year affordability requirement, even though no additional tax credits may be claimed in those years.

### ***LIHTC Equity: “Syndicated” versus “Direct Investment”***

**Direct investment** is the simplest form of LIHTC investment: a large corporation purchases the entire investor interest in the project. By contrast, in a **syndicated transaction**, the investor interest is purchased by a fund or investor pool composed of many investors. Syndicated transactions are organized by LIHTC **syndicators**, who recruit corporate investors, create investor funds / pools that appeal to a wide array of investors, and represent the investors for purposes of getting the project funded, completed, leased-up, and operated in accordance with all applicable compliance requirements.

*The entity that applies for HOME funding is typically the owner, developer, or sponsor of a project. Applicants for LIHTCs are generally referred to as “LIHTC project sponsors.” Under LIHTC, this would typically be either the owner or developer of the project. An LIHTC project sponsor is not the same as a sponsor under the HOME Program. Under HOME, a sponsor is a community housing development organization (CHDO) that works in partnership with another nonprofit to develop and manage a property in certain circumstances. Unless otherwise specified, this publication uses the term “owner” to refer to LIHTC project sponsors as well as developers and sponsors of HOME projects.*

## 9 Percent and 4 Percent LIHTCs

In terms of the requirements and how the credit works, there is little difference between a 9 and 4 percent LIHTC. Simply put, the 9 percent LIHTC leverages more equity for a project than a 4 percent LIHTC, and is therefore usually more desirable. An award of 9 percent LIHTCs typically

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generates sufficient investor equity proceeds to cover 50 to 90 percent of the cost to develop the LIHTC units; whereas, an award of 4 percent LIHTCs typically generates investor equity proceeds to cover only 20 to 40 percent of the cost to develop the LIHTC units.

The key differences between the two forms of Federal LIHTCs are summarized in Exhibit 1-1.

### ***Competitive Allocation of 9 Percent LIHTCs***

Because of the greater potential financial benefit of the 9 percent tax credit, these are in greater demand, and are therefore allocated competitively, according to the state allocating agency's annual QAP. Typically, 9 percent LIHTC applications are received only once a year (although some larger states might have more than one funding "round" to allocate credits.) Most state allocating agencies use a point-scoring system to evaluate applications; this system is described in the QAP. Some states create a pool of potential LIHTCs that are reserved for particular types of projects (such as preservation projects in rural areas) or for particular types of sponsors (such as nonprofit sponsors or public housing authorities). Within each pool, the highest-scoring projects that meet all threshold requirements are selected to receive reservations of LIHTCs.

Tax-exempt bond financing cannot be used in conjunction with 9 percent LIHTCs.

### ***Noncompetitive Allocation of 4 Percent LIHTCs***

Because 4 percent credits are not in as high demand, most states accept LIHTC applications and issue reservations on a noncompetitive basis year-round. However, 4 percent LIHTC applications must still meet the state's threshold requirements in order to be eligible to receive a reservation of tax-exempt bond authority. Tax-exempt bond financing must be used in conjunction with 4 percent LIHTCs. The associated tax-exempt bonds can be issued by any state or local agency that has the legal authority to issue bonds (for example, a state housing finance agency, a local public housing authority, or a local redevelopment agency).

For tax-exempt bond projects, there is an LIHTC requirement that at least 50 percent of the total development cost be financed with tax-exempt bonds. Typically, the required amount of tax-exempt bond financing is greater than the supportable first mortgage; in these situations, the required amount of tax-exempt bonds are issued at the start of construction. Then, at the end of the development period, some of the bonds are repaid ("redeemed") so that the amount of the remaining bonds matches the first mortgage loan amount.

### Exhibit 1-1: Summary of Key Differences in 9 and 4 Percent Tax Credits

	9 Percent Credits	4 Percent Credits
Typical equity raised	50% to 90% of project's total development cost	20% to 40% of project's total development cost
Typical allocation process	Competitive allocation; one time a year	Non-competitive allocation; year-round
Typical use	New construction and substantial rehabilitation	Moderate rehabilitation

### How LIHTC Equity Is Calculated

The amount of LIHTC equity that can be secured for a project depends on a number of factors:

- Total development cost and how much of that cost is eligible under LIHTC
- Proportion of the project that will be LIHTC-assisted
- Type of LIHTC (9 or 4 percent)
- Price the LIHTC project sponsor is able to get for the credit.

Exhibit 1-2 illustrates the relationship of these variables and how the LIHTC equity is calculated.

### Exhibit 1-2: Determining the LIHTC Equity

<b>Total Development Costs</b>	<b>\$6,400,000</b>
Amount of Eligible Basis	\$5,000,000
X Applicable Fraction	75%
= Qualified Basis	\$3,750,000
+ 30% Basis Boost	\$1,125,000
= Qualified Basis	\$4,875,000
x LIHTC Percentage (9%)	x0.09

= Annual Credit Amount	\$438,750
X LIHTC Period	10 years
= Total LIHTC	\$4,387,500
X Net Syndication Price	\$ .75
= Net Syndication Proceeds (LIHTC Equity)	\$3,290,625

**Total development cost.** *Total development cost* is the total development budget (all costs necessary to produce a finished, occupied project).

**Eligible basis.** *Eligible basis* is the amount of the development cost that is LIHTC-eligible (excluding land and certain other costs that are not depreciable). This concept is discussed in more detail in Chapter 2.

**Applicable fraction.** *Applicable fraction* represents the share of the property that is LIHTC-assisted. It is based on the lesser of either: (1) the number of tax credit units to the total number of units, or (2) the square footage of the tax credit units to the total square footage of the property. Many tax credit projects have 100 percent tax credit units, and these projects have an applicable fraction that is 100 percent. However, QAPs increasingly favor mixed-income projects that include some market-rate units; mixed-income projects have applicable fractions well below 100 percent.

**Qualified basis.** *Qualified basis* is eligible basis multiplied by the applicable fraction. In other words, the portion of eligible basis that is attributable to the LIHTC units.

**Basis boost percentage.** *Basis boost percentage* is usually 100 percent. However, projects located in HUD-designated qualified census tracts or difficult development areas can be allocated up to 30 percent additional LIHTCs, at the discretion of the state LIHTC allocating agency. (Note that the Housing and Economic Recovery Act of 2008 gave the states' housing finance agencies the right to determine which areas in their states could be designated as difficult-to-develop areas.) If the full 30 percent addition is allocated, the basis boost percentage is 130 percent. Basis boost may not be applied to acquisition costs.



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**LIHTC percentage.** The LIHTC percentage represents the amount of credits that will be generated by the qualified (and boosted) basis. The LIHTC percentage is published monthly by the IRS, and is historically lower than the 9% or 4% factor. However, for buildings placed in service through the end of 2013 the **LIHTC percentage** is fixed at exactly 9 percent for the 9 percent LIHTC program, in accordance with changes made by the Housing and Economic Recovery Act of 2008.

**LIHTC period.** The **LIHTC period** is the ten-year period over which the investor may claim the LIHTCs. This is also sometimes referred to as the “credit period.” This is **not** the same as the 15-year compliance period (the period during which the IRS can recapture the tax credits from the investor for noncompliance with the affordability restrictions.)

**Total LIHTCs.** **Total LIHTCs** equals the qualified basis multiplied by the LIHTC percentage multiplied by ten years. This is the total dollar amount of LIHTCs that the owner is expected to receive over the ten-year credit period.

**Net syndication price.** **Net syndication price** is the amount that the LIHTC investor pays for \$1.00 of Federal income tax credit. Historically, the net syndication price typically ranged from 70 cents to 90 cents. (This means that the investor is willing to pay 70 to 90 cents today for every \$1.00 of anticipated tax credit that it will receive later.) In the mid-2000s, the typical price rose above 90 cents, only to drop significantly beginning in 2008. At this publication, net syndication prices are volatile and are most often reported toward the low end of the historical range.

**Net syndication proceeds.** **Net syndication proceeds** are the total dollar amount that the LIHTC investor pays the LIHTC project sponsor. It is based on the total project credit amount multiplied by the net syndication price. In this example, the net syndication proceeds are sufficient to pay for 51 percent of total development cost.

### Market Trends in LIHTC Equity Prices

Historically LIHTC prices have been stable and there has been an adequate market of potential LIHTC investors. As a result, developers had high confidence that an LIHTC reservation could readily be converted into LIHTC equity. However, financial upheaval in 2008 created significant stress in the LIHTC equity market, demonstrating that there can be unpredictability in this market.

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In summary, many of the largest LIHTC investors lost confidence that the business environment would be profitable. Without anticipated profits, there would be no Federal income taxes; and without tax liability, there would be no need for credits. The market stopped purchasing LIHTCs. This has had two primary results:

- LIHTC prices became (and continue to be) unstable.
- Some LIHTC projects have been unable to find an investor—particularly those with less-experienced or less financially-sound developers, large projects (over 200 units), projects in rural areas, projects with especially complex financial and compliance structures, and projects in areas of or declining population.

Recent market trends dictate that the PJ understand that the demand for tax credits can change over time; one cannot assume there will always be a supply of investors. PJs should discuss this issue with the state allocating agency when making decisions about funding tax credit projects. In addition, PJ underwriters should consider the following:

- Currently, pre-2008 benchmarks for LIHTC equity prices are not reliable.
- Developers today are under pressure to propose projects that are less complex and that involve fewer risks, as compared to the types of projects that could readily find LIHTC investors prior to 2008.
- There is a greater need for flexibility, creativity, and professionalism by PJs in working with the state and with developers.

### **LIHTC Deadlines**

There are three primary deadlines in the LIHTC program:

- Allocation and reallocation deadlines
- “Carryover” requirement
- Placed in service requirement.

### ***Allocation and Reallocation***

The state has two years to make an initial allocation (reservation) of LIHTCs. If a developer returns its LIHTC reservation, the state has two additional years to reallocate the LIHTCs to another project.

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### ***Carryover Requirement***

Once the state makes an initial reservation of LIHTCs for a project, the developer must incur 10 percent of the reasonably expected eligible basis within 12 months of when the LIHTC reservation was made. This is called the ***carryover requirement***. Although 10 percent must be spent, the expenditures need not be for basis-eligible items. Once this threshold is achieved, the developer receives a “carryover allocation” from the state; that is, the state allocates the remaining credits to the project. If the developer is unable to spend 10 percent of the reasonably expected eligible basis within 12 months, the project loses the credits and they are reallocated by the state to another project. (Note: the ***Housing and Economic Recovery Act of 2008*** extended this expenditure deadline from six months.)

### ***“Placed In Service” Requirement***

The LIHTC program does not have a deadline for full expenditure of funds like the HOME Program, but it has a deadline for project occupancy, called “placed in service.” The state LIHTC allocating agency and the IRS track LIHTC projects at the building level. A new construction LIHTC building is ***placed in service*** when construction has been completed and when the first unit in the building is certified as suitable for occupancy under state or local law (see IRS Notice 88-116). Rehabilitated LIHTC buildings are considered to be placed in service at the close of any 24-month period – selected by the taxpayer – over which the rehabilitation expenditures are aggregated. LIHTC buildings must be placed in service no later than December 31 of the second year following the year of the LIHTC reservation. For example, a project that receives 2008 LIHTCs must be placed in service by December 31, 2010.

## **1.3 Preliminary Review of Project Applications for HOME-LIHTC Projects**

Upon receipt of a specific HOME funding request for a project with LIHTCs or where LIHTCs are anticipated, the PJ should:

- Review the state’s QAP or consult with the state to understand its funding priorities and application process.
- Determine if the project is eligible for both HOME and LIHTC programs (eligibility screening).
- Understand the project timetable.

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## Coordination with the State Allocating Agency

When a PJ receives a viable funding application and considers investing HOME funds in a project that has or is likely to pursue an allocation of tax credits, it is extremely important that the PJ coordinate with the state allocating agency to:

- Identify the best projects to leverage both funding sources.
- Determine the appropriate level of each source of subsidy for the project.
- Share information on the allocating agency's underwriting assumptions.
- Identify important milestones in the application, funding, and development process.
- Share information on housing quality and project viability upon completion.

Allocating agencies have certain rights to make decisions about projects, and it is important for the PJ to build a partnership with the allocating agency so that the allocating agency understands the PJ's interests when these project decisions are made. Likewise, the state allocating agency might have funding preferences that the PJ does not share. For instance, the state might target a special needs population to meet a statewide housing need, but a particular jurisdiction might not have that need in its community.

## Determination of Preliminary Project Eligibility

Before investing time and resources in reviewing a project proposal, the PJ must determine that the project is an eligible HOME-LIHTC project. Both the HOME PJ and the state allocating agency have a range of choices in how they administer their respective programs to meet their jurisdictions' affordable housing needs, in terms of the eligible activities and housing types they fund and the housing partners they work with. In addition, both programs have clear requirements about who can be served and the long-term affordability of the housing that is financed.

### ***Eligible Target Population***

Key to both the HOME and LIHTCs program are the requirements that funds must be invested in housing that is occupied by income-eligible households. Each program defines income eligibility in slightly different ways, however. Therefore, the tenant of a unit that is designated as both a HOME- and LIHTC-assisted unit must meet the income requirements of both programs (that is, ***the most restrictive income requirement***).

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During the preliminary screening of the project, the PJ should determine, generally, that the project is designed to provide affordable housing to income-eligible households. Both HOME and LIHTC programs permit mixed-income projects. The project can serve a mix of income-eligible occupants and **over-income** occupants. During the financial underwriting of the project (discussed in [Chapter 2](#)), the PJ evaluates whether the developer is proposing an appropriate level of affordability. The specific **income targeting** requirements of both programs are explained further in [Chapter 4](#).

### ***Special Needs Housing***

Both HOME and LIHTC can be targeted to income-eligible persons with special needs, provided certain conditions are met. These groups can be served in standard rental housing, or funds can be invested in group homes or single room occupancy (SRO) projects. HOME and LIHTC both have particular requirements for these types of projects; even more restrictive rules apply if tax-exempt bond financing is used. PJs should encourage owners of these housing types to retain expert attorneys and/or advisors to assist with developing special needs housing.

For more information about using LIHTC and HOME to finance special needs housing, see IRC §42(i)(1)(3) and HUD Notice CPD 94-01, *Using HOME Funds for Single Room Occupancy (SRO) and Group Housing*, issued January 4, 1994. This HUD Notice is available online at <http://www.hud.gov/homeprogram/>.

## **1.4 Other Project Eligibility Criteria**

Exhibit 1-3 summarizes additional threshold criteria for a HOME-LIHTC project. These are the minimal criteria that must be met in order for a project to be eligible to be funded under both programs and to comply with both sets of program requirements.

**Exhibit 1-3: Threshold Criteria for a HOME-LIHTC Project**

Eligible Activities	<ul style="list-style-type: none"><li>• New construction or acquisition and rehabilitation of rental housing</li></ul>
Ineligible activities	<ul style="list-style-type: none"><li>• Projects with program participation requirements (such as “clean and sober” programs)</li><li>• Public housing development or rehabilitation</li><li>• Facilities (such as nursing homes or dormitories)</li></ul>

	<ul style="list-style-type: none"> <li>• Projects previously assisted with HOME funds after initial 12 months following project completion, but still during the affordability period</li> </ul>
Eligible housing structures	<ul style="list-style-type: none"> <li>• Single family structures, including scattered site rental units</li> <li>• Duplexes and townhouses</li> <li>• Garden apartments</li> <li>• Elevator structures</li> </ul>
Eligible housing partners	<ul style="list-style-type: none"> <li>• Community-based nonprofit developers (including CHDOs)</li> <li>• Governmental entities (such as public housing authorities)</li> <li>• For-profit developers</li> <li>• Nonprofit organizations</li> </ul>

### Eligible Forms of HOME Investment

During the threshold review, the PJ should also determine that the requested form of assistance is an eligible form under the HOME Program. Eligible forms of assistance include: predevelopment financing, construction loans, permanent loans, bridge loans, interest subsidy, loan guarantee, or refinancing (in certain circumstances). For additional information on the ways that HOME funds can be provided, see 24 CFR 92.205(b).

## 1.5 The Project Timetable

The PJ might receive a request for HOME funds for an LIHTC project either before the owner has applied for tax credits, or after the project has received a tax credit reservation.

### Project Review Pre-LIHTC Award

If the PJ receives the application for HOME funds when the project is in the preliminary stage, the PJ is able to conduct only a preliminary review of the project since the owner has only sketch plans, has not received bids for the construction work, has not yet asked for or received any first mortgage commitment, and does not yet know how many tax credits might be awarded. Accordingly, the limited availability of information limits the depth of the PJ's initial review. Based on this preliminary review, the PJ can provide only a conditional commitment of funding

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that makes HOME funding subject to certain conditions that must be met. PJs should talk to the state allocating agency about the HOME commitment being an “up to” award amount subject to the maximization of the LIHTC allocation, as HOME funds are meant to provide the gap in funding sources.

Since many states give preference to tax credit projects that have local support, a PJ’s conditional funding commitment can help a tax credit project application. In a conditional funding commitment, the PJ specifies in writing the all the terms and conditions that the owner needs to satisfy before the PJ makes a firm commitment to the project and enters into a written agreement with the owner, developer, or sponsor. This should include the condition that the project receives an allocation of LIHTCs.

### Project Review Post-LIHTC Award

If the PJ receives the application after LIHTCs have been awarded to the project, the PJ will have considerable information about the project and will be able to do a more thorough review. However, it must be sensitive to the fact that the LIHTC project sponsor must meet certain strict LIHTC deadlines in order to keep its reservation of funds: carryover requirements and placed in service requirements (discussed in Section 1.2 of this chapter). For HOME-LIHTC projects, this deadline can be a difficult one to meet if the funding application is received after the “clock has started ticking.”

LIHTC developers often plan to purchase the land in order to meet part of the initial 10 percent requirement for a carryover allocation. HOME rules prohibit the PJ and developer from incurring any project costs (including the purchase of land) until environmental clearance has been received. For some PJs, this is a time-consuming step in the development process. (See [Chapter 3](#) for a more detailed discussion of the environmental clearance process.) Upon application of a funding request that already has LIHTCs, the PJ may want to consider initiating its *environmental review* process at the same time that it completes its project review (i.e., before a firm funding commitment is made).

## CHAPTER 2: REVIEW FINANCIAL FEASIBILITY

This chapter continues the discussion on project review that commenced in Chapter 1. Chapter 2 provides guidance on how to review the financial factors that impact a HOME-LIHTC project's success and feasibility and describes the issues the PJ must analyze in order to determine how to best structure HOME funding invested in a HOME-LIHTC deal.

### 2.1 Overview of the Financial Feasibility Review

The need for a thorough project feasibility and sustainability review is just as important for a project with HOME and LIHTC funding as it is for a project only funded with HOME. Even if the state allocating agency has already reviewed the project and allocated credits, the PJ should undertake its own review of the project application. The state allocating agency's review assesses the project in relation to the state's needs and standards. The PJ can never assume that the state's standards accurately reflect current local construction costs and building standards, include all the costs that may be associated with compliance with HOME financing, and meet the PJ's local housing and cost policies.

The review of the project's feasibility and long-term sustainability is referred to as underwriting.

- **Project feasibility** refers to the process of analyzing and evaluating the likelihood that a proposed project will be successfully completed. For the PJ, it involves analyzing a project's

#### CHAPTER 1: CONDUCT THRESHOLD AND ELIGIBILITY REVIEW



#### CHAPTER 2: REVIEW FINANCIAL FEASIBILITY

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#### CHAPTER 3: COMMIT TO PROJECT AND CONSTRUCT UNITS



#### CHAPTER 4: LEASE UP AND COMPLETE PROJECT



#### CHAPTER 5: ENSURE LONG-TERM COMPLIANCE



#### CHAPTER 6: ADDRESS LONG-TERM AFFORDABILITY



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eligibility, site, financing, and development team, in order to determine whether the project can be initiated, completed, and successfully opened for business.

- **Project sustainability** refers to the project's ability to generate affordable rental housing for the duration of the affordability period, without additional public subsidy. Projects are sustainable when the underwriting is based on realistic and conservative cost estimates, the market for the unit mix is strong, the financing structure of the deal is viable, construction is sound, and, once operational, the project is maintained and managed effectively.

Through the underwriting process, the PJ assesses the risks of the project, and decides whether or not to finance the project based on its assessment. Projects that are based on sound underwriting and realistic financial projections are far more likely to succeed in the long term than those that are based on poor underwriting or unrealistic financial projections.

The underwriting process is comprised of four key areas of review:

- Preliminary screening of the project, sometimes referred to as a “threshold review” (see [Introduction](#))
- Market risk assessment
- Borrower risk assessment (review of the project development team qualifications)
- Project risk, feasibility, and sustainability analysis.

Projects that are funded with FY 2012 HOME funds and later<sup>2</sup> are subject to new underwriting requirements imposed by the *Consolidated and Further Continuing Appropriations Act of 2012* (P.L 112-55). The Act requires PJs to underwrite each project, assess the developer capacity and fiscal soundness of the developer being funded, and examine the neighborhood market conditions to ensure that there is an adequate market for the project. When it makes a project commitment, the PJ must certify that it has taken these actions. The Act also requires that any ConPlan submitted after November 2012 must be based on an assessment of the local market that helps the PJ specify the types of housing, locations, and target populations that will be eligible for funding.

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<sup>2</sup> These requirements apply to any development project that receives FY 2012 HOME funds, including all 2012 CHDO set-aside funds. A **FY 2012 HOME-funded project** is defined as any HOME activity set up in Integrated Disbursement and Information System (IDIS) under a 2012 Consolidated Plan/Annual Action Plan Project.

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Underwriting addresses elements of the project beyond regulatory compliance; however, complying with HOME and LIHTC requirements are integrally related to underwriting and the financial and operational viability of the project.

*Attractive new affordable housing projects -- home to responsible tenants and recognized as major improvements to their neighborhoods – make all of the PJ’s efforts worthwhile. It is especially satisfying to see the same projects - ten, fifteen, and even twenty years later - continuing to meet the community’s affordable housing needs.*

*Long-term success in HOME-LIHTC projects is rarely an accident. It is a function of good up-front planning and project review that emphasizes both feasibility and sustainability.*

## 2.2 Assessing Developer Capacity

The purpose of the PJ’s review of the developer’s capacity is to assess whether the proposed development team has the right mix of skills, capacity, and experience to develop the proposed HOME-LIHTC project. The core questions in reviewing HOME- LIHTC developers are the same as for the PJ’s review of any HOME project.

Exhibit 2-1 summarizes the key questions that the PJ should answer when it assesses the development team of a proposed project. With an LIHTC ownership entity, the PJ’s review should assess the capabilities of the managing partner or general partner who will carry out the day-to-day responsibilities of the project.

**Exhibit 2-1: Assessing Development Team Qualifications**

<b>Requisite Skills</b>	<ul style="list-style-type: none"><li>• Does the development team have at least the following sets of skills (provided by a single person or a number of persons throughout the organization)?<ul style="list-style-type: none"><li>○ Project management</li><li>○ Market analysis</li><li>○ Site selection and control</li><li>○ Finance</li></ul></li></ul>
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	<ul style="list-style-type: none"> <li>○ Design, architecture, engineering</li> <li>○ Construction</li> <li>○ Legal</li> <li>○ Accounting</li> <li>○ LIHTC syndication, investment, and compliance</li> <li>○ HOME compliance</li> <li>○ Property management.</li> </ul>
<b>Capacity</b>	<ul style="list-style-type: none"> <li>● Do the key team members have enough uncommitted time to undertake this project without causing other important work to slip?</li> <li>● If owner funds are required in order to close the deal or complete the construction, does the owner have a reliable source for these funds?</li> </ul>
<b>Experience</b>	<ul style="list-style-type: none"> <li>● Have the team members successfully completed similar projects recently?</li> <li>● Have these projects been located in this same geographic area?</li> </ul>

In evaluating the development team's skills, capacity, and experience, the PJ should consider how similar the proposed project is to the projects that the team has previously developed. For instance, in a HOME-LIHTC project, the ideal development team has experience building and operating affordable rental housing using HOME funds, LIHTC funds, and HOME and LIHTC combined. If the development team has experience in only one program, it is important for the PJ to determine how the team plans to gain expertise in the other program, in order to ensure that the team is competent to develop and manage the property in compliance with both sets of program requirements.

Likewise, the PJ should evaluate whether the developer has undertaken projects that are similar to the proposed project—in terms of the project size and scope, target population, and geographic location. A developer may succeed with a series of projects of one type, but then fail when it

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attempts a different type of project, a project in a different market, or a project of significantly greater size. For instance, a developer who has a wonderful track record with medium-sized new construction projects for low-income seniors in the suburbs may fail when it attempts a large rehabilitation project for low-income families in the inner city, or a market-rate project, or a project in another town.

### CHDO Involvement in LIHTC Projects

When CHDO funding is involved in a HOME-LIHTC project, the PJ needs to evaluate the CHDO's anticipated role in the project. This is especially true if the PJ wants to "count" the HOME funds invested in the project toward its CHDO set-aside requirement. This is the HOME requirement that a minimum of fifteen percent of each annual HOME allocation must be invested in housing that owned, developed, or sponsored by a CHDO.

In some HOME-LIHTC projects, the CHDO is the managing member of an LLC or general partner of a limited partnership. Often, however, the CHDO is a co-sponsor with a larger or more experienced developer. If the CHDO is not the sole managing partner of the LLC, the PJ must obtain a waiver to use CHDO set-aside funds. In these projects, the larger developer may be the managing member or general partner, and the CHDO may be a subordinate member with a more limited role. These roles and responsibilities are explicitly addressed in the project's Partnership Agreement (discussed in [Chapter 3](#)). If the PJ wants to use CHDO set-aside funds in the project, it must determine that the CHDO serves in a capacity where it has effective *project control*. The PJ should review the Partnership Agreement carefully to make that determination.

For more information on what constitutes effective project control, see HUD Notice CPD 97-11, *Guidance on Community Housing Development Organizations (CHDOs) Under the HOME Program*, issued October 8, 1997. This HUD Notice is available on the HOME website at <http://www.hud.gov/homeprogram/>.

*To use CHDO set-aside funds in an LIHTC project, the CHDO must have effective project control. For tax credit projects, this generally means that the CHDO must serve in the capacity of managing member (in an LLC) or the general partner (in a limited partnership).*

## 2.3 Reviewing the Project's Marketability

Before investing in an affordable rental housing project, the PJ should secure and/or review a *market study* of the specific project under consideration. The market study describes the demand for the housing (including an assessment of the proposed rent structure) and competition for the

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proposed housing, the *capture rate* needed to maintain an occupied property, and the *absorption rate* expected for the project. A market study is required of projects that are funded with HOME FY 2012 funds, or later.

The PJ must review the market study carefully to evaluate the validity of the developer's assumptions about the marketability of the project. Exhibit 2-2 summarizes the key elements of the market study. This evaluation is extremely important because if the project is unable to attract tenants to keep the building occupied, it will not remain financially viable and will be unable to provide affordable housing to the community. Failure of the project to provide affordable housing throughout the affordability period may result in HUD requiring the PJ to repay HOME funds.

For HOME-LIHTC projects, market studies are required as part of the owner's tax credit application. The state typically provides detailed instructions for preparing the market study in the QAP. This sometimes includes specific qualifications for those that prepare the market study. The PJ should become familiar with the state's requirements. If the state's requirements are satisfactory, the PJ may want to adopt them or it might impose additional requirements of its own. If the state's market study is sufficiently detailed to meet the PJ's criteria, the PJ may elect to simply request a copy and conduct its own review of that study. If the state's market study criteria are not as stringent as those adopted by the PJ, the PJ may wish to request a more detailed study.

### **Exhibit 2-2: Key Elements of the Market Study**

#### **Demand for the Housing**

- How many potential renter households (target market) might want to live in the project?
- What unit features/amenities are desired by the target market?
- How much is the target market willing to pay?

#### **Competition**

- What existing rental properties will the target market consider?
- Are there other competing properties that are under construction, or proposed, that the target market would consider?
- What features (such as, unit size, number of bathrooms, appliances) and amenities (such as, parking, swimming pool, or laundry facilities) do the competing properties have?

## Exhibit 2-2: Key Elements of the Market Study (continued)

### Capture Rate

- What share of renter households seeking housing of this type, in this location, and at this price range, need to be “captured” (i.e., leased) by the proposed property in order for it to succeed? (This capture rate is usually stated as a percentage.)
- Is the capture rate low enough to suggest that the property is likely to succeed and lease up quickly?

The PJ needs to understand its neighborhoods and housing markets to understand the capture rate. Generally, the capture rate may need to be higher for populations with a greater number of options than it would need to be for those who might have fewer options. For example, a property would need a low capture rate for a deeply subsidized apartment, whereas it might need a higher capture rate for a unit that will be rented at or near market.

### Absorption Rate

- What is the number of units per week or month that the property can be expected to “absorb” (i.e., lease) once the property begins accepting residents? For example, if the property is 60 units, and the expected *absorption rate* is ten units per month, it should take six months for the property to lease up.

To determine if the project’s absorption rate is sufficient, the PJ should compare the absorption rate with how quickly the property *must* lease up in order to be financially successful. To continue the example, if the property is 60 units, and in order to succeed, the property must lease up in four months, an absorption rate of 15 units per month is needed.

$$\frac{\text{NUMBER OF UNITS}}{\text{TIME REQUIRED FOR LEASE UP}} = \frac{\text{ABSORPTION RATE}}{(\text{UNITS PER MONTH})}$$

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## 2.4 Financial Review of HOME-LIHTC Projects

The financial review process for a HOME-LIHTC project is substantially the same as it is for a project funded with HOME funds alone. The PJ's financial feasibility analysis involves:

- Evaluating the development-related expenses and the availability of funds to develop the project
- Making predictions about the future operating expenses and revenues to anticipate the long-term viability of the project
- Analyzing the financial data, the impact of HOME and LIHTC requirements, and economic and market trends, in order to make decisions about how much HOME funds to invest, and what terms and conditions of funding to impose.

For the PJ, it is important to make realistic, if not conservative financial judgments. This helps ensure that the development of the project will be completed and the project will yield the revenues it needs in order to be sustained throughout the affordability period, while complying with the HOME Program's occupancy and rent restrictions.

*This chapter assumes that the reader has a basic understanding of project underwriting for affordable housing. For more information on underwriting, see the Underwriting HOME Rental Housing Guide. This publication is available online at <http://www.hud.gov/homeprogram/>.*

The PJ underwriter may save time and be more thorough in its financial analysis if it reviews and understands the state's underwriting standards. These are typically available in the QAP. These standards explain the state's financial requirements for tax credit projects, such as requirements for the maximum total development cost, replacement reserves, operating expense levels, and first mortgages. These QAP requirements may be inconsistent with PJ requirements, and the PJ needs to decide how to resolve the differences and how to respond to questions from developers about these differences. To the extent feasible, PJs should seek to minimize any conflicts between PJ underwriting requirements and underwriting requirements in the state's QAP.

### **Coordinating the PJ's and State's Financial Feasibility Review**

*It is a best practice for the PJ and the state allocating agency to coordinate with each other regarding underwriting requirements and determinations. This practice is likely to improve the accuracy of both underwriting analyses, and is necessary to ensure the appropriate level of total assistance to projects.*

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## 2.5 Financial Analyses

The PJ typically begins to review the financial projections of a project by reviewing financial information that the developer provides. Typically, this financial information is presented in the form of Sources and Uses Statement and an operating pro forma:

- ***Sources and uses of funds statement*** shows the uses of funds (i.e., the development budget) together with the sources of funds (i.e., the funds that will be used to pay for the costs in the development budget). The uses of funds are an estimate for all of the costs that the developer will incur to complete and lease-up a project.
- ***Operating pro forma*** is an estimate of the revenue and expenses that the proposed project should produce upon completion.

Initially, the PJ reviews these documents to ensure that the costs are reasonable, necessary, and complete.

## 2.6 Reviewing the Development Budget

The PJ underwriter reviews the development budget (uses) to evaluate whether it contains reasonable estimates for all of the project development costs. In general, these development costs are the same for a project, regardless of the funding source. However, there are some differences in the development budget for a HOME-LIHTC project of which the PJ should be aware:

- There may be some costs in an LIHTC project that a PJ might not normally see in a HOME-assisted project.
- There may be some costs in a HOME project that might not otherwise be in an LIHTC-assisted project.
- Presentation of the budget may differ because of LIHTC cost eligibility.
- Certain costs may be higher in a tax credit project than in other HOME-assisted projects.

### LIHTC Costs that Are Not Found in a HOME Project

Housing tax credit projects can be complex, and the owner needs to engage the services of a variety of experts in order to successfully execute a housing tax credit deal. The PJ should expect to see the following costs in a project that has LIHTC equity funds. These costs are not typically present in a project that is funded only with HOME:



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- **Syndication Fees.** Usually, the owner pays a syndicator to serve as a broker between the equity investor and the developer. This is referred to as the *syndication fee*. The syndicator might pool several projects into one equity fund, so that investors share the risk among several projects. Syndication is key to securing investor equity to the tax credit project.
  - **Tax advisors.** Owners and investors rely on the advice of tax advisors to ensure the project complies with the IRS rules, so as not to jeopardize the tax credit.
  - **LIHTC application fees.** Most states impose LIHTC application fees, to offset the costs of reviewing and processing LIHTC applications. In some states, there is a different fee structure for for-profit and nonprofit developers.
  - **Organizational fees.** This is the cost to create the new ownership entity (Limited Liability Corporation or Limited Partnership) for the project.

These costs are standard costs in LIHTC deals, and they should be reflected in the development budget. The PJ should consult with the state to assess the cost-reasonableness of these fees; the state's QAP may also provide guidance on the expected cost of these fees.

### HOME Costs that Are Not Found in an LIHTC Project

There are a number of HOME requirements that are not LIHTC requirements. When reviewing a development budget, particularly for a project that was initially conceived as a tax credit project or that has already received an allocation of tax credits, the PJ should be sure that the budget reflects these HOME-related costs, as applicable:

- **Davis-Bacon prevailing wage** for projects with twelve or more HOME-assisted units
- **Lead-based paint treatment** for projects that include a pre-1978 building
- **Environmental clearance requirements**
- **Relocation costs** for any project that includes a property that is currently occupied
- **Energy efficiency improvements** required by the International Energy Conservation Code.

All of these costs are eligible HOME costs. Some of these costs may be eligible in the LIHTC basis, such as Davis-Bacon prevailing wages and lead-based paint treatment costs. These costs are related to the construction and building and can, therefore, be depreciated. Some of these other costs may or may not be eligible in the LIHTC basis, depending on the specific type of the cost and whether the cost(s) can be depreciated for income tax purposes. The project sponsor

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should consult with its tax attorney or tax credit advisor to make this determination. The following section of this chapter discusses eligible LIHTC costs in more detail.

### Presentation of LIHTC-Eligible and Ineligible Costs

LIHTC cost eligibility is important for determining how many tax credits can be allocated to a project. The general principle underlying LIHTC cost eligibility is that a cost must be eligible to be depreciated for income tax purposes in order to count toward *LIHTC basis*. Therefore, eligible costs are referred to as “in LIHTC basis,” and ineligible costs are “outside LIHTC basis” (that is, the costs are not eligible to be included in LIHTC calculations which determine the amount of tax credits that can be issued). These items are driven by IRS rules about depreciation. There are no limits on how the equity in an LIHTC project can be spent once basis is established and tax credits are allocated (equity can pay for costs that are outside of the basis). This is significantly different than the HOME Program – HOME funds can be spent only on eligible costs for HOME-assisted units.

The development budget for an LIHTC project is often presented so that the costs are identified as “in basis” or “outside of basis.” For instance, when LIHTC funds are involved in a project, the development budget usually separates the land and building costs because construction costs are in basis (LIHTC-eligible), but land is outside of LIHTC basis (not LIHTC-eligible).

In general, the PJ does not need to review whether or not this delineation is accurate because the state reviews this component of the project. If the project has not yet secured a tax credit allocation, however, it is helpful for the PJ to have a basic understanding of what is inside and outside of basis because if the owner calculates the eligible basis incorrectly, it impacts its projection of how much tax credits the project can secure and this impacts how much HOME funding the project needs. Using the example of splitting the land and building cost, if the state has accepted the land/building split proposed by the developer, the PJ does not need to question this split and the inclusion in basis further. However, if the tax credits have not yet been requested, the PJ should understand the reasoning behind the split, so that it can assess if the tax credits anticipated by the developer are realistic.

Exhibit 2-3 identifies the standard line items in a development budget, and identifies if these are eligible costs under the HOME Program, and whether they are in or outside of LIHTC basis.

**Exhibit 2-3: HOME Eligible Costs and LIHTC Eligible Basis**

Development Budget Line Item	HOME Eligible Cost	LIHTC Eligible Basis
<b>Acquisition</b>	Eligible	Land is outside of basis; Improvements are in basis
<b>Hard costs (construction)</b>	Eligible (Note, onsite infrastructure costs are eligible, but off-site infrastructure costs are not)	In basis
<b>Construction-related soft costs (architectural and engineering services, builder fee, soils testing, etc.)</b>	Eligible	In basis
<b>Developer fee</b>	Eligible	In basis (may be paid in cash up-front or deferred)
<b>Project reserves</b>	Initial operating reserve to cover up to 18 months during lease-up is eligible	Outside basis
<b>Financing costs</b>	Eligible, provided they are reasonable and customary in the jurisdiction	Depends on the specific cost; fees related to the permanent loan are outside basis
<b>Other soft costs (relocation, application fees, counseling fees)</b>	Eligible, provided the cost can be specifically tied to the HOME-assisted project	Most are included in basis. Costs related to forming the LIHTC ownership entity and cost of selling tax credits to investors are outside basis

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## Additional Costs

Certain fees may be higher for a HOME-LIHTC project than they are for a HOME-only project, including developer fees and attorney fees. These higher costs may be reasonable, depending on the project and the market, and should be expected because an LIHTC project is more complex than a typical deal and requires a high level of expertise and more time to put the deal together. The PJ may want to consult with the state to determine the cost reasonableness of these higher costs.

## 2.7 Assessing Sources and Uses

The Sources and Uses Statement shows all the funding sources available and all the proposed costs, or uses of the funds (the development budget). Exhibit 2-4 provides a sample, simplified Sources and Uses Statement.

**Exhibit 2-4: Sample Sources and Uses Statement**

FUNDING SOURCES SUMMARY		Amount
First Mortgage		\$2,100,000
HOME Second Mortgage		\$750,000
Developer Investment (Deferred Fee)		\$100,000
LIHTC Equity		\$3,600,000
Construction Period Net Income		\$100,000
<b>Total Sources of Funds</b>		<b>\$6,650,000</b>

FUNDING USES SUMMARY		Amount
Acquisition Costs		\$50,000
Hard Costs		\$4,600,000
Construction Related Soft Costs		\$225,000
Developer Fee		\$725,000
Initial Project Reserves		\$150,000
Financing Costs		\$575,000
Other Soft Costs		\$325,000
<b>Total Uses of Funds</b>		<b>\$6,650,000</b>

The PJ should review the Sources and Uses Statement to determine three things:

- The availability of all the sources to ensure that the Sources and Uses are in balance before construction proceeds.

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- Whether uses are cost-eligible, considering the restrictions on the uses.
  - Whether the timing of the availability of sources is adequate to meet uses, throughout the development and construction period.

### Availability of Sources

First the PJ should assess whether the owner has firm commitments for all sources listed on the Sources and Uses Statement. A firm commitment would be a legal agreement or legally binding commitment letter from the source.

In many instances, HOME funds are committed to projects early, before other sources are invested. In some cases, other funders, such as private lenders, want to know that the public sources are “locked in” before the funder will commit to the project. It is acceptable for HOME to be the first source committed to the deal, *but*, the PJ should be careful in how and when it allows draws of HOME funds for these types of projects. If the PJ allows HOME funds to be used to acquire the land or begin the construction prior to having all of the other sources firmly committed, it runs the risk that the developer will be unable to raise sufficient resources to complete the units. If this occurs and the affordable housing is not completed, the PJ must repay the HOME funds back to HUD.

### Cost Eligibility

The PJ should examine the Sources and Uses Statement to determine that: (1) there are sufficient sources of funds to pay all of the costs of the project, and (2) all of the costs of the project can be borne by sources for which they are eligible.

As noted above, the notion of “eligible cost” is different in HOME and LIHTC. The HOME rules identify specific costs as eligible and ineligible (found in 24 CFR 92.206 and 92.214, respectively). HOME funds cannot be used to pay any cost that is not eligible.

### Timing of Sources, Including Equity Pay-In

For any project, the PJ must consider the cash flow into a project throughout construction. Generally, most uses need to be paid during the construction period. Typically, the LIHTC equity is paid to the developer in stages over the development period. The investor usually prefers to delay payment until stabilization, when the project has been completed, has been leased-up, has achieved its projected *Net Operating Income (NOI)*, and when the investor has less risk regarding project completion. The developer, on the other hand, prefers to receive payment as early in the construction process as possible, offsetting the need to borrow funds (and

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pay interest costs) during construction. The tension between these two points of view results in a wide variety of pay-in structures.

Typical events in the pay-in schedule include:

- Initial closing
- 25 percent, 50 percent, 75 percent, and 100 percent construction completion
- 100 percent of the units have been placed in service
- Stabilization

The PJ should be aware that there is often a tradeoff between the price of the tax credits and the pay-in schedule. Investors are willing to pay more for credits when their pay-in schedule is late in the construction process and their risk is minimized. While the PJ might desire an earlier equity pay-in schedule to limit its own risk, this will likely decrease the price of the credits, which in turn may increase the need for HOME financing.

Due to these timing issues, typical HOME-LIHTC transactions need temporary financing to be able to pay construction costs before all of the permanent sources of funds have been received. The two most common forms of temporary financing are:

- **Construction loans**, which usually are for the same principal amount as the permanent first mortgage, from a lender who specializes in managing the risks during the construction period.
- **Bridge loans**, which most commonly bridge the timing gap between when LIHTC equity funds are needed (in order to pay construction and other development costs) and when the LIHTC investor has agreed to provide the funds.

Exhibit 2-5 illustrates how to project the timing of Sources and Uses over the development period. In this example, a construction loan has been added to the Funding Sources Summary in order to make sure there are sufficient sources to meet uses at each point during the development period.

**Exhibit 2-5: Sample Sources and Uses Timing Illustration – Requiring a Construction Loan**

<b>FUNDING SOURCES SUMMARY</b>	<b>Total</b>	<b>Initial Closing</b>	<b>25% Complete</b>	<b>50% Complete</b>	<b>75% Complete</b>	<b>100% Complete</b>	<b>Stabilization / Final Closing</b>
First Mortgage	\$2,100,000						\$2,100,000
Construction Loan			\$282,500	\$560,000	\$1,110,000	\$1,010,000	(\$2,962,500)
HOME Second Mortgage	\$750,000	\$47,500	\$702,500				\$0
Developer Investment (Deferred Fee)	\$100,000						\$100,000
LIHTC Equity	\$3,600,000	\$700,000		\$700,000		\$700,000	\$1,500,000
Construction Period Net Income	\$100,000					\$25,000	\$75,000
<b>Total Sources of Funds</b>	<b>\$6,650,000</b>	<b>\$747,500</b>	<b>\$985,000</b>	<b>\$1,260,000</b>	<b>\$1,110,000</b>	<b>\$1,735,000</b>	<b>\$812,500</b>

FUNDING SOURCES SUMMARY		Total	Initial Closing	25% Complete	50% Complete	75% Complete	100% Complete	Stabilization / Final Closing
Acquisition Costs	\$50,000		\$50,000					\$0
Site Work Costs	\$350,000			\$175,000	\$175,000		\$1,010,000	\$0
Construction/ Rehabilitation Costs	\$4,250,000			\$750,000	\$1,000,000	\$1,000,000	\$1,500,000	\$0
Architectural and Engineering Fees	\$225,000		\$185,000	\$10,000	\$10,000	\$10,000	\$10,000	\$0
Interim Financing Costs	\$500,000		\$50,000	\$50,000	\$75,000	\$100,000	\$125,000	\$100,000
Permanent Financing Fees	\$75,000		\$37,500					\$37,500
Developer's Fee	\$725,000		\$100,000				\$100,000	\$525,000

The PJ must also consider how the pay-in schedule might impact the project's ability to pay the ineligible costs of the project during construction. If HOME funds provide the bridge or construction loan, the proceeds of the HOME loan can only pay for eligible costs, even if the tax credit equity will take out the HOME financing upon completion. There must be sufficient other funds during the construction process to pay the cost of any ineligible items. For instance, consider a project that requires sewer development. This is not a HOME-eligible cost. The PJ must determine that the full cost of the sewer development can be carried by another source of funds (such as the private financing) during construction and permanent financing.



## 2.8 Reviewing the Operating Pro Forma

Accurately and realistically projecting operating costs in HOME and LIHTC projects is important because the project's long-term financial viability will be impacted if there are inaccuracies in the projected costs and revenues. The pro forma should encompass all stages of the project—from lease-up to stabilized operations, and throughout the affordability period. Exhibit 2-6 illustrates a multi-year operating pro forma.

**Exhibit 2-6: Sample Multi-Year Operating Pro Forma**

Multi-Year Operating Pro Forma			
	Year 1	Year 2	...etc.
Gross Potential Rent	\$550,000	\$561,000	
Rent Loss (Vacancy/Bad Debt/Concession)	(\$150,000)	(\$40,000)	
Other Revenue	\$5,000	\$5,100	
<b>Effective Gross Income</b>	<b>\$405,000</b>	<b>\$527,000</b>	
Management Fee	(\$30,000)	(\$31,620)	
Other Administrative Expenses	(\$120,000)	(\$123,600)	
Operations and Maintenance Expenses	(\$50,000)	(\$51,500)	
Utilities Paid by Property	(\$20,000)	(\$20,600)	
Taxes and Insurance	(\$60,000)	(\$61,800)	
Reserves for Replacement Deposit	(\$30,000)	(\$30,900)	
<b>Total Expenses</b>	<b>(\$310,000)</b>	<b>(\$320,020)</b>	
<b>Net Operating Income</b>	<b>\$105,000</b>	<b>\$206,980</b>	
First Mortgage Debt Service	(\$160,000)	(\$160,000)	
<b>Cash Flow (After Debt Service)</b>	<b>(\$55,000)</b>	<b>\$46,980</b>	
Note --- Year 1 is lease-up, Year 2 is stabilized			

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In the example illustrated by Exhibit 2-6, the first year is not stabilized (meaning that the property has not yet achieved full occupancy) and it produces a loss of (\$55,000). Typically, this “lease-up” expense would be paid through a reserve established specifically for this purpose, and it would be funded as a development expense of the project.

In addition to its standard review of the operating pro forma, the PJ should pay special attention to the following elements of the pro forma in a HOME-LIHTC project:

- Unit mix
- The reasonableness of the gross potential rent projections
- The reasonableness of operating expenses, including whether they are sufficient to ensure the long-term success of the project
- Trending assumptions about the inflation rate for revenues and expenses.

### Unit Mix

The term *unit mix* refers to the range of unit types, sizes, and rents and occupancy restrictions that are proposed to be included in the HOME-LIHTC project.

The PJ determines the minimum number of units which must be designated HOME-assisted based on the amount of HOME investment in the project and the maximum per unit subsidy for the area. This process is known as *cost allocation*. Attachment 2-3, located at the end of this chapter, illustrates how to use cost allocation to determine the minimum number of HOME-assisted units in the project. The PJ may designate a greater number of HOME units than the minimum required. The PJ also determines how many units must be designated High HOME Rent and Low HOME Rent units in the project. In projects with five or more HOME-assisted units, at least 20 percent of the units are designated as Low HOME Rent units. Again, the PJ may designate more than 20 percent of the units as Low HOME Rent units if it so chooses. The remaining units are High HOME Rent units. See the section below for more information about rents.

The number of units that are designated as tax credit units is stated in the use agreement with the state allocating agency. This must either be a minimum of 40 percent of the units when the occupancy is restricted to households with incomes at or below 60 percent of area median income (AMI), or 20 percent of the units when occupancy is restricted to households with incomes at or below 50 percent of AMI. Many tax credit project owners designate all the units as LIHTC units, because the greater the percentage of tax credit units, the greater the amount of tax credits that can be allocated to the project.

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The developer and PJ face the decision whether to add the HOME restrictions to units that are subject to LIHTC rent restrictions, or to apply the HOME restrictions to units that are not LIHTC-restricted (if any). This decision may be impacted by what the HOME and LIHTC rent limits are, the market rents, and the financing impact of overlaying rent and occupancy restrictions to achieve greater tax credit equity.

It is helpful to generate a unit mix table that summarizes key unit mix information:

- Number of units of this type
- Number of bedrooms
- If there is more than one type of unit with this number of bedrooms, additional information identifying this particular unit type (for example, number of baths, whether there is a den, or affordability level)
- Rental square feet
- Gross potential rent
- Whether the unit rent is subject to LIHTC rents, High HOME rents, Low HOME rents and/or other rent restrictions
- Whether any utilities are tenant-paid, and what utility allowance applies (estimate for the monthly cost of tenant-paid utilities).

Exhibit 2-7 provides a sample of how this information can be presented.

**Exhibit 2-7: Sample Unit Mix Table**

This is a sample unit mix and configuration table that reflects the information outlined above. This sample illustrates a 50-unit property with an equal number of one- and two-bedroom units, in which all of the units are LIHTC, and 40 percent of the units are also HOME. This means that each HOME unit also meets the LIHTC affordability requirements. In this example the High and Low HOME rent limits are lower than the 50 percent AMI LIHTC rent limit; further, the High and Low HOME rents are the same.

Number of Units	Type	Square Footage	Gross Rent	Utility Allowance	Net Rent	Programs Served	Effective Rent Limit
2	1BR, 1BA	630	\$750	(\$90)	\$660	50% LIHTC, Low-HOME	FMR Low-HOME
8	1BR, 1BA	630	\$750	(\$90)	\$660	50% LIHTC, High-HOME	FMR High-HOME
15	1BR, 1BA	630	\$830	(\$90)	\$720	50% LIHTC	50% AMI LIHTC
2	2BR, 1.5BA	750	\$810	(\$110)	\$700	50% LIHTC, Low-HOME	FMR Low-HOME
8	2BR, 1.5BA	750	\$810	(\$110)	\$700	50% LIHTC, High-HOME	FMR High-HOME
15	2BR, 1.5BA	750	\$845	(\$110)	\$735	50% LIHTC	50% AMI LIHTC

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## Rents

Since both HOME and LIHTC units carry rent restrictions, it is critical that the PJ's underwriters verify that the correct rents are being used in the rent projections. The rent projections that should be used will depend on:

- The unit mix (i.e., how many units are designated High HOME Rent units, Low HOME Rent units, LIHTC units, and both HOME and LIHTC units)
- The current High and Low HOME Rents and LIHTC rent limits for the jurisdiction, and whether or not the tenant pays for utilities
- The estimated market rents for the project.

### HOME and LIHTC Rent Limits

Both HOME and LIHTC require that the rents that are charged for assisted units are affordable to income-eligible households. Each program issues its own rent limits to define what is affordable. The rent limits represent the maximum rents that can be charged to income-eligible households. The cost of any tenant-paid utilities must be deducted from the published rent limit to determine maximum rents that can be charged. Each program issues utility allowances for this purpose—these represent the average utility cost for the area.

For each specific unit(s), the PJ's underwriter uses the following guidelines to determine the rent limit that applies:

- HOME rent limits apply to units that are designated as HOME-assisted units only.
- Tax credit rent limits apply to units that are designated as tax credit units only.
- The lower of the HOME or LIHTC rent limit applies to units that are designated as both HOME and tax credit.

If the estimated market rents for HOME or LIHTC units are below the program-restricted rent limits, the underwriter should use the lower, market rent in underwriting the project. Simply because a rent is restricted does not guarantee that it is below-market, and tenants will never pay above-market, restricted rents.

If the project has any market rate units (that is, units are neither HOME- nor LIHTC-assisted), the estimated market rate rents should be used.

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In projects that serve persons with special needs, it may not be possible for a unit to carry a HOME- and LIHTC-assisted designation and still be in compliance with the program's requirements related to serving the special needs group. See [Chapter 4](#) for a more detailed discussion of this issue.

### Basis of the Rent Limits

HUD issues HOME and LIHTC rent limits and adjusts them for different localities and for each bedroom-size unit from zero (efficiency) to six bedrooms. HUD updates the HOME and LIHTC rent limits every year.

*High HOME rent limits* are based on the *lesser* of one of the following:

- The Section 8 Fair Market Rents (FMRs) for existing housing
- 30 percent of the adjusted income of a family whose annual gross income equals 65 percent of AMI.

*Low HOME rent limits* are based on one of the following:

- 30 percent of the tenant's actual adjusted income
- 30 percent of the annual gross income of a family whose income equals 50 percent of AMI (this is the HUD-issued Low HOME Rent)
- If a property has a Federal or state project-based rental subsidy and the very low-income tenant pays no more than 30 percent of his or her adjusted income toward rent, the maximum rent allowable under the project-based rental subsidy program.

Note that Low HOME Rents are used in the units that must be occupied by very low-income occupants in properties with five or more HOME-assisted units. Low HOME Rent units must represent at least 20 percent of the units in projects with five or more HOME-assisted units. Most PJs use the HUD-issued Low HOME Rents, unless the project has a project-based rental subsidy.

*LIHTC rent limits* are based on one of the following:

- 30 percent of 50 percent of AMI, when units are restricted to this population
- 30 percent of 60 percent of AMI, when units are restricted to this population
- 30 percent of a lower AMI, as required by the project-specific use agreement.

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For a unit that serves to meet both the HOME and LIHTC requirements, the rent cannot exceed the FMR, because the FMR serves as a ceiling rent for the HOME Program. State allocating agencies update rent limits annually based on HUD-issued income limits.

### Using Utility Allowances

In projects where the tenants pay for some or all of the utilities, the PJ's underwriter must deduct the anticipated *utility allowances* from the rent limits to determine the maximum rent that can be charged for the unit. Failure to do this will result in an over-estimate of the potential gross rents of the property since utility costs can impact the rent figures significantly.

LIHTC and HOME may use different utility allowances. The LIHTC utility allowance must be deducted from the LIHTC rent limit to determine the maximum allowable LIHTC rent. The PJ's utility allowance must be deducted from the HOME rent limits to determine the maximum allowable High HOME Rents and Low HOME Rents. The PJ can choose to adopt the LIHTC utility allowance for its tax credit projects, to simplify this process. For each unit that is designated as both a HOME and LIHTC unit, the lesser rent limit is used *after utility allowances have been deducted*.

### Affordability and Market Rents

It is risky to assume that the property will achieve its "use-restricted" rent limits. The PJ should *always* compare the HOME and LIHTC rent limits to the market rents in the neighborhood. In some communities, the rent limits imposed by the LIHTC and HOME Programs will result in a higher rent for a unit than the market will actually bear. For example, a unit might have a maximum tax credit rent of \$660 after utilities, a maximum HOME rent of \$625 after utilities, and a maximum market rent of \$500. Regardless of the program rent limits, the property cannot charge more than the market will pay, or \$500. This lower market rent complies with the LIHTC and HOME rent restrictions, because it is always acceptable to set rents lower than the rent limits.

### Expenses that Help Ensure Long-Term Success

Both HOME and LIHTC require compliance for some period of time after construction completion. Certain line items impact the longevity and long-term financial viability of the project. The PJ should be sure that these line items are sufficient to meet the project's needs over the long term:

- Maintenance budget

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- Property management
  - Reserve for replacements.

### Maintenance Budget

Preventive maintenance helps ensure that major systems meet their useful life. Operating budgets should provide for adequate ongoing maintenance.

### Property Management

Sufficient property management fees help attract and retain qualified and competent property managers. Managing a HOME-LIHTC project requires understanding and complying with requirements of two different programs, and includes annual income certifications, periodic property inspections, implementing rent restrictions, and organized recordkeeping systems. The PJ should expect to pay more for a property manager of this type of project than it might for smaller projects, or for projects that are HOME-assisted only. PJs should be careful not to underwrite to below-market property management fees, even if such fees will be charged to the project initially. Doing so may leave the property without enough breathing room in its operating expense budget to replace a failing management agent with a qualified agent, at prevailing prices.

### Replacement Reserve Deposits

Replacement reserves are payments made in escrow to cover the costs of capital needs and major systems repairs and replacements that occur as the property ages. For example, this might include the need to replace appliances, air conditioners, water heaters, and roofs. The state allocating agency and/or the first mortgage lender may have guidelines about the level of *Reserves for Replacements*. The PJ should not adopt these guidelines without making its own assessment of whether the required replacement reserve is sufficient. Without sufficient reserves, as these properties age, they will need to supplement the replacement reserves with some combination of excess future cash flow, refinancing proceeds, or new government subsidy.

The Replacement Reserves estimate should be based on a *capital needs assessment*, whenever possible. Attachment 2-1, found at the end of this chapter, discusses how to prepare a capital needs assessment.

### Assumptions about Inflation

In affordable rental housing underwriting, it is prudent to assume that revenues will grow at a slower rate than expenses. Depending on the relative growth assumptions for revenues and

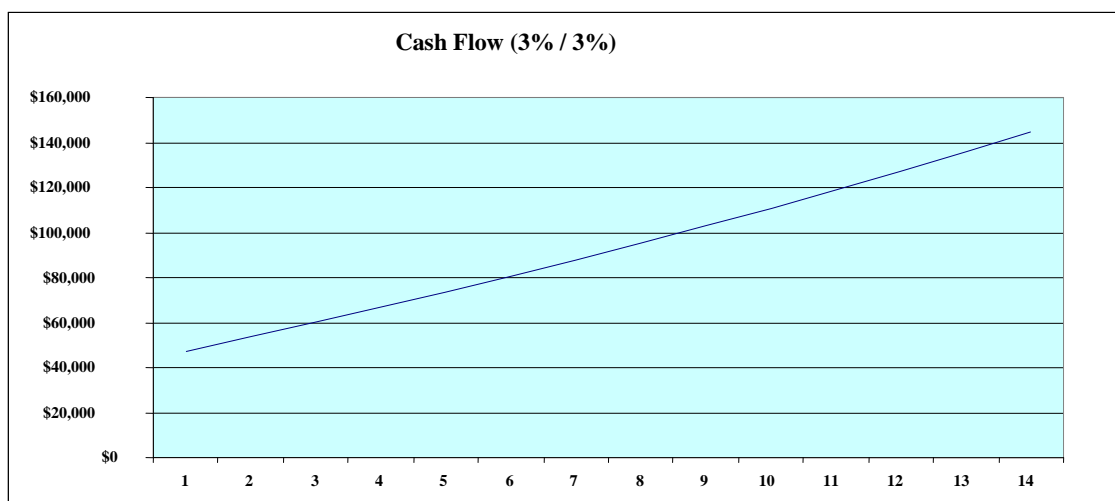


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expenses, NOI may actually decline as the property ages. This could be a serious problem for HOME-LIHTC properties that must comply with affordability restrictions for some period of time.

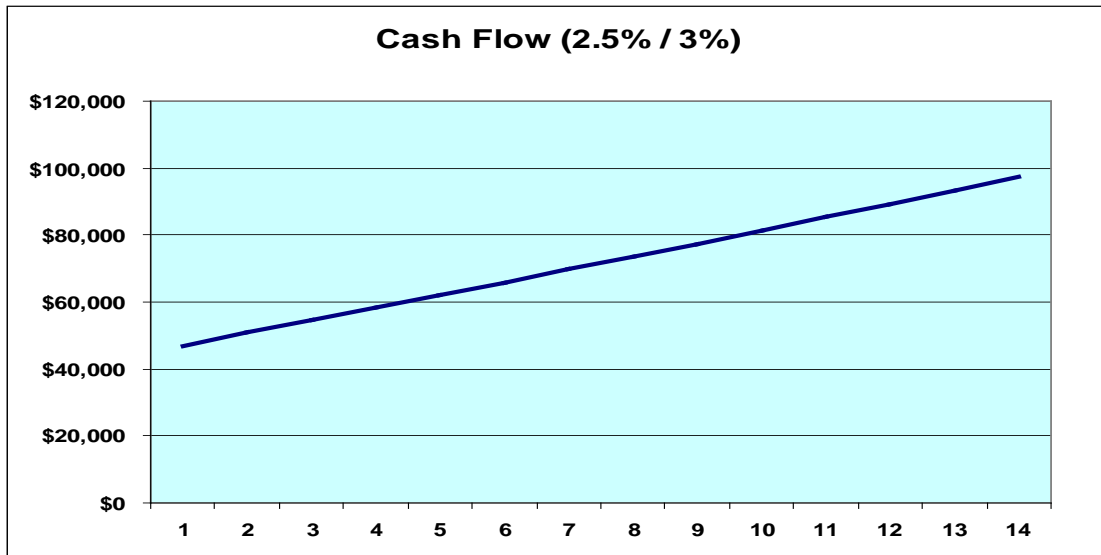
The following exhibits illustrate the impact of using the same income and expenses, but different assumptions for long-term inflation rates; they illustrate how these assumptions impact cash flow. Exhibit 2-8 shows inflation assumptions that are typical for market rate apartments, where the inflation rates assumed for revenues and expenses are the same. Exhibits 2-8 and 2-9 illustrate the effect of lowering the inflation rate assumption for revenues, while holding the inflation rate for expenses constant. In the third illustration, in which income is projected to rise at 2 percent per year while expenses increase at 3 percent per year, cash flow starts to decline after about Year 10.

**Exhibit 2-8: Illustration with Equal Inflation Rate for Revenue and Expenses**  
(3% Inflation for Revenue, 3% Inflation for Expenses)



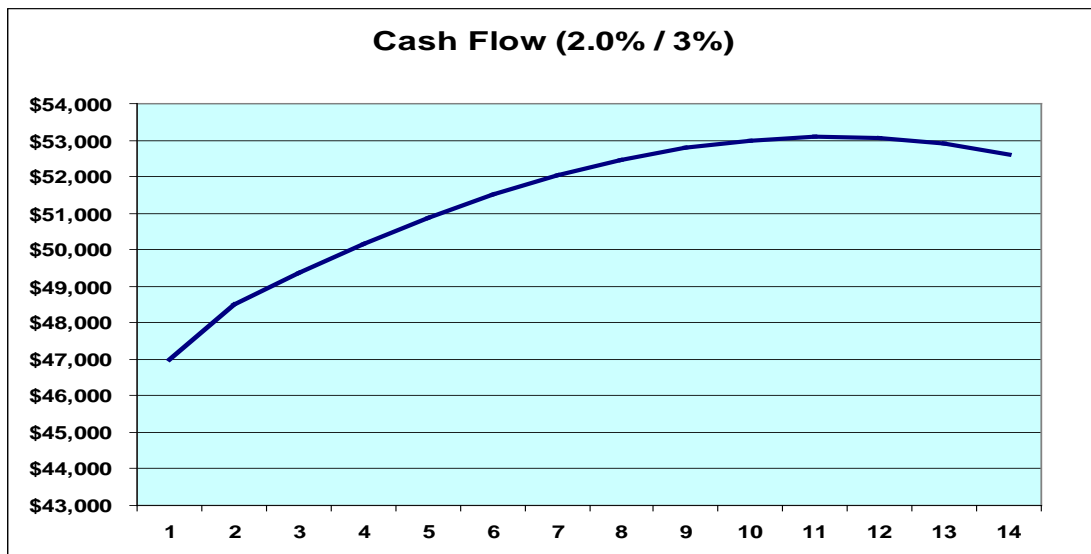
### Exhibit 2-9: Illustration with Lower Inflation Rate for Revenue than for Expenses

(Assuming 2.5% Inflation for Revenue, 3% Inflation for Expenses)



### Exhibit 2-10: Illustration with Lower Inflation Rate for Revenue than for Expenses

(Assuming 2.0% Inflation for Revenue, 3% Inflation for Expenses)



These illustrations demonstrate how seemingly small differences in the trending assumptions can have a very significant impact on the outcome of NOI and cash flow over time. There are significant implications for HOME-LIHTC projects. In many HOME-LIHTC projects, conservative underwriting indicates that expenses will increase at a faster rate than income

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(rents), because of the market, the proposed project's regulatory structure, and the restrictions on rents that can be charged. In these projects:

- The project will probably need a larger *debt service coverage ratio* (DSCR) at the beginning, so that if NOI growth becomes negative at some point in the future, there will still be an adequate operating margin.
- The monthly deposits to the Reserve for Replacements will probably need to be increased, because there is much less likelihood that there will be available future cash flow to pay for some long-term capital needs.
- The first mortgage loan should probably have a shorter rather than longer period of amortization, so that principal will be paid down quickly, ensuring that the project will be able to refinance if necessary.

## 2.9 Determining the Amount of HOME Subsidy

Once the PJ has evaluated the developer's financial information and has determined that the cost estimates are sound, the PJ must analyze this information to determine whether or not to fund the project, and if so, the amount of the HOME subsidy.

The maximum HOME subsidy that can be invested in a project is the *lesser* of these three amounts:

- The financial needs of the project, based on a subsidy layering review
- The portion of the total project cost that is HOME-eligible and can be allocated to HOME-assisted units
- The 221(d)(3) maximum per unit subsidy limit.

The PJ can make changes to its assumptions about the HOME funding, in order to increase the amount of funding it invests in the project. For instance, by increasing the number of units that are designated HOME-assisted, the amount of HOME funds that can be allocated to the project increases.

In a HOME-LIHTC project, there are a number of specific issues that the PJ must analyze to make these final determinations, such as:

- What is the appropriate level of subsidy for the project, given the tax credit equity?

- Is the project's financing gap closed?
- Are the PJ's requirements met?
- Is the proposed subsidy at or below the HOME maximum per unit subsidy limit?
- How does the form of the HOME subsidy (grant vs. loan, and interest rate terms) impact the potential tax credit contribution?
- Will the tax credits be marketable to investors for the proposed project, and at what price?

With a thorough analysis, the PJ can make the best possible choices about how to invest HOME funds in the project to ensure that the HOME investment is protected, and potentially yields a return to the PJ.

### The Financing Gap

Typically, the role of HOME funding in a HOME-LIHTC project is to fill the *financing gap* between the development budget, on the one hand, and the available sources of funds, on the other hand. Exhibit 2-11 illustrates a project with a financing gap.

**Exhibit 2-11: Illustration of the Financing Gap**

<b>Uses of Funds</b>	
Land	\$500,000
Hard Costs	\$3,750,000
Soft Costs	\$750,000
Total Development Costs	\$5,000,000
<b>Sources of Funds</b>	
LIHTC Equity	\$3,000,000
First Mortgage	\$1,321,000
Total Sources	\$4,321,000
<b>Financing Gap</b>	<b>\$679,000</b>

The financing gap is not static. It changes every time the owner or the PJ alters its key economic assumptions (e.g., rents and the unit mix that affects rents, rent loss, expenses, and development costs). Exhibits 2-12 and 2-13 illustrate how the financing gap changes for a proposed 50-unit HOME-LIHTC project with gross potential rents at \$650 per unit per month (Exhibit 2-12) versus \$600 per unit per month (Exhibit 2-13). In some jurisdictions, this might be the rent differential between the High HOME Rent and the LIHTC rent.

In each illustration, the arrow indicates the direct relationship between the amount of first mortgage debt service that the NOI can support, and the first mortgage amount.

**Exhibit 2-12: Illustration When Gross Potential Rent is \$650 Per Unit Per Month**

Operating Budget		Sources and Uses	
Gross Potential Rent	\$390,000	Land	\$500,000
Rent Loss	(\$23,400)	Hard Costs	\$3,750,000
Other Income	\$5,000	Soft Costs	\$750,000
Effective Gross Income	\$371,600	Total Development Costs	\$5,000,000
Operating Expenses	(\$225,000)		
Replacement Reserve Deposit	(\$20,000)	LIHTC Equity	(\$3,000,000)
Net Operating Income	\$126,600	First Mortgage	(\$1,321,000)
First Mortgage Debt Service	(\$105,000)		
Cash Flow	\$21,100	Financing Gap	\$679,000

**Exhibit 2-13: Illustration When Gross Potential Rent is \$600 Per Unit Per Month**

Operating Budget		Sources and Uses	
Gross Potential Rent	\$360,000	Land	\$500,000
Rent Loss	(\$21,600)	Hard Costs	\$3,750,000
Other Income	\$5,000	Soft Costs	\$750,000
Effective Gross Income	\$343,400	Total Development Costs	\$5,000,000
Operating Expenses	(\$225,000)		
Replacement Reserve Deposit	(\$20,000)	LIHTC Equity	(\$3,000,000)
Net Operating Income	\$98,400	First Mortgage	(\$1,027,000)
First Mortgage Debt Service	(\$82,000)		
Cash Flow	\$16,400	Financing Gap	\$973,000

Without having changed any other assumptions, the \$50 (7.7%) reduction in rents results in a \$294,000 (43%) increase in gap financing requirements for this sample project.

Most economic assumptions are interrelated, and every time one key assumption changes, the underwriter needs to re-evaluate how the change impacts the other assumptions. For example, in the illustrations above, if the rents are lowered, there may also be a reduction in rent loss, because the proposed rents are more of a bargain.

Or, the underwriter may need to consider how a reduction in unit size might impact rents and operating expenses. For instance, the cost to repaint or replace carpet might be lower for a smaller unit.

The financing gap can only be determined after generating a relatively realistic development budget and operating pro forma. The PJ must evaluate its funding estimates by asking:

- Is the development budget aggressive? Conservative? Adequate without being excessive?
- Is the operating budget aggressive? Conservative? Adequate without being excessive?
  - Are the proposed reserves adequate without being excessive?
  - Are the proposed rents achievable?

- 
- Are the underwritten rent loss (vacancy and bad debt) assumptions realistic?
  - Is the proposed income from other sources (laundry, parking, or commercial space) realistic?
  - Could the owner get a real estate tax abatement or payment in lieu of taxes?
  - Might the owner secure better loan terms from another lender?
    - Could the owner secure a lower interest rate than that proposed?
    - Could the owner get a loan with longer amortization, later maturity, lower origination or prepayment costs, or fewer restrictions?
  - Is the proposed LIHTC equity price competitive? Does the equity pay in early (resulting in lower bridge financing costs), or later?

### Subsidy Layering Requirements

HOME and LIHTC each contain requirements to ensure that the total amount of government assistance is no more than is necessary to produce the project. The term **subsidy layering analysis** refers to the process that PJs (for HOME) and state LIHTC allocating agencies use in order to make this determination. The subsidy layering review ensures that the PJ identifies the amount of the financing gap and invests no more funds than the amount that is sufficient to fill the gap, neither more nor less. Funding **more** than the gap means the project is over-subsidized. Funding **less** than the gap means that the owner may have inadequate funds to complete the project successfully.

#### ***HOME Subsidy Layering Requirements***

The PJ is required to conduct a Subsidy Layering Review (SLR) whenever HOME funding is combined with other public funding, including LIHTC funding. HOME requires the PJ to develop and use standardized procedures to conduct this subsidy layering review. The PJ's SLR must be in writing and must remain in the PJ's project file.

For HOME-LIHTC projects, PJs are permitted to accept the subsidy determination of the state allocating agency for subsidy layering purposes, as described in the following section. The PJ must still conduct its own review to determine compliance with all other HOME requirements.

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## ***Tax Credit Subsidy Layering Requirements***

The LIHTC regulations contain a requirement similar to the HOME subsidy layering requirement. These regulations require that the state allocating agency have procedures for making the tax credit allocation determination, including standards for acceptable developer and builder fees.

For tax credit projects, if the PJ chooses to adopt the subsidy determination of the state allocating agency, it must request a copy of the state's subsidy layering review. The PJ should thoroughly review and analyze it to ensure there is agreement with its determinations. If the PJ determines it is satisfactory, it can adopt the review for the HOME-LIHTC project and retain a copy of this review in the project file.

### ***Rate of Return on Equity***

When conducting a subsidy layering review, the PJ should carefully assess the rate of return on the owner's equity. All else equal, the more cash flow and residual profit the owner can expect, the less HOME funding should be provided, because the owner should be expected to make more of an initial investment itself.

### ***Post-Construction Subsidy Layering Reviews***

Both the PJ and the state allocating agency are required to conduct a SLR at the time the HOME award is made. LIHTC projects are also required to include a post-construction ***cost certification audit*** by an independent accountant. This type of audit details the actual development costs that are incurred by a project. Because often there are material changes between the projected and actual sources and uses, it can be extremely helpful for the PJ to also conduct a final SLR based on the actual sources and uses. A post-construction (actual cost) subsidy layering analysis determines whether ***actual*** uses were lower than estimated in the underwriting. For tax credit projects, this is done to verify that there was enough actual basis for the tax credits.

If the PJ intends to carry out a post-construction SLR based on actual costs, the written agreement between the PJ and the owner should make the owner aware of this requirement and should provide that the amount of the HOME award may be decreased (but not increased) based on the result of eligible costs within the post construction SLR.



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*For more information on subsidy layering requirements and evaluating the owner's rate of return, see [Layering Guidance for HOME Participating Jurisdictions When Combining HOME Funds with Other Government Subsidies](#), HUD Notice CPD 98-01, issued January 22, 1998. This Notice is available online at <http://www.hud.gov/homeprogram/>.*

### Allocation of Costs to HOME-Assisted Units

All HOME funds that the PJ invests in a project must be allocable to the HOME-assisted units plus a proportionate share of costs for the common areas. This is sometimes called HOME's fair share. The PJ can never invest more HOME funds in a project than its fair share.

The approach to determining the cost allocation depends on whether or not the units in the project are **comparable units**, meaning similar in size, quality, and amenities. When the units that are HOME-assisted are not comparable to the non-HOME-assisted units, the PJ must determine cost allocation based on actual unit costs plus a fair share of common costs. When the units are comparable, a pro-rata method of cost allocation can be used, or the actual cost method can be used. Attachment 2-3, found at the end of this chapter, illustrates both methods of cost allocation.

### HOME Maximum per Unit Subsidy Limit

HOME imposes a **maximum per unit subsidy limit**. This is a fixed dollar amount that is based on the current Section 221(d)(3) cost limits for the city or county where the proposed project is located, based on number of bedrooms. These 221(d)(3) limits are available from the HUD Field Office or online on the HOME Program website at <http://www.hud.gov/homeprogram/>.

The total amount of HOME funds invested in a project can never exceed the per unit subsidy multiplied by the total number of HOME-assisted units in the project.

### Impact of Lender Requirements on the Financing Gap

The first mortgage lender imposes a number of important requirements, typically including the following:

- **First mortgage loan amount.** This affects the size of the financing gap.
- **First mortgage monthly payment (debt service).** This is based on the term and interest rate. It affects the financial viability of the project on an ongoing basis.

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- **Prepayment / refinancing requirements.** Some loans may not be refinanced for some period of time (referred to as a prepayment lockout period). Other loans may be refinanced if the owner pays a fee (referred to as a prepayment penalty). Other loans must be refinanced at a particular point in time (these loans are referred to as balloon loans or bullet loans). Depending on these requirements, the underwriter can make different assumptions about changes to debt service over time.
  - **Funding conditions.** The first mortgage commitment specifies the requirements the developer must meet before the first mortgage loan funds will be made available to the project. Funding conditions for a HOME-LIHTC project typically include:
    - Completion of the project
    - Issuance of certificates of occupancy
    - Evidence that all buildings are placed in service within the required deadline
    - Satisfaction of the lease-up requirement, typically 90 percent physical occupancy for 90 consecutive days
    - An NOI requirement, typically achievement of the pro forma stabilized NOI for three consecutive months.

### Determining the Form of HOME Assistance

HOME allows virtually any form of financial assistance, or subsidy, to be provided for eligible projects and to eligible beneficiaries. The PJ decides what forms of assistance it will provide. However, some forms of HOME assistance will affect the amount of tax credits the project may receive. In addition, some forms of assistance will require specific legal instruments to implement. The HOME regulations list the following forms of subsidy as eligible:

- **Interest bearing loans or advances.** These loans are amortizing loans. Repayment is expected on a regular basis, usually monthly, so that over a fixed period of time, all of the principal and interest is repaid.
  - Such loans may have interest rates at or below the prevailing market rate. Often, very low interest rates (i.e., one to three percent) can make monthly payments more affordable to the borrower. Prior to 2008, the interest rate on the HOME loan determined whether the costs paid by that loan could be included in the LIHTC basis. However, with the Housing

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- and Economic Recovery Act (HERA) programmatic changes in 2008,<sup>3</sup> any eligible amounts paid by a HOME loan may be included in basis, regardless of whether the interest rate on that loan was less or more than the applicable Federal rate (AFR).
- The property or some other assets are used as collateral.
  - The term of the loan may vary.
  - **Non-interest bearing loans or advances.** The principal amount of such loans are paid back on a regular basis over time, but no interest is charged.
    - As with interest-bearing loans, these loans use the property or other assets as collateral and the term of the loan varies depending on the nature of the activity funded.
    - Such loans are made when the borrower is able to make regular payments but even a small amount of interest is not affordable.
    - Eligible costs covered by these types of loans are generally permitted in the LIHTC basis provided there is a reasonable expectation that the loan will be repaid (i.e., that it is actually a loan and not a grant).
  - **Deferred loans (forgivable or repayable).** These loans are not fully amortized. Instead, some, or even all, principal and interest payments are deferred to some point in the future. Deferred loans can be structured in many different ways.
    - Deferred payment loans can be forgivable or repayable.
      - If forgivable, the forgiveness might be structured to occur at one point in time (such as at the end of the affordability period), or forgiven incrementally (such as forgiving one-fifth of the loan each year over five years).
      - If repayable, repayment might be required at the sale or transfer of the property or at the end of a fixed period of time.
    - Like the amortizing loans discussed above, these loans can either accrue interest or be non-interest bearing.
    - Deferred payment loans require the property or some other form of collateral to be used as security for repayments.

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<sup>3</sup> Public Law 110-289, also known as the Housing and Economic Recovery Act of 2008 (HERA), became law on July 30, 2008. HERA made significant programmatic changes to the Low-income Housing Tax Credits (LIHTC).

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- Deferred payment loans may be used to help rental projects by allowing deferral of loan payments for the first few years until the project becomes stable.
  - Deferred payment loans may be problematic if the owner wishes to count the costs paid by these loans in the LIHTC basis. The state allocating agency needs to assess whether or not there is a reasonable expectation that this loan will be re-paid. If the state determines that the deferred loan functions like a grant, it will likely determine that the costs paid by this deferred loan are not eligible in the basis.
  - **Grants.** Grants are provided with no requirement or expectation of repayment.
    - Grants require no liens on the property or other assets.
    - HOME is sometimes used for acquisition of land and other costs that are ineligible to be included in the LIHTC basis and therefore can be granted without impact on that basis.
  - **Interest subsidies.** This is usually an up-front discounted payment to a private lender in exchange for a lower interest rate on a loan. An interest subsidy may also be a deposit into an interest-bearing account from which monthly subsidies are drawn and paid to a lender along with the homeowner's monthly payment.
  - **Equity investments.** An equity investment is an investment made in return for a share of ownership. Under this form of subsidy, the PJ acquires a financial stake in the assisted property and is paid a monetary return on the investment if money is left after expenses and loans are paid.
  - **Loan guarantees and loan guarantee accounts.** HOME funds may be pledged to guarantee loans or to capitalize a loan guarantee account. A loan guarantee or a loan guarantee account ensures payment of a loan in case of default.
    - A loan guarantee is a written promise to pay the lender some percentage of the outstanding principal balance of a loan in the event the borrower defaults. It may be held for a specified period of time or reduced by a specific amount over time as the loan principal is repaid.
    - A loan guarantee account is a loan loss reserve held by the lender in an amount equal to some percentage of the outstanding principal.
      - The lender holding the loan guarantee account may require a minimum balance, as well as a percentage of the principal amount of the loan. The percentage of the loan amount held as guarantee may vary from loan to loan, or from program to program.
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- HOME rules require that the amount of money in a loan guarantee account must be based on a reasonable estimate of the default rate on the guaranteed loans, and may not exceed 20 percent of the total outstanding principal guaranteed, except that the account may include a reasonable minimum balance.

## **2.10 Negotiating the Best Position for the PJ**

Due to project viability considerations, HOME funds will most often be provided in the form of a soft loan. This term refers to a loan that has one of the following repayment structures:

- No required payments from operations
- Required payments that are limited to a percentage of available excess cash
- Payments that do not begin until late in the life of the project.

When structuring a soft loan, PJs need to consider the interest rate, loan term, repayment requirements, lien position, and sale / refinancing requirements. The LIHTC project sponsor may have certain needs and preferences about how the PJ structures these terms, because of the impact of these terms on the investors' taxes (and their resulting impact on the price of the credits). These terms should be discussed and negotiated before the PJ finalizes its loan structure. This is because loans increase the amount of eligible basis in the project. IRS regulations require that loans are likely to be repaid; and therefore the HOME loan will need to be structured in a way that demonstrates it is likely to be repaid.

### Factors Affecting the Strength of the PJ's Negotiating Position

*The PJ may be in either a strong or weak position to negotiate favorable loan terms, depending on a number of factors including:*

- ***The timing of the LIHTC application.*** *If the owner has already negotiated a cash flow waterfall with other parties to the transaction, it is more difficult to accommodate the PJ's requirements.*
- ***The size of the PJ's investment.*** *If the HOME funds are a relatively large source of funds to the project, the PJ is in a stronger position to negotiate favorable terms.*
- ***The level of expertise on the PJ's team.*** *If the PJ's underwriter, attorney, and other advisors are experienced in LIHTC deals, and are aware of the factors that impact a HOME-LIHTC project's success, then there is an increased likelihood that the PJ can negotiate favorable terms.*

### Loan Terms

LIHTC owners typically prefer HOME loans that have as long a term as possible. One reason is that it may be important for income tax purposes to demonstrate a reasonable expectation that the loan will be repaid from cash flow and sale proceeds. All else equal, extending the term of the HOME loan increases the likelihood that it will be repaid. It is a good practice for PJs to develop policies for the maximum loan term that the LIHTC owner finds acceptable.

### Repayment Requirements

Typically, PJs are more interested in ensuring the long-term affordability of the project than maximizing repayment of HOME funded loans. Consequently, when lending HOME funds to projects, PJs often offer loans at the lowest rate of interest and the longest term that are acceptable to both the PJ and the LIHTC owner.

Other HOME loans are intended to provide future program income to the PJ. These loans are intended to be repaid, at least in part. For these loans, the PJ needs to consider:

- **Interest rate.** A relatively high interest rate generates more program income for the PJ. However, a relatively low rate minimizes the risk that the property will have too much debt, and maximizes the likelihood that the project will be able to repay the loan in full. The LIHTC owner's income tax concerns affect this decision as well.

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- **Level of required payment.** A best practice is to require the project to repay a percentage of available (surplus) cash. HUD's Office of Multifamily Housing provides a good definition of *surplus cash*: cash that is not needed to meet operational requirements on a particular day (such as December 31). If the PJ requires a relatively low percentage of the surplus cash to be repaid (such as one-third), the owner may have more incentive to maximize cash flow. If the PJ requires a high percentage of surplus cash be repaid (such as three-fourths), it may minimize the owner's incentive to operate the property efficiently and in so doing reduce the amount of surplus cash.
  - **Deferral.** It is a best practice for PJs to begin required payments after the project has stabilized for a few years. This practice limits the burden on cash flow in the early years of the project.
  - **Priority position.** LIHTC owners are likely to ask the PJ to *subordinate* payments on the soft HOME loan to a variety of non-operational payments. This means that these non-operational payments would be made before calculating available surplus cash, a percentage of which will be paid to the PJ. Project sponsors may refer to this process as deciding the *position* that the HOME loan will have in the *cash flow waterfall*.

In HOME-LIHTC projects, negotiations regarding priority are likely to arise in at least these areas:

- **Asset management / monitoring fees to the LIHTC investor.** Investors commonly ask for an annual fee to be paid by the project, from excess cash, to cover the investor's cost for monitoring compliance.
- **Deferred developer fee.** If a portion of the developer fee cannot be paid from Sources of Funds, that portion of the fee is called a *deferred developer fee* and is paid from future cash flow, refinancing proceeds, and sale proceeds. In order to include a deferred developer fee within LIHTC basis, the project sponsor must be able to demonstrate a reasonable expectation that the deferred fee will be repaid, with interest, during the 15-year LIHTC compliance period. Obviously, if the deferred developer fee has a high position in the cash flow waterfall, the likelihood of repayment is greater than if it has a lower position in the waterfall. Sophisticated PJs will project how much of the deferred developer fee is likely to be repaid based on the long-term operating pro forma, and will negotiate a cash-flow sharing arrangement that balances the developer's interest in collecting the deferred fee, with the PJ's interest in repayment of its loan.

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- **LIHTC adjusters.** LIHTC investors typically negotiate guarantees from the LIHTC owner that the owner/manager will not rent to ineligible tenants, set rents above LIHTC maximums, commit fair housing violations, or take other actions that could cause the investor to lose LIHTCs. LIHTC owners often ask a PJ to subordinate HOME loans to these as “LIHTC adjusters.”

It is a good practice for the PJ to have clear requirements, stated in its Request for Proposals (RFP) or Notice of Funding Availability (NOFA), regarding repayment provisions, and for these requirements to strike a reasonable balance between meeting the PJ’s needs and providing the LIHTC owner with sufficient flexibility to achieve a successful project. Otherwise, the owner can (and likely will) claim that it was not aware of the PJ’s requirements, that the owner has already negotiated the cash flow waterfall, and that it is simply not possible to accommodate the PJ’s requirements.

### Lien Position and Payment Priority

If there are multiple soft loans, there will be negotiations concerning *lien position* and *payment priority*. The lien position determines which soft lender will be paid first in the event of foreclosure. The payment priority identifies which soft lender will be paid first from available cash. Most typically, soft lenders demand lien position and payment priority according to loan amount. That is, the largest soft loan is most likely to demand and receive second lien position and second payment priority, after the first mortgage. PJs need to be aware of lien position because of the requirement to repay HOME funds in the event of loss of the affordable units during the minimum affordability period.

### Sale / Refinancing Requirements

In structuring their HOME loans, many PJs require the HOME loan to be due on sale. Many LIHTC owners, however, want to be able to sell the property, and to refinance the first mortgage, without triggering repayment requirements for the HOME loan.

The PJ, however, will not want to grant these types of concessions routinely. It should consider the following issues regarding assumption of the HOME loan by a subsequent purchaser:

- **Acceptability of the purchaser.** The PJ wants to ensure that the purchaser is qualified to own/manage the property in compliance with remaining HOME requirements. One approach is to require that the purchaser meet any requirements that were contained in the PJ’s NOFA or RFP and to require the purchaser to submit its qualifications to the PJ, and be subject to PJ approval.



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- **Affordability.** At a minimum, the PJ must require, as a condition of assumption, the continuation of the existing affordability requirements. The PJ may opt to impose longer and/or deeper affordability restrictions on the purchaser.
  - **Paydown.** The PJ may want to require that a portion of the loan be repaid, in a lump sum, as a condition of assumption. This is especially true if the sale involves equity pay-out to the seller and/or a new developer fee to the purchaser. This enables the PJ to capture some of the net proceeds from the sale and not allow all of it to go to the owner. At a minimum, the PJ may require the loan to be brought current to the date of the sale. For example, consider the case where a PJ provides a loan of \$100,000 with the understanding that it would be repaid over 20 years, with principal payments of \$5,000 if there is surplus cash flow. If there is no cash flow, the payment is deferred. In year 10 the property is sold. The PJ has been repaid \$25,000 through year 10 and has deferred \$25,000. A sale occurs and generates net proceeds of \$100,000. The PJ may say that the first \$25,000 must be paid to bring the HOME note current, and the remaining balance will be paid from future cash flows of the project. The original use agreement stays in force.
  - **Lien position and payment priority.** The PJ typically would not want to allow assumption if the result is that the HOME loan would have a lower lien position and/or a lower position in the cash flow waterfall.

Because assumption decisions typically require case by case judgment, it is difficult to state these sorts of requirements in advance, so it is a best practice for HOME loans to be due on sale, allowing the PJ to later negotiate transaction-specific terms.

Similar issues arise with respect to refinancing. LIHTC project owners often ask for the right to refinance the first mortgage without requiring any payment on the HOME loan. PJs typically are reluctant to agree to such a request in advance. However, if the proposed first mortgage term is shorter than the term of the proposed HOME loan, the PJ and owner should discuss what happens when the first mortgage either has to be refinanced or is paid off.

Issues that may come up regarding a potential future refinancing include:

- **First mortgage loan amount.** Typically the PJ does not want the new first mortgage amount to be higher than the amount being refinanced, but the LIHTC owner will want the opposite result.
  - **First mortgage loan payment.** Similarly, the PJ generally does not want the new first mortgage payment to increase because it decreases the amount of cash flow available for
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repayments on the HOME loan, and the LIHTC owner is likely to have an opposite motivation.

- **Equity pay-out.** Typically, the PJ wants a portion of any net refinancing proceeds to be paid toward the HOME loan. The LIHTC project sponsor wants any such payment to be as small as possible.
- **Affordability.** The PJ may want a commitment to longer and/or deeper affordability as a condition of refinancing, especially if there will be an equity pay-out.

## ATTACHMENT 2-1: CAPITAL NEEDS: SAVING FOR A RAINY DAY

Capital planning for affordable rental housing can be summed up simply: stuff wears out. Importantly, however, the **rate** at which the various building systems wear out is well known and replacement costs also are well known. As a result, it is possible to estimate how much money will be needed to cover replacements, year by year, as the property ages. This analysis is called **capital needs assessment** or capital planning. Exhibit 2-14 provides a simple capital needs assessment in the form of a spreadsheet.

**Exhibit 2-14: Sample Capital Needs Assessment Sample (only five years shown)**

Building System	Now	Year 1	Year 2	Year 3	Year 4	Year 5
Refrigerators	\$0	\$500	\$1,000	\$1,000	\$1,000	\$1,000
Furnaces	\$2,500	\$12,500	\$12,500	\$12,500	\$12,500	\$12,500
Parking Lot Resurfacing	\$0	\$0	\$0	\$0	\$0	\$45,000
[...etc.]						
<b>Total</b>	<b>\$2,500</b>	<b>\$13,000</b>	<b>\$13,500</b>	<b>\$13,500</b>	<b>\$13,500</b>	<b>\$58,500</b>

Actual capital needs assessments typically evaluate building systems over a 20-year period. Twenty years is used because most major systems require at least one replacement during that time frame. The column labeled “Now” may also be labeled “Rehab” or “Year 0” or “Required Repairs.” It indicates replacements that are needed because the inspector found (for example) a furnace that was not working and was old enough to require replacement.

The Refrigerators line indicates one replacement in the first year, then two replacements per year for years 2-5 (at \$500 per refrigerator). The Furnaces line indicates one immediate replacement, then 5 per year for years 1-5 (at \$2,500 each). The Parking Lot Resurfacing line indicates no needs until year 5.

The Total line tells the owner and PJ how much money will need to come from Replacement Reserve withdrawals, future cash flow, future refinancing, and possibly future subsidies, in order

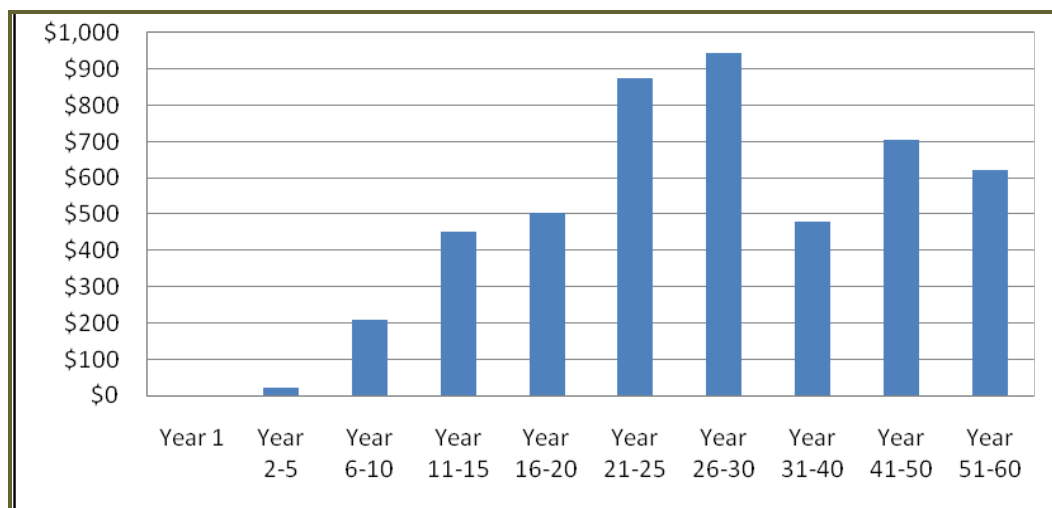
to maintain the proposed project. The cost of replacing capital items is not reflected in the operating expense underwriting or budget of the property.

### Typical Timing of Capital Needs for New Construction Projects

Below, Exhibit 2-15 illustrates the annual capital needs, per unit, that a newly constructed property might expect to incur over its first sixty years.

The capital needs are virtually nonexistent in the first five years, small in years 6-10, and then increase steadily over the next 20 years, with a peak in years 21-30 when a number of major building systems (typically, roofs, siding, windows, and parking lots) require major repair or replacement.

**Exhibit 2-15: Average Annual Capital Needs Per Unit (constant dollars)**



### *Lessons on Replacement Reserves in Affordable Housing*

Traditionally in the apartment business, Replacement Reserve deposit requirements have been created by lenders, specifically for market-rate apartments. Because most first mortgage loans for market-rate apartments must be refinanced every seven to twelve years, and because market-rate apartments are expected to generate annual increases in NOI, lenders typically have required relatively small Replacement Reserve deposits in combination with relatively large requirements for repairs at the time of financing or refinancing. Because of the relatively short period between refinancings, market-rate apartment lenders also typically did not require the Replacement Reserve deposits to increase for inflation.

Affordable housing underwriters adopted these Replacement Reserve practices from the lenders of market-rate apartments, only to find that these practices did not translate well into affordable

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apartments. In particular, these problems became apparent as the first wave of affordable apartments aged:

- Rents did not rise as quickly in rent-restricted developments as they did in market-rate apartments. Therefore, NOI did not rise as quickly.
- Many early affordable apartments had significantly greater operating expenses than owners and funding agencies expected. As a result, affordable apartments generally did not have the same *financial* ability to refinance as market-rate apartments.
- First mortgage loans on affordable housing developments generally did not require refinancing, and were designed to be self-amortizing (that is, after the final payment during the mortgage term, the remaining balance would be zero).
- Many first mortgage loans were designed not to be refinanced. In fact, many first mortgage loans for affordable apartments contained the key affordability provisions and accordingly contained prohibitions on prepayment.
  - As a result, many affordable apartments *could not* refinance even if doing so would be sensible from a purely financial standpoint.
- Following market-rate apartment practice, first mortgage loans did not require inflation adjustments to the Replacement Reserve deposit.

The result is that affordable housing owners and funding agencies have found themselves invested in properties that face increasing capital needs as properties age, with small Replacement Reserve balances, small ongoing Replacement Reserve deposits, only modest cash flow, and often regulatory prohibitions on refinancing.

Funding agencies made two primary responses to this set of problems:

- Second mortgage programs and grant programs, for needed repairs
- Decisions to structure new properties so that this would not happen again. These decisions involved requirements and guidelines to ensure:
  - Larger initial Replacement Reserve deposits
  - Increased monthly deposits to cover inflation
  - More attention to the sustainable underwriting principles discussed in this publication.

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## ATTACHMENT 2-2: HOW TO DETERMINE THE MINIMUM NUMBER OF HOME-ASSISTED UNITS IN A PROJECT

### Determining the Minimum Number of HOME-Assisted Units

The PJ must designate the number of HOME-assisted units at the time of project commitment. The minimum number of units that the PJ can designate is based on the amount of the HOME investment. The process for determining this number varies, depending on whether the units are comparable or not. Comparable units have the same number of bedrooms, amenities, and square footage.

- When units are **not** comparable, the minimum number of HOME-assisted units is based on:
  - The actual units in which HOME funds are invested (i.e., the actual costs for the HOME-assisted units, plus a proportional share of the HOME-eligible common costs). These costs cannot exceed the maximum per unit subsidy limit.
  - For example, if the PJ rehabilitates six units that are not comparable, the PJ must track the development costs by unit. If the PJ invests \$25,000 per unit for three 3-bedroom units, and invests only private funds in the remaining units, then only the units with HOME investments are HOME-assisted.
- When units **are** comparable, the minimum number of HOME-assisted units is based on one of the following:
  - The proportional share of total HOME-eligible costs paid with HOME funds, in relation to the total eligible development cost
  - The maximum per unit subsidy limit, in relation to the total eligible development cost.

The HOME maximum per unit subsidy is based on the 221(d)(3) limits. These limits are available on the HOME Program website at <http://www.hud.gov/homeprogram/>.

Exhibit 2-16 illustrates how to determine the minimum number of HOME-assisted units in a project with comparable units.

The PJ may designate more than the minimum number of HOME-assisted units, if it so chooses.

**Exhibit 2-16: Example: Determining the Minimum Number  
of HOME-Assisted Units When the Units Are Comparable**

**Scenario:** The Paradise PJ plans to develop a 10-unit rental property. It will invest \$450,000 in HOME funds. The maximum per unit subsidy for the planned bedroom size in this locality is \$80,000. The units are comparable, as they all have the same square footage, two bedrooms, and the same amenities.

Paradise PJ must perform two tests, to determine the *minimum* number of units that it must designate as HOME-assisted.

**Test 1: Fair Share Test**

Step 1: Determine the total eligible project costs.	\$900,000
Step 2: Determine the planned HOME investment.	\$450,000
Step 3: Divide the HOME investment by the total project cost and convert to a percentage.	$\$450,000/\$900,000$ $= .5$ $= 50\%$
Step 4: Multiply the number of total units in the development by the cost percent (determined in Step 3), to get the pro-rata share.	$10 \text{ total units}$ $\times 50\%$ $= 5 \text{ units}$
Step 5: If the result is not a whole number, round up.	

**Test 2: Per Unit Subsidy Test**

Step 1: Determine the total eligible project costs.	\$900,000
Step 2: Identify the maximum per unit subsidy.	\$ 80,000
Step 3: Divide the total eligible project costs by the maximum per unit subsidy.	$\$450,000/\$80,000$ $= 5.6 \text{ units}$
Step 4: Note—if the result is not a whole number, round up:	6 units

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**Minimum Number of HOME Units is the greater number of the Fair Share Test and the Per Unit Subsidy Test**

**Paradise PJ must designate at least six of the units as HOME-assisted.**

For more information on determining the number of HOME-assisted units in a property, refer to HUD Notice CPD-98-02, *Allocating Costs and Identifying HOME-Assisted Units in Multifamily Projects*, issued March 18, 1998. This Notice is available online at <http://www.hud.gov/homeprogram/>.



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## ATTACHMENT 2-3: HOW TO DETERMINE THE HOME COST ALLOCATION

The approach to determining the cost allocation depends on whether or not the units in the project are comparable units, meaning similar in size, quality, and amenities. For example, if the HOME-assisted two bedroom units have the same square footage, features (e.g., refrigerators), and finishes (e.g., carpet) as the non-HOME-assisted two bedroom units, then these units are comparable. If the HOME-assisted units are smaller or have a lower quality of features or finishes than the non-HOME units, then the units are *not* comparable.

When the units that are HOME-assisted are not comparable to the non-HOME-assisted units, the PJ must determine cost allocation based on actual unit costs plus a fair share of common costs. When the units are comparable, a pro-rata method of cost allocation can be used, or the actual cost method can be used.

- **Pro-Rata Method of Cost Allocation.** If all the units in a multi-unit project are comparable, the PJ may determine its “fair share” of costs based on the portion of units that are to be HOME-assisted. The percentage of the total HOME-eligible costs that may be paid by HOME is equal to the percentage of units that are HOME-assisted. In general, the cost allocation equation may be described as:

$$\frac{\text{HOME UNITS}}{\text{TOTAL UNITS}} = \frac{\text{HOME INVESTMENT}}{\text{TOTAL ELIGIBLE DEVELOPMENT COSTS}}$$

It is important to note that this equation is based on total *HOME-eligible* costs, not all costs. If the project’s development budget includes ineligible items under HOME, such as swimming pools or luxury amenities, these costs must be subtracted before the percentage can be applied.

- **Actual Cost Method of Cost Allocation.** If all the units in a rental project are *not* comparable, or if the developer/PJ chooses to use this method, then the cost allocation is determined by assessing actual unit construction costs. In other words, the PJ or the architect/engineer must determine the specific and actual costs for the HOME units. This can be determined based upon the work write-up for these units. Once these unit costs are known, HOME can then pay for its “fair share” of the common costs such as the acquisition, eligible soft costs, or common areas such as lobbies, elevators, or roof.

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The PJ must always ensure that the HOME investment does not exceed the 221(d)(3) limit. (In rental housing, units that are not comparable must always be *fixed* rather than *floating units*.)

In general, the cost allocation equation for units that are *not* comparable may be described as:

$$\begin{array}{l} \text{Total Eligible Costs} \\ \text{for HOME Units} \end{array} + \frac{\text{HOME UNIT SQUARE FOOT}}{\text{TOTAL UNIT SQUARE FOOT}} \times \text{Eligible Common Costs}$$

Note, for both methods of cost allocation, the total amount of eligible costs directly relates to the number of HOME-assisted units in the project. If the financing gap in a project is greater than the amount of funds that can be allocated to the project, the PJ can increase the number of HOME-assisted units in order to increase the total amount of HOME funds that can be invested. PJs should be aware that adding additional HOME units may affect (lower) the property's rental income. This, in turn, could reduce the amount of first mortgage debt and increase the size of the funding gap.

If the PJ knows the total amount of investment it wants/needs to make in a project, Exhibit 2-17 illustrates the corollary principle of how to determine the minimum number of units that must be designated HOME-assisted.

### Exhibit 2-17: Illustrations of Cost Allocation

#### Example: Pro-Rata Cost Allocation – Comparable Units

Total Development Costs	\$1,500,000
Costs for Pool Repair	\$50,000
Total Number of Units	8
HOME-assisted Units	3
221(d)(3) Limit	\$160,000
\$1,500,00 (total cost) - \$50,000 (ineligible cost) =	\$1,450,000
3 HOME units/8 total units =	37.5%
\$1,450,000 (total eligible cost) x 37.5%	\$543,750
\$160,000 (maximum subsidy) x 3 =	\$480,000
Maximum investment is the lesser of either the proportionate share (\$543,750), or the maximum subsidy (\$480,000), assuming that the subsidy layering supports this. In this instance, the maximum HOME investment permitted is \$480,000.	

The example below illustrates the approach when units are not comparable.

Example: Actual Cost Allocation – Not Comparable Units	
Total Development Costs	\$1,500,000
Cost of the HOME Units	\$400,000
Total Common Costs	\$300,000
Costs for Pool Repair	\$50,000
Total Number of Units	8
HOME-assisted Units	3
Square footage of all Units	12,000 S.F.
Square footage of HOME Units	2,700 S.F.
221(d)(3) Limit (max per unit subsidy)	\$160,000
2,700 (HOME S.F.)/12,000 (total S.F.) =	22.5%
\$300,000 (total common costs) - \$50,000 (ineligible cost) =	\$56,250
\$250,000 x 22.5% =	
\$56,250 (per unit common cost) + \$400,000 (total HOME units cost) =	\$456,250
\$160,000 (221(d)(3) limit) x 3 units=	\$480,000
The maximum HOME investment is the lesser of the actual cost of the HOME units plus the prorated share of the common costs, or the maximum subsidy based on the per unit subsidy amount. In this case, the maximum HOME investment is \$456,250, assuming that the subsidy layering supports this.	

For more information on cost allocation, see *Allocating Costs and Identifying HOME-Assisted Units in Multifamily Projects*, HUD Notice CPD-98-02, issued March 18, 1998. This Notice is available on the HOME Program website at <http://www.hud.gov/homeprogram/>.

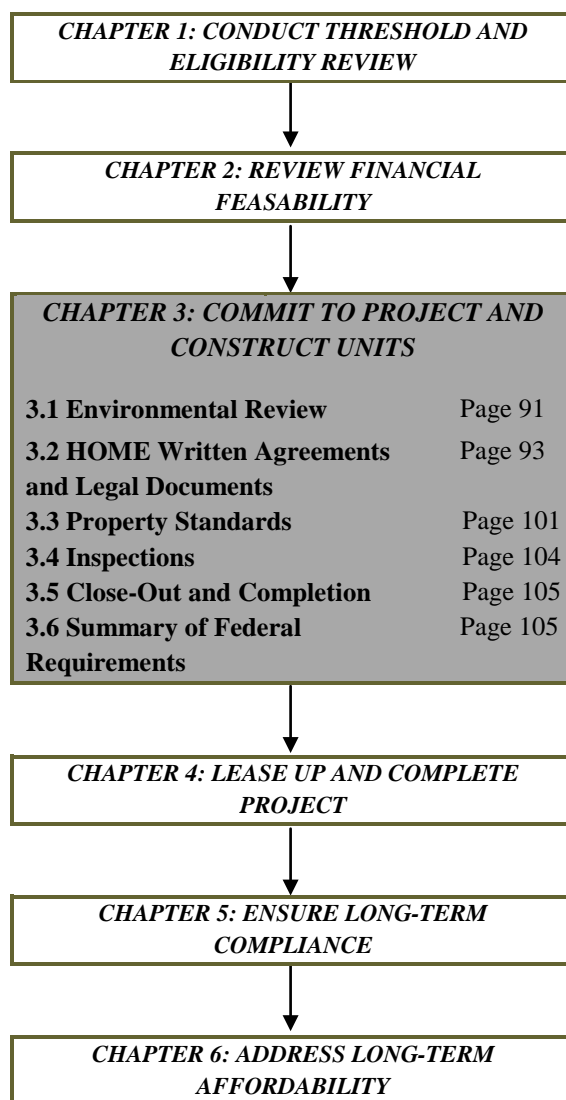
## CHAPTER 3: COMMIT TO PROJECT AND CONSTRUCT UNITS

Once the PJ has reviewed the HOME-LIHTC application and makes a decision to fund a project, it must take certain steps to secure that funding commitment, and must ensure that the property is constructed in accordance with applicable HOME requirements. This chapter reviews the requirements that apply to a HOME-LIHTC project during the project commitment and construction phases of development. Specifically, it reviews:

- Environmental review requirements that must be met before the PJ can make a commitment of HOME funds to the project
- Written agreements and other legal documents that are required for HOME and typical in LIHTC transactions
- Timing of investments
- Property standards requirements
- Other Federal requirements
- Project close-out and completion.

### 3.1 Environmental Review

HOME projects, unlike LIHTC projects, are subject to certain Federal environmental review requirements. Therefore, when HOME funding is invested in a tax credit project, the PJ must undertake an environmental review. The presence of tax credits presents important timing issues that the PJ must consider. LIHTC projects are under strict deadlines to meet carryover commitments and for placement in service. To ensure the LIHTC project meets these deadlines, the PJ must be sensitive to the LIHTC time constraints and undertake the environmental review as quickly as possible.



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## Environmental Review Requirements

Before a PJ can commit any HOME funds to a project, it must conduct an *environmental review* in accordance with 24 CFR Part 58 (also known as a “Part 58 review”) to ensure that the proposed project does not negatively impact the surrounding environment and that the property site itself is safe for development. The PJ and LIHTC owner are prohibited from taking any “choice limiting action” on the project (such as acquisition, demolition, or construction) until the environmental clearance is secured.

The environmental review is not generally required for the LIHTC program, and therefore it will not have been completed prior to the LIHTC owner’s application to the PJ for HOME funding. Under most tax credit project funding circumstances, the PJ will be considered the Responsible Entity (RE), and the release of funds must be approved by HUD.

PJs may also be subject to state or local environmental review laws. State or local requirements do not pre-empt the Federal standards. Both sets of requirements must be met. Generally, adherence to the more stringent standards (usually the Federal standards) can help to achieve compliance for both.

For more information on the PJ’s responsibilities in performing its environmental reviews in accordance with 24 CFR Part 58, see HUD Notice CPD-01-11, *Environmental Review and the HOME Investment Partnerships Program*, issued July 17, 2001, and available on the HOME Program website at <http://www.hud.gov/homeprogram/>.

### Determining the Level of Environmental Review

The environmental review process is the same for a HOME-LIHTC project as it is for any project that has HOME funding alone. HOME-LIHTC projects most likely will be classified as one of the following:

- **Subject to an environmental assessment** (24 CFR 58.36). Multifamily new construction, conversion, or substantial rehabilitation projects are subject to a full environmental assessment, known as the NEPA *Environmental Assessment (EA)*. An *Environmental Impact Statement (EIS)* may be triggered as a result of the EA, but this is not common among tax credit projects. It is unlikely that an EIS could be completed within the strict deadlines under the LIHTC rules, and such projects are not likely to be awarded credits until the environmental issues are resolved.

Note: Part 58 defines “major rehabilitation” to include projects where the costs of rehabilitation exceed 75 percent of replacement cost, the project increases density by more than 20 percent, or the project converts nonhousing space to housing use.

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- **Categorically excluded from NEPA requirements** (24 CFR 58.35). Existing residential projects that are subject to only minor rehabilitation and do not involve increases in density or changes in use are generally classified as “categorically excluded,” and are subject to only Part 58.5 and 58.6 authorities (commonly referred to as the “non-NEPA requirements” or the “Statutory Checklist”). If no environmental compliance issues are found, the project may be converted to exempt (24 CFR 58.34(a)(12)).

### Timing for the Environmental Review in a HOME-LIHTC Project

In any project, it is desirable to secure the environmental review quickly because no activity on a project can move forward until it is complete. However, if a project has an LIHTC allocation or that allocation is imminent, PJs will need especially to commence with the environmental review and determine the environmental classification of the project quickly. LIHTC projects are under strict deadlines to meet carryover and for placement in service requirements. Since PJs cannot commit funds and the developer cannot undertake “choice limiting activities” before clearance is secured, PJs need to be able to move quickly to conduct the review, so as not to jeopardize the developer’s ability to meet tax credit deadlines.

For some projects, there may be time-saving steps the PJs can take when initiating the environmental review process:

- For projects with other Federal assistance in addition to HOME, there may be opportunities to cooperate on the environmental review with other state or local entities that might also need to conduct environmental review for the other Federal funding source(s).
- For projects that are planned for multiple phases (because of tax credit availability or market absorption issues), aggregation is encouraged under Part 58. Aggregation enables the PJ to conduct the review of the entire project up-front. It gives a better picture of environmental impact, and it might save time in review of later phases.

## 3.2 HOME Written Agreements and Legal Documents

When underwriting is complete and environmental clearance is secured, the PJ is ready to execute a HOME written agreement and other legal documents that detail the HOME requirements and enable the project to proceed. In addition to the HOME written agreement and other legal documents required by the HOME Program, in a HOME-LIHTC project, the PJ also should review a set of project agreements and documents related to the LIHTC transaction. This is critically important so that the PJ can understand the structure of the LIHTC deal and ensure protection of HOME Program interests. Tax credit projects tend to be complex deals with multiple legal agreements.

PJs will need to analyze the following agreements:

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- Use restrictions imposed by the allocating agency and perhaps other lenders
  - Joint venture agreement, if the project involves multiple development partners
  - Partnership (or syndication) agreement between the developer and the investors
  - Inter-creditor agreement(s) between the lenders, including the PJ.

The PJ's legal counsel with expertise in both real estate law and tax law should be involved in the review of these documents.

### HOME Written Agreement

HOME requires the PJ to execute a written agreement with all recipients of HOME funds.

***Mortgage and loan documents are not sufficient to meet this requirement.*** The ***HOME written agreement*** must convey HOME requirements and impose enforcement provisions; it can also be a vehicle for the PJ to clarify roles and responsibilities, and establish terms and conditions that will enhance its asset management during the affordability period.

The HOME written agreement is the basis of making a commitment of funds. It precedes other legal documents that are recorded at closing, including the note and mortgage (or deed of trust) and the required deed restrictions. PJs may have different terms to refer to the commitment document for rental projects. The most common terms are the “loan commitment” or “project funding agreement.”

### ***Provisions in a HOME Written Agreement with a Developer***

The written agreement should describe all of the requirements of the HOME Program with which the developer must comply. Certain required provisions of the HOME written agreement with owners, developers, and sponsors of HOME-assisted housing are specified in the HOME Rule at 24 CFR 92.504(c)(3), as follows:

- Use of HOME funds
  - Affordability requirements
  - Project requirements (rental and tenant provisions)
  - Property standards
  - Other program requirements (such as affirmative marketing, relocation, etc.)
  - Records and reports
  - Enforcement of the agreement
-



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- Disbursement of funds provisions
  - Duration (affordability period)
  - If a CHDO project, CHDO provisions.

In addition to these required provisions, the PJ should incorporate additional provisions that facilitate monitoring and asset management, including:

- Definition of roles and responsibilities
- Procurement
- Performance standards
- Project audit or cost certification
- Buyout provisions (discussed in more detail in [Chapter 6](#)).

It is very important that the PJ have a clear understanding of how the owner will meet the HOME requirements. The written agreement should include strong enforcement provisions, to ensure that the PJ can enforce the HOME affordability requirements for the duration of the affordability period. In a HOME-LIHTC project, if the HOME affordability period is longer than the 15-year LIHTC compliance period, the PJ should evaluate whether it needs to tailor its enforcement provisions to the specific project. [Chapter 6](#) of this guide discusses exit strategies LIHTC investors might use upon expiration of the LIHTC compliance period, and how these might impact HOME compliance. The PJ should become familiar with the investor's exit strategy and determine if it needs to document any mitigating strategy in the HOME written agreement.

More information about developing HOME written agreements with owners, developers, and sponsors of HOME-assisted housing is forthcoming from HUD. When available, these guidebooks will be posted at <http://www.hud.gov/homeprogram/>.

### ***HOME Deed Restriction or Covenant***

In addition to requirements and restrictions in the HOME written agreement, the HOME Rule at 24 CFR 92.252(e) requires the PJ to impose a ***deed restriction or covenant*** running with the land (or some other legal mechanism approved by HUD) that places specific use or other restrictions on the property. This use restriction is needed to impose HOME requirements throughout the period of affordability, even in the event the HOME loan is repaid. The deed restriction or covenant should be a stand-alone document that is properly recorded as part of the closing package and is received by the PJ after recording. Do not put the use restrictions in the mortgage or loan documents.

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For a HOME rental project, the deed restriction or covenant imposes the following requirements:

- Designation of HOME-assisted units (24 CFR 92.252(j))
- Occupancy of assisted units (24 CFR 92.216(a) and 92.252(a) and (b))
- Initial and ongoing rent restrictions (24 CFR 92.252(a) through (c) and (f))
- Tenant eligibility (24 CFR 92.203 and 92.252(h) and (i))
- Period of affordability (24 CFR 92.252(e)).

#### **Recording the HOME Covenant**

*It is imperative that PJ staff verify that this legal mechanism is duly recorded to preserve its rights. The PJ should also require that the HOME restrictive covenants be recorded before mortgage documents are recorded to ensure their enforceability and survivability.*

Some PJs also incorporate property standards under 24 CFR 92.251 in this document. The PJ may also choose to incorporate its authority under zoning ordinances and local and state building codes to condemn a unit or building, fine an owner, or take possession of a property.

#### ***Note and Mortgage***

Typically, a ***note*** and ***mortgage*** (or a deed of trust in some states) and other loan documents are signed at closing and recorded. The note (also known as a promissory note) sets out the specific terms of the loan (interest rate, term, payment schedule); and the mortgage provides the lender a security interest in the property.

For HOME rental projects, ***a note and mortgage are not sufficient to meet regulatory requirements*** for a written agreement or to convey the HOME requirements. The HOME Program requires the use of a deed restriction to secure the HOME affordability requirements throughout the affordability period, as discussed in the previous section.

Nevertheless, a note and mortgage (or deed of trust) may be important and valuable tools for the PJ to secure its lien position to claim repayment of the HOME funds in the event of foreclosure, noncompliance, or other outcomes. Therefore, while not required by regulation, a note and mortgage should be considered by PJs in discussion with legal counsel.

If such documents are used, the PJ should ensure that they are recorded, and that copies of all closing documents, including agreements between other lenders and the owner/sponsor, are received after recording.

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### ***Locally-Imposed Affordability Period***

The PJ can opt to establish a longer period of affordability than that required by HUD. If the PJ does this, it is prudent to record two deed restrictions or covenants—the first to secure the HOME requirements and the second to establish the additional time period that is locally-imposed. Using two agreements ensures that the PJ does not inadvertently extend the period during which it might be subject to repay HOME funds to HUD in the event of noncompliance. After the end of the affordability period required by the HOME Rule, the local PJ specifies what requirements apply.

### ***Foreclosure-Proof Restrictions***

In a foreclosure, the HOME Rule allows the affordability restrictions required by the HOME Rule to be removed before the primary lender takes the property. This is a way of permitting lenders to maximize the amount of investment recouped in the event of a default and can remove concerns private lenders may have about participating in the HOME Program. Notwithstanding the termination of affordability restrictions conveyed to a lender due to foreclosure or transfer in lieu of foreclosure, the PJ must repay the HOME account because the project has not met the affordability requirements for the full affordability period.

The PJ may wish to include in its agreement with the owner, a right of purchase, right of first refusal, or other preemptive rights to help it reclaim the property in the event the property defaults to avoid foreclosure and loss of the affordable units.

For a complete discussion of this issue, see HUD's *HOMEfires*, Vol. 5 No. 2, issued June 2003. This is available on the HOME Program website at <http://www.hud.gov/homeprogram/>.

### ***Other Use Restrictions***

The LIHTC program, and potentially other public funding sources, also imposes use restrictions. These may be slightly different from those imposed by HOME. The PJ should review the LIHTC use restrictions to:

- Determine if there are any possible conflicts with the use restrictions imposed by HOME. The key differences between the affordability requirements of HOME and LIHTC are discussed throughout this guide. PJs should be aware of differences in income levels, rent limits, property standards, and over-income requirements.
- Identify any priority of these use restrictions over HOME, and possible compliance conflicts. PJs should also determine if there are opportunities for the various enforcement entities to cooperate in enforcing restrictions and doing workouts. These should be addressed in the inter-creditor agreements discussed below.

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***It is prudent to record separate deed restrictions or use agreements to impose the affordability requirements of each program,*** so that the PJ does not inadvertently extend the requirements of both programs throughout the period of compliance of the other program.

### Development Entity Agreements

By nature, LIHTC ownership entities are complex. At a minimum, there is likely to be an agreement between the general partner (the developer) and limited partners (the investors). This is usually called the “Partnership Agreement.” Sometimes, there are multiple general partners, especially in cases where CHDOs and other nonprofits team with for-profit developers.

While it is not the responsibility of the PJ to review the legality of these agreements, it is important that the PJ review these agreements to identify issues that may affect the ability of the project to comply with HOME requirements, to remain viable for the HOME affordability period, and to repay the HOME investment under various circumstances.

Partnership or syndication agreements are executed between the general partner(s) and the investors; they document the terms under which the limited partner investments will be made. Some of the key items to review are:

- Performance obligations and guarantees of the developer
- Residual interests and buyout provisions at the end of the partnership. These are discussed in more detail in [Chapter 6](#).

In projects where there are multiple general partners, there is typically a joint venture agreement or other legal agreement between the partners. This agreement governs how the roles, responsibilities, risks, and fees are to be divided. This is important because it specifies how the entity will implement the project. It should be reviewed by the PJ to determine if everything is clearly laid out.

PJs need to review carefully those joint venture agreements that involve CHDOs. 24 CFR 92.300(a)(1) specifies that CHDO set-aside funding may only be provided to projects in which the CHDO is the managing general partner. HUD’s requirement is that the CHDO must have 51 percent interest in this joint venture entity, and be in control of the key development decisions. PJs need to review the joint venture agreement to determine if the CHDO has the controlling interest and control of the decision-making process.

#### **CHDO Joint Venture Negotiation Tips**

*See Tool 5 in the CHDO Survivor Kit in the HOME Model Guide series for some tips on negotiating joint ventures and executing joint venture agreements. This guide is available on the HOME Program website at <http://www.hud.gov/homeprogram/>.*

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Some CHDOs and nonprofits are inexperienced with tax credit projects, and may not negotiate agreements that adequately protect their interests or controlling rights. While the primary focus of PJ review should be on the regulatory compliance issue, PJs may want to use this opportunity to provide technical assistance to these organizations to help them negotiate better partnerships in the future.

### Inter-Creditor Agreements

Many LIHTC projects involve multiple lenders, both public and private. Typically, a private lender provides a first mortgage, and one or more public lenders or intermediaries provide gap financing – construction, bridge, and permanent. With multiple lenders involved, there is a need to determine issues that arise among and between the creditors. These are documented in an Inter-Creditor Agreement.

Some of the key inter-creditor issues are:

- **Lien priority.** The lien position is critically important to PJs because of the requirement to repay the HOME funds in the event the project is foreclosed upon or otherwise fails to achieve completion and compliance (see 24 CFR 92.503(b)). If there is a foreclosure, lien holders are paid in order of lien priority, so the lower the PJ's lien position, the greater the risk it will not recover all of its HOME funds. The PJ should negotiate the highest lien position possible, particularly when there are multiple subsidy lenders involved in a project. An emerging trend is for multiple subsidy lenders to agree to a *pari passu* lien structure, where the lien position and rights are shared to simplify legal negotiations and documents. Exhibit 3-1 provides an example of this.

#### Exhibit 3-1: Example of Pari Passu

Consider a project where the HOME PJ and a CDBG grantee share a second lien position behind the private 1<sup>st</sup> mortgage lender on a deal that has outstanding balances on the mortgages at the time of foreclosure as follows:

\$2,500,000	1st mortgage private lender
\$ 500,000	shared 2 <sup>nd</sup> mortgage HOME PJ
\$ 500,000	shared 2 <sup>nd</sup> mortgage CDBG grantee

The 1<sup>st</sup> mortgage lender forecloses and sells the property at auction for \$3,000,000. The 1<sup>st</sup> mortgage holder gets the first \$2,500,000, reflecting its first lien position. The remaining \$500,000 is split on a pro rata basis between the HOME PJ and the CDBG grantee, providing each with \$250,000.

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- **Disbursement order and procedures.** Most lenders and developers assume that public funds like HOME should be the first disbursed to a project, as these funds usually have the lowest interest rates. However, the first dollars disbursed are the riskiest dollars in the project. The PJ has a number of competing needs to balance when negotiating this point. To equally share risk with the other investors, the PJs may want to seek pro-rata distribution from the various sources. By investing HOME funds early in the construction process, however, the PJ may be able to reduce the need for construction financing, thereby reducing the cost of the project, and reducing the overall need for HOME funds. Additionally, if the PJ funds are invested early and the contribution of equity from the LIHTC investor is delayed, this may result in a higher price for the tax credits (as discussed in [Chapter 2](#)).
  - **Enforcement of provisions.** The PJ needs to be able to enforce all HOME rules, both during construction and in occupancy. Typical subordination requirements limit a junior lien holder's ability to enforce provisions without the consent of the senior lien holder. This needs to be resolved in advance. Senior lenders will need assurance that rule enforcement will not jeopardize the viability of the project.
  - **Foreclosure rights and procedures.** In the event of default and foreclosure, the senior lender usually wants to reserve all rights to itself, and to be able to proceed as necessary toward foreclosure, unfettered by junior lien holders. However, PJs need to communicate their repayment risk in the event of foreclosure, and secure agreement with the senior lien holder to give the PJ rights to prevent foreclosure or take action in lieu of foreclosure to ensure continued affordability. Senior lien holders cannot be expected to have endless patience, but may accept terms which provide for a notification of delinquency to the PJ and forbearance on foreclosure for a short period of time to allow the PJ to intervene, correct the default, and even assume or assign control.

These and other issues are usually contained in an inter-creditor agreement, which must be negotiated among the lien holders. PJs should not assume that the other lenders understand the repayment risk of the PJ. PJs need to communicate this issue to the lenders, and negotiate for the rights the PJ needs to protect its interest.

Inter-creditor negotiations also might address longer-term control issues, including balloon debt, partnership buyouts, and other long-term strategies. This is important to a PJ. A newly constructed tax credit project has a HOME compliance period of 20 years, while the partners can be bought out in 15 years, and the senior debt might be structured to this term. This issue is explored in more detail in [Chapter 6](#) of this guide.

### 3.3 Property Standards

The HOME Program has multiple requirements with regard to *property standards* and condition, and these generally exceed what is required for the LIHTC program. Therefore, the PJ should make sure the LIHTC developer understands these requirements, and that any adjustments to the plans and specifications are made accordingly.

#### Codes and Standards

At the conclusion of construction or rehabilitation, HOME-funded properties must comply with applicable codes and standards. The property codes that are applicable to HOME-LIHTC projects include:

Type of rental activity	Applicable Property Standards
New Construction	<ul style="list-style-type: none"><li>• State/local codes and standards or model codes (if no state/local codes)<sup>4</sup></li><li>• International Energy Conservation Code</li><li>• Uniform Federal Accessibility Standards (for accessible units)</li><li>• Site and neighborhood standards (24 CFR 983.57(b))</li></ul>
Rehabilitation	<ul style="list-style-type: none"><li>• State/local codes and standards or model codes (if no state/local codes)</li><li>• PJ written rehabilitation standards</li><li>• Uniform Federal Accessibility Standards (for accessible units)</li></ul>

<sup>4</sup> Since the promulgation of the HOME Program regulations, these code issuing agencies have merged to form the International Code Council (ICC). The model codes used for the HOME Program are no longer being updated. In their stead, the ICC has issued the International Building Code. HUD will consider whether changes to the HOME regulations incorporating the International Building Code are appropriate. The HOME Program website provides updated information on all HOME requirements. (See <http://www.hud.gov/homeprogram/>.) For more information about the International Building Code, see <http://www.iccsafe.org>.



Ongoing rental occupancy	<ul style="list-style-type: none"> <li>• Applicable state and local housing codes or Housing Choice Voucher Program Housing Quality Standards (formerly Section 8 HQS)</li> </ul>
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While most of the codes and standards are established outside of the HOME Program, each PJ must develop written rehabilitation standards to apply to all HOME-funded rehabilitation work. These standards define the quality and functionality of a property upon completion of rehabilitation. They include the methods and materials to be used when performing rehabilitation activities, but can also include other elements preferred or required in rehabilitation, including standards for energy efficiency and useful life of structure and systems.

While the LIHTC program does not impose property standards on new construction or rehabilitation, some states impose property standards through the QAP (such as Energy Star). LIHTC requires ongoing inspections based on the HUD Uniform Property Conditions Standards at 24 CFR 5.703.

### Accessibility Requirements

HOME-funded programs are subject to several Federal laws governing *accessibility for persons with disabilities*. Key among these are:

- Section 504 of the Rehabilitation Act of 1973 (24 CFR Part 8)
- Fair Housing Act, as amended (24 CFR Part 100).

Generally, these laws ensure that individuals with disabilities have access to programs and activities that receive Federal funding, and impose structural requirements for the design and construction of housing. LIHTC projects are subject to the Fair Housing Act requirements, but they are not subject to Section 504. PJs must be certain that HOME-LIHTC properties meet the requirements of both laws.

The technical specifications required by Section 504 apply the *Uniform Federal Accessibility Standard (UFAS)*, which is generally a higher standard of accessibility than that imposed by the Fair Housing Act. Since UFAS does not typically apply to tax credit units, it is important for PJs to be sure that architect and construction contractors of the HOME-LIHTC project understand the specific UFAS standard for any units that are designated as accessible to meet the Section 504 requirements.

In addition to the design and construction standards, Section 504 requires that the PJ's program, when viewed in its entirety, be readily accessible to, and usable by, persons with disabilities. This requirement may have some operational implications for the property's management (such as requirements for accommodations for persons with disabilities, and defining disability).



## Lead-Based Paint Requirements

When the HOME-assisted project involves rehabilitation of a property that was constructed prior to 1978, the rehabilitation is subject to the **lead-based paint** regulations at 24 CFR Part 35.<sup>5</sup> The LIHTC program does not specifically impose lead-based paint rehabilitation standards. However, tax credit properties are subject to the HUD Uniform Property Conditions Standards (UPCS) and all tax credit properties (including pre-1978 properties) are subject to ongoing inspections and paint maintenance requirements.

A HOME-LIHTC project must meet the lead-based paint requirements of both programs. In general, the HOME lead-based paint requirements are more stringent than those imposed by LIHTC. These requirements vary, based on the amount of Federal rehabilitation assistance per unit, as summarized in Exhibit 3-2.

**Exhibit 3-2: Summary of Federal Lead-Based Paint Requirements**

Rehabilitation (Subpart J)			
	≤ \$5,000	\$5,000 - \$25,000	> \$25,000
<b>Approach to Lead Hazard Evaluation and Reduction</b>	Do no harm	Identify and control lead hazards	Identify and abate lead hazards
<b>Notification</b>	Yes	Yes	Yes
<b>Lead Hazard Evaluation/Assessment</b>	Paint Testing (of surfaces to be disturbed)	Paint Testing and Risk Assessment	Paint Testing and Risk Assessment
<b>Lead Hazard Reduction</b>	Repair surfaces disturbed during rehabilitation  Safe work practices Clearance	Interim Controls  Safe work practices Clearance	Abatement (Interim Controls on exterior surfaces not disturbed by rehabilitation)  Safe work practices Clearance
<b>Ongoing Maintenance</b>	For HOME rental	For HOME rental	For HOME rental

<sup>5</sup> Some pre-1978 properties may be exempt under 24 CFR 35.110, including properties that are LBP-free or LBP-removed, zero bedroom units, and rehabilitation that will not disturb any painted surfaces.

	only	only	only
<b>EIBLL Requirements</b>	No	No	No
<b>Options</b>	Presume lead-based paint. Use safe work practices on all surfaces.	Presume lead-based paint and/or hazards. Use standard treatments.	Presume lead-based paint and/or hazards. Abate all applicable surfaces.

Ongoing maintenance requirements also apply to HOME rental projects during the affordability period, and are discussed in [Chapter 5](#).

### Enforcement of Labor Standards during Construction

The HOME Program imposes certain **labor standards** during construction. None of these standards typically apply in an LIHTC-only project; therefore, the PJ must be sure that the LIHTC owner understands and complies with these requirements. The HOME labor-related requirements are summarized in the last section of this chapter. Among the requirements are Equal Employment Opportunity, Minority and Women Owned Business Enterprise outreach, Davis-Bacon labor standards for projects of 12 or more HOME-assisted units, and Section 3 requirements for awards over \$200,000 and construction contracts over \$100,000.

## 3.4 Inspections

Property inspections during construction and upon completion are important to document compliance with property standards, and conformance to approved plans and specifications, and to verify the basis of payments. When there are multiple funders involved, it is recommended that the involved parties coordinate the inspections. However, PJs need to rely on inspections done by persons who have a programmatic relationship with the PJ. Particularly because the HOME property standards are more stringent than the LIHTC property standards, the PJ cannot rely on the state allocating agency to inspect on the PJ's behalf.

The following inspections are recommended for a HOME-LIHTC project:

- **Progress inspections.** During construction, and at least at every point in the contract when payment is requested by the contractor, the property should be inspected to verify that:
  - Stated work is completed to justify payment.
  - The contractor is complying with all applicable work, labor, and contracting provisions.

- 
- Work complies with safe work practices and the interim controls or abatement requirements of the job, if lead-based paint rules apply.
  - **Final inspections.** At the end of construction, a final inspection(s) is needed to:
    - Verify completion of the scope.
    - Determine the punch list of uncompleted items.
    - Obtain certificates of occupancy.
    - Certify compliance with applicable standards prior to occupancy.
    - Approve release of retainage.

### 3.5 Close-Out and Completion

PJs should have well-established procedures for closing out projects; and the state allocating agency will also have well-established close-out procedures. The LIHTC owner will have to satisfy the close-out requirements of both agencies. Typical closeout procedures include collecting: all permits, inspection reports, warranties, as-built drawings and other documentation of completion; and final disbursement records, releases of liens, and cost certification or project audit, as required. Cost certification is required by the LIHTC program.

Under HOME rules, a project must be closed out within 120 days of the final disbursement. A project is not completed for purposes of closing out the project in the Integrated Disbursement and Information System (IDIS) until it is fully occupied by income-eligible tenants. [Chapter 4](#) discusses the process of closing out the project upon occupancy.

PJs also should use this opportunity to check in with all other funders to ensure that full compliance with all requirements has been achieved. Disputes with other funders can delay final closing or cause financial hardships.

### 3.6 Summary of Federal Requirements

Many, but not all, of the requirements related to project commitment, construction, and completion have already been discussed in this chapter. Below is a summary chart of all of the ***Federal requirements*** that apply to HOME projects. In general, these other Federal requirements do not apply to LIHTC projects. The PJ should inform and educate the LIHTC owner about these requirements, and provide sufficient monitoring to ensure compliance.

### Federal Requirements for HOME Rental Projects

Requirement	Impact on the Project
Procurement 24 CFR 85.36	Depending on the PJ's procurement policies and the size of the contract being awarded, selection of a contractor may require competitive bidding, or the PJ may need to do cost estimating and cost analysis to determine reasonableness of the project costs as proposed.
Contractor Selection 24 CFR 85.35	The PJ must check the website at <a href="http://www.epls.gov">http://www.epls.gov</a> to determine if a contractor has been suspended or disbarred before awarding HOME funds to any firm.
Section 3 24 CFR 92.508(a)(7) 24 CFR Part 135	Construction contracts of \$100,000 or more (where the project assistance is \$200,000 or more) must include language regarding best efforts to include businesses and low-income residents in the project area. This applies to the hiring and training of additional workers, and using project-area suppliers for materials. Section 3 may impose specific hiring goals for the project that may impact how quickly the project can get under construction.
Women/Minority Business Enterprise 24 CFR 92.351(b)	All competitive bidding must include Women and Minority Businesses, including subcontracts. PJs must ensure that these firms have a fair opportunity to participate.
Labor Requirements, including Davis-Bacon 24 CFR 92.354	Before beginning construction or rehabilitation of projects with <b>12 or more HOME-assisted units</b> , the PJ must obtain the prevailing wages for various building trades from the Dept. of Labor. The PJ must designate staff to monitor onsite work and payrolls; report as required by Davis-Bacon and related requirements.
Equal Employment Opportunity 24 CFR 85.36	PJs must ensure that all construction contracts over \$10,000 (including subcontracts) have language prohibiting employment discrimination based on race, color, religion, sex, or national origin.
Conflict of Interest	Conflict of interest pertains to the PJ, both with respect to

24 CFR 92.356	contracts and unit benefits. Rental project owners are subject to conflict of interest requirements with respect to award of rental units. PJs need to be fully aware of parties involved in a contract and seek legal counsel if there is the potential for real or perceived conflict of interest.
Fair Housing and Section 504 24 CFR 92.350 24 CFR 92.508(a)(7)	PJs and partners must ensure nondiscrimination in all aspects of the housing program, and develop units that meet a minimum standard of accessibility in accordance with Section 504 and the Fair Housing Act.
Affirmative Marketing 24 CFR 92.351(a)	PJs must develop and adopt an Affirmative Marketing Plan to ensure that there is outreach to those least likely to apply for housing. The plan applies to properties with <i>five or more HOME-assisted units</i> .
Uniform Relocation Act and Section 104(d) 24 CFR 92.353	<p>The PJ is ultimately responsible for ensuring that tenants in properties that may be acquired or rehabilitated with Federal funds receive correct and timely notices and protections; and tenants living in units purchased with HOME funds are protected by the URA.</p> <p>If units are demolished or converted with HOME funds, Section 104(d) (one-for-one replacement) may be triggered and appropriate notices and assistance must be provided.</p> <p>Since no one can be forced to move (displaced) without at least 30 days' notice, a project that involves relocation may not meet a developer's schedule.</p>
National Environmental Policy Act (NEPA) 24 CFR Part 58	PJs are responsible for ensuring that the environmental review process is satisfied before nonexempt HOME funds are committed to a specific project.
Site and Neighborhood Standards	New construction rental projects must meet site and neighborhood standards that place limiting conditions on building in areas of "minority concentration" and are "racially mixed." PJs must maintain records that document the results of

24 CFR 983.6(b)	the site and neighborhood standards review.
Lead-Based Paint Requirements 24 CFR Part 35	PJ and developers must ensure that all HOME-assisted units fully comply with the lead-based paint requirements in 24 CFR Part 35 which specifies the four approaches to addressing lead-based paint in projects and the requirements for notifications, evaluations, reduction, ongoing maintenance, recordkeeping, and relocation.

## CHAPTER 4: LEASE-UP AND PROJECT COMPLETION

This chapter reviews the HOME and LIHTC requirements that apply during the lease-up phase of the property, including the requirements for project completion. Specifically, this chapter addresses the following:

- Income targeting
- Income determinations
- Rents
- Leases
- Tenant selection
- Project completion.

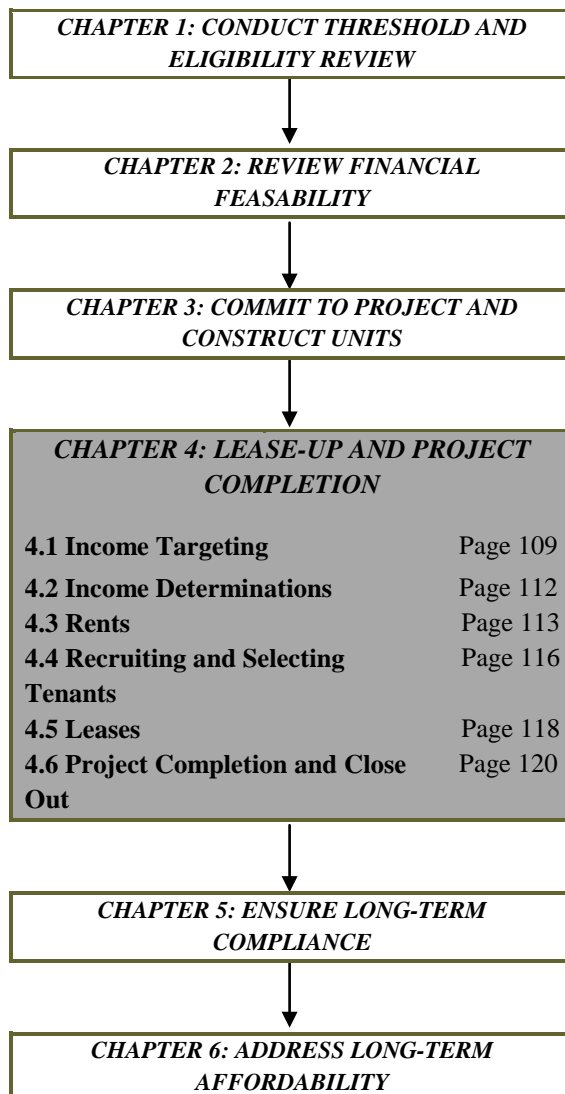
As previously discussed, the requirements that apply to each unit depend on whether that unit is considered a HOME-assisted unit, an LIHTC-assisted unit, or both.

### 4.1 Income Targeting

Both the HOME and LIHTC programs have specific tenant *income targeting* requirements that affect initial and continued occupancy throughout the affordability period. *Income targeting* is the process of designating units by the income of their occupants. These requirements apply to the HOME-assisted and LIHTC-assisted units of a property.

*This chapter uses the term “property manager” to refer to the person or entity that is carrying out property management tasks for the project. It applies equally to property management staff, contracted property management entities, and owners that carry out property management functions for the property.*

Note that both programs also have rent restrictions to ensure that these income-eligible tenants can afford the rents of the assisted housing. Section 4.3 of this chapter discusses these rent restrictions.



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Income targeting requirements may be determined up-front during the underwriting process, but the implementation of the income targeting requirements begins during the project's lease-up phase. Property managers must be familiar with the income targeting requirements imposed by the underwriting process, as well as the specific income limits that are imposed by the regulations of the two funding sources. For a particular project, the income targeting will be specified in the HOME written agreement and the LIHTC Use Agreement.

Income targeting may vary from project to project. However, overall, the following minimum income targeting requirements apply to the HOME Program:

- **Low-income occupancy.** All HOME-assisted units must be occupied by low-income households, whose annual gross incomes do not exceed 80 percent of area median income (AMI).
- **Program Rule.** The *program rule* requires that, at initial occupancy, 90 percent of the households served across all of the PJ's rental programs, must have annual gross incomes that are at or below 60 percent of AMI. For each project, the PJ needs to determine how this rule applies. Many PJs restrict initial occupancy of High HOME Rent units to tenants that have annual gross incomes that do not exceed 60 percent of AMI.
- **Project Rule.** The *project rule* requires that, at initial occupancy and throughout the period of affordability, in projects with five or more HOME-assisted units, 20 percent of the households that occupy HOME-assisted units must be very low-income (that is, have annual gross incomes that are at or below 50 percent of AMI). The units that the very low-income households occupy are called Low HOME Rent units.

LIHTC has a minimum set-aside requirement that one of the following must be met:

- 40 percent of units must be affordable to households whose annual gross incomes are at or below 60 percent of AMI.
- 20 percent of the units must be affordable to households whose annual gross incomes are at or below 50 percent of AMI.

These income targets are the LIHTC minimums for the program. The state allocating agency may impose additional income targeting in its *Qualified Allocation Plan (QAP)*, and, developers can propose deeper targeting in the application process as well. The income targeting chosen must be met at initial occupancy and throughout the LIHTC compliance period.

On an annual basis, HUD updates and issues the HOME and LIHTC income limits. The HOME income limits are issued for both low-income and very low-income households.



## Combining the Two Rules at Initial Occupancy

For any property that is funded by both HOME and LIHTC, there may be some combination of units in the property that carry a variety of designations (HOME-assisted, LIHTC-assisted, or both HOME- and LIHTC-assisted). For each unit type, the income targeting rule that applies to that unit type must be met. ***If a unit carries the designation of both programs, it must meet the more restrictive of the two income limit requirements.*** Exhibit 4-1 specifies the income limits that are imposed for each unit type.

Consider a unit that is designated as both an LIHTC unit and a Low HOME Rent unit:

- The tax credit income limit for the project requires that tax credit units be occupied by tenants with incomes at or below 60 percent of AMI.
- The HOME income limit for a Low HOME Rent unit restricts occupancy to tenants with incomes at or below 50 percent of AMI.

For this unit to meet the requirements of both programs, it must be occupied by a household that has an income at or below 50 percent of AMI because it is the lesser of the two income limits.

**Exhibit 4-1: Applicable Income Limits, by Unit Type**

Unit Type	Applicable Income Limit
HOME-assisted High HOME Rent unit	HOME low-income limit (at or below 80% AMI), unless otherwise specified by the PJ
HOME-assisted Low HOME Rent unit	HOME very low-income limit (at or below 50% AMI), unless otherwise specified by the PJ
LIHTC-assisted unit	Tax credit limit (either at or below 60% or 50% AMI, or lower depending on restrictions reflected in the LIHTC Use Agreement)
HOME- and LIHTC-assisted unit	<b><i>Lesser of</i></b> HOME income limit or the tax credit income limit
Market rate unit	No income restrictions

The written agreement and deed restriction should clearly specify the tenant income requirements at initial occupancy and over the period of affordability.

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## 4.2 Income Determinations

The process of making income-eligibility determinations for applicants who will reside in a HOME and/or LIHTC unit is substantially the same for both programs. The property manager must determine the household's annual gross income and compare it to the current income limits for the applicable program. The PJ must define income so that the property manager knows what income to "count." If the applicant's income is greater than the income limit that applies to that unit, the household cannot occupy the unit.

### Definition of Income

The HOME Program permits the PJ to choose the definition of income from three options: the Part 5 definition (also known as the "Section 8" definition); the IRS 1040 Adjusted Long Form; or the U.S. Census. However, the LIHTC program requires the use of the Part 5 (Section 8) definition. Therefore, for HOME-LIHTC projects, the PJ should adopt the Part 5 definition so that it complies with both programs. The PJ must provide this definition to the owner (ideally in the written agreement between the PJ and the owner) and provide guidance on how to apply the definition to the income determination process.

### Income Calculation

For both HOME and LIHTC, when determining the tenant household's income, the following rules apply:

- The income of all adult household members must be included.
- The determination must be based on income that is expected in the next twelve months.
- For the initial income-eligibility determination, property managers must examine income *source documents* to verify the accuracy of the income information that the tenant reports on the application.

There is not an asset limit or "asset test" in the HOME Program; however, the LIHTC program requires tenants to certify asset amounts and asset income that are more than \$5,000. The HOME Program requires all asset income to be verified with source documentation regardless of definition. Therefore, all asset income must be verified for the applicant of any unit that is counted as both an LIHTC and a HOME unit.

### Comparing Household Income to Applicable Income Limits

Once the property manager determines the tenant household's annual gross income, it must compare the household's income amount to the current income limits for the property, based upon the unit type, whether the unit is HOME-assisted only, LIHTC-assisted only, or HOME-

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and LIHTC-assisted. When the unit carries both designations, the lesser of the income limits applies.

Note that income limits are published by HUD for both programs, but the income limits for each may be published and effective at different times. Managers must be sure to check the income limits posted for each of the programs, as applicable, and note the effective dates.

The following tools can help the property manager determine tenant income:

- **Online Income Calculator.** The *Online Income Calculator* calculates a household's income and determines if it meets HOME income-eligibility requirements. It is available as a Tool on the HOME Program website at <http://www.hud.gov/homeprogram/>.
- **HUD Publication.** The HOME Program's model program guide, *Technical Guide for Determining Income and Allowances for the HOME Program, Third Edition* (HUD 1780-CPD, issued January 2005) provides instructions and forms to determine tenant income for the HOME Program. This guide is available at no cost from the HOME Program website at <http://www.hud.gov/homeprogram/>.

### 4.3 Rents

Once the property manager has identified an income-eligible occupant for a unit, it must determine what rent it will charge for the unit.

Generally, the rent structure for the property is established during the financial feasibility and sustainability phase of the project (see [Chapter 2](#)). For sound financial operations, the property manager needs to strive to achieve the underwritten rents in order to keep the property's revenue within the projections. However, in day-to-day management, there may need to be some flexibility with rents of specific units to enable the manager to keep units occupied.

In order to exercise sound judgment when establishing rents and ensuring compliance with the affordability restrictions of both the HOME Program and the LIHTC program, the property manager needs to understand how to use each program's rent limits and related utility allowances and which rent limits apply to each unit type (HOME-assisted, LIHTC-assisted, and HOME- and LIHTC-assisted).

#### HOME and LIHTC Rent Limits

Within a given property, there are a number of rent limits that might apply to different units:

- HOME-assisted units must use either *High HOME rent limits* or the *Low HOME rent limits* (for at least 20 percent of the units in projects with five or more HOME-assisted units).

- LIHTC units must use rents based on 30 percent of either 50 percent or 60 percent of AMI, depending on the use restrictions imposed on the project.

[Chapter 2](#) reviews the bases of these HOME and LIHTC rent limits and discusses how to use utility allowances.

### Combining the Two Rules

The rent limit that applies to a specific unit is based on the unit type. *If a unit carries the designation of both programs, it must meet the more restrictive of the two rent limit requirements.* Exhibit 4-2 specifies the rent limits that are imposed for each unit type.

**Exhibit 4-2: Applicable Rent Limits, by Unit Type**

Unit Type	Applicable Rent Limits
HOME-assisted High HOME Rent unit	High HOME Rent
HOME-assisted Low HOME Rent unit	Low HOME Rent
LIHTC-assisted unit	Tax credit rent limit (30% of either 50% or 60% AMI, or a lower AMI, depending on the use restrictions applicable to the property)
HOME- and LIHTC-assisted unit	<b>Lesser of</b> HOME rent limit that applies (either High or Low HOME Rent unit, depending on the unit designation) or the tax credit rent limit
Market rate unit	No rent restrictions (rent is based on what the market can bear)

HUD updates and issues the HOME income and rent limits on an annual basis. The HUD-issued rent limits are adjusted for different localities and for each bedroom-size unit from zero (efficiency) to six bedrooms. For LIHTC, state credit agencies compute the rent limits based on the HUD-issued income limits for the jurisdiction.

The property manager must deduct any tenant-paid utility allowance (using the applicable utility allowance) from the rent limits of each program in order to determine the maximum rent that can be charged for the unit.

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Further, the rent structure must be approved by the PJ (and documented in the written agreement) and rents may not be increased without the PJ's permission.

### Project-Based and Tenant-Based Rental Assistance

Both the LIHTC and HOME Programs make certain exceptions to the rent limits for units with project-based rental assistance where tenants pay no more than 30 percent of their income for rent and tenant-paid utilities.

The following rent limit rules apply to units with a project-based rental subsidy:

#### **For a unit that is HOME-assisted only:**

- **High HOME Rent unit with project-based assistance.** The *lesser of* the project-based rent or the High HOME Rent may be charged when the tenant household is low-income, but not very low-income, *or* if the tenant pays more than 30 percent of its income towards rent.
- **Low HOME Rent unit with project-based assistance.** The project-based rent may be charged (even if it is higher than the Low HOME Rent) for any unit that meets three conditions:
  1. Receives state or Federal project-based rental assistance
  2. Is occupied by a very low-income tenant
  3. Tenant household pays no more than 30 percent of its adjusted monthly income toward rent.

**For an LIHTC-assisted unit,** the rent for each unit is established so that tenant monthly housing costs, including a utility allowance, do not exceed the applicable LIHTC rent limit. The LIHTC Program restricts only the portion of the rent paid by the tenant, not the total rent. As a result, rental assistance programs can be used to raise the total rent above the LIHTC rent limit. The maximum rent cannot exceed the *greater of* the LIHTC rent limit or the rent limit established by the rental assistance program. When there is rental assistance, the tenant portion cannot exceed the LIHTC rent limit, less the utility allowance.

**For a unit that is both HOME- and LIHTC-assisted,** the following rent limits apply:

- **High HOME Rent Unit.** The most restrictive rent of the three programs applies to the unit. That means the rent limit is established at the *lesser of*:
  1. The High HOME Rent
  2. The LIHTC rent
  3. The project-based rental assistance program rent.

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- **Low HOME Rent Unit.** The rent cannot exceed the project-based rental assistance program rent limit.

Note that neither program makes an exception to its rent limits when a unit is occupied by a tenant that has a tenant-based rental subsidy, since this subsidy is portable with the tenant.

It is important to note that both HOME and LIHTC have floor rents that prevent rent limits over time from falling below initially approved rent limits, and these may need to be taken into account when determining applicable rent limits annually over the compliance period.

## 4.4 Recruiting and Selecting Tenants

Both the HOME and LIHTC programs impose certain requirements related to fair housing, marketing (the recruitment of tenants), and tenant selection policies and procedures. In addition, HOME requires PJs to approve marketing and tenant selection procedures. HOME also imposes affirmative marketing requirements to projects with five or more HOME-assisted units. When combining these sources of funds, the requirements of both programs must be met.

### Fair Housing

Both HOME and tax credit projects are subject to the *Federal Fair Housing Act*. This means that property managers of HOME- and LIHTC-assisted housing are prohibited from discriminating on the basis of race, color, religion, sex, familial status, national origin, and disability, in all aspects of the rental housing program administration and management. Owners and managers cannot discriminate in the leasing of units, in establishing terms and conditions of property rentals, or in advertising the availability of rental housing units. Additional state and local fair housing laws may also apply.

### Marketing

Owners of HOME- and LIHTC-assisted rental housing and their property managers must conduct marketing and advertising activities in accordance with applicable fair housing laws. HOME imposes additional requirements related to affirmative marketing of HOME-assisted units; and additional marketing restrictions on units that are accessible in accordance with the requirements of Section 504. These additional requirements apply to projects that are funded with both HOME and LIHTC.

### *Affirmative Marketing*

PJs must develop *affirmative marketing procedures* for properties with five or more HOME-assisted units. Affirmative marketing procedures ensure that special outreach and advertising efforts are made to communicate the availability of HOME-assisted housing to those groups or individuals who might otherwise be unlikely to apply for it. Affirmative marketing should be

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made part of the property's overall marketing activities. Generally, PJs require owners and managers to propose affirmative marketing procedures as part of written marketing and tenant selection procedures for the project.

### ***Marketing Accessible Units***

Property managers of properties with accessible units that are built in accordance with Section 504 requirements must develop procedures to ensure that information regarding the availability of accessible units reaches eligible individuals with disabilities. Reasonable, nondiscriminatory steps must be taken to make sure that available, accessible units are offered:

- First, to a current occupant of the property who might require or benefit from the accessibility feature(s) of the unit
- Second, to an eligible qualified applicant on the waiting list who requires the accessibility feature(s) of the unit
- Last, to a nondisabled person on the waiting list.

A nondisabled tenant may rent an accessible unit only when the property manager has made all reasonable efforts to attract a tenant with a disability, and has followed the above steps.

### **Tenant Selection**

Although LIHTC does not have any specific requirements about tenant selection, under HOME, the owner must establish written tenant selection procedures (see 24 CFR 92.253(d)). These procedures describe the methods and procedures for taking applications and screening tenants for any HOME-assisted property, including HOME-LIHTC properties. The PJ should be sure that the procedures for a HOME-LIHTC project clearly describe the income restriction requirements that apply to the project.

### ***Preferences for Tenants with Special Needs***

The HOME and LIHTC programs have different approaches and requirements related to developing special needs housing. In some instances, in order to comply with the requirements of both programs, it may not be possible to designate a single unit as both HOME- and LIHTC-assisted.

Under the HOME Program, in certain circumstances, the PJ can authorize a property owner to give preference in the tenant selection process to persons with special needs, such as the elderly or persons with disabilities. The PJ must state this preference in its Consolidated Plan, document that the special needs group getting preference has an unmet housing need, and demonstrate that the preference is necessary to narrow the gaps in benefits and services to the special needs group.

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However, PJs cannot permit owners and managers to limit the assisted housing to persons with a *specific type* of disability. Although HOME funds can be used to assist housing that gives a preference to persons with disabilities, civil rights laws (which confer certain protections on persons with disabilities) in most cases prohibit owners from discriminating based upon the nature of a disability. Consequently, HOME-assisted housing for persons with disabilities must be equally available to *all* persons with disabilities. Property managers may offer and advertise nonmandatory services that may be appropriate for persons with a particular special need or disability.<sup>6</sup>

The LIHTC program rules do not impose these same restrictions on serving special needs groups. In fact, the state allocating agency may require that a certain number of units are “set aside” for a specific population. It is not uncommon for an owner to receive bonus points on its tax credit application for setting aside units for a specific population. The state identifies these types of preferences and requirements in its QAP.

For a tax credit project that has certain special needs set-asides, the tenant selection policies must clearly state these preferences, and these units must be marketed and occupied by persons who meet the state’s criteria. LIHTC rules require these set-aside units to remain vacant until an eligible tenant is found.

It is difficult in most situations to comply with the HOME and LIHTC rules in implementing any LIHTC-imposed special needs preference, particularly if the preference is for tenants with a specific type of disability. As a general rule, LIHTC set-aside units should not be combined as both HOME- and LIHTC-assisted units.

## 4.5 Leases

The HOME and LIHTC Programs impose certain lease requirements for the purpose of protecting tenants’ rights. Generally, the HOME Program imposes more restrictive requirements, and these must be followed for units that are both HOME- and LIHTC-assisted. As a general practice, these requirements would be followed across all units in the property operating under both programs.

### Required Lease Provisions

The following HOME lease requirements, in accordance with 24 CFR 92.253, must be met for all HOME-LIHTC units:

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<sup>6</sup> Note, the only exception to this rule is for housing for persons with a specific type of disability who could not reside in housing that is available to the general public. In practice, this exception would apply to persons whose disabilities require them to have onsite supportive services (such as 24-hour supervision), because without the onsite services, these persons would be unable to maintain themselves in housing. See 24 CFR 8.4(b)(1)(iv).



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- Every tenant must have a written lease.
  - The lease for a HOME-assisted unit must explain the HOME rent requirements and clearly state the rent amount, applicable utility allowance (if any), whether or not there is project-based assistance, and under what circumstances rents may be adjusted. It should also clearly state the LIHTC requirements.
  - The lease term must be for at least twelve (12) months, unless there is mutual agreement between the owner and the tenant. This is more restrictive than the LIHTC six-month requirement.
  - Services or program participation requirements (such as “clean and sober” programs) cannot be mandated through the lease document.
  - The PJ must approve the lease form.

### Prohibited Lease Provisions

HOME also expressly prohibits the use of certain lease provisions (which may not be allowable under state or local tenant-landlord law as well). Therefore, leases for units that are assisted with both HOME and LIHTC may not include the following provisions:

- Agreement to be sued
- Agreement regarding seizure of property
- Agreement excusing the owner from responsibility
- Waiver of notice
- Waiver of legal proceedings
- Waiver of a jury trial
- Waiver of right to appeal a court decision
- Agreement to pay legal costs, regardless of outcome.

*The LIHTC program permits the property manager to impose a requirement for tenants to participate in certain services or tenant programs. This is not permitted under the HOME Program. Therefore, no tenant of a unit funded with both HOME and LIHTC can be required to participate in any services or tenant programs.*

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## Provisions for CHDO Projects

The HOME Program imposes additional requirements on projects that are owned, developed, or sponsored by CHDOs. These projects must adopt tenant participation plans and fair lease and grievance procedures to ensure ongoing involvement of low-income residents in decisions at the property.

### ***Lead-Based Paint Disclosure***

Federal law requires all owners of pre-1978 to disclose any knowledge of lead-based paint to tenants. Rules require a disclosure notice and provision of the *Protect Your Family from Lead* brochure.

In addition, property managers of HOME-assisted housing that is built prior to 1978 must comply with rules related to controlling or abating the hazards of lead-based paint in federally assisted housing. These rules require that the owner make additional disclosures regarding any evaluations or clearances of lead-based paint hazards.

The HOME requirements related to lead-based paint control are discussed in [Chapter 3](#).

## **4.6 Project Completion and Close Out**

HOME and LIHTC have slightly different project close-out requirements and procedures. These requirements do not generally conflict; therefore, for projects that have both HOME and LIHTC funding, the PJ and LIHTC project sponsor must comply with the requirements of both programs.

### HOME Project Completion Requirements

When the project is fully leased, and presuming the construction close-out requirements (discussed in [Chapter 3](#)) have been satisfied, the PJ is required to ensure project completion steps are undertaken to start the affordability period.

Upon lease-up, PJs must require owners to report on rents and occupancy to enable the PJ to complete the *Rental Set Up and Completion Form* and enter information into IDIS.

Once the project completion data has been entered into IDIS and all the costs have been incurred, the PJ should mark the project as complete. ***The date associated with this project completion data is the date that the period of affordability begins for the HOME assistance.*** The PJ must contact the owner to notify it of the affordability period start and end dates. If possible, the PJ should also amend the HOME written agreement and deed restriction to include these dates. The date in IDIS may be altered to match the date on these legal documents.

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PJs should note that not all units need to be occupied to enter completion data, and that completed units may be initially recorded in IDIS as vacant, but that the information regarding the first occupant must be entered into IDIS when available for the system to credit the unit as meeting HOME requirements. PJs should require their managers to report regularly until full occupancy of assisted units is achieved.

### LIHTC Completion Requirements

Project completion under the LIHTC program is defined in terms of the placed in service date. The placed in service date is typically provided on a building by building basis when the first unit in an LIHTC building is certified as suitable for occupancy under state or local law.

### Reconciling the Completion Dates under HOME and LIHTC

The completion date in IDIS and the placed in service date for the LIHTC program are different and the HOME period affordability could start either *before or after* the LIHTC-assisted buildings are considered placed in service.

From a practical standpoint this may have little operational impact on the project, as the requirements of the two programs run parallel during most of the affordability period. However, the property manager should be aware that the affordability/compliance periods may begin and terminate on different dates, even for projects where the period is the same for both programs (e.g., 15 years).

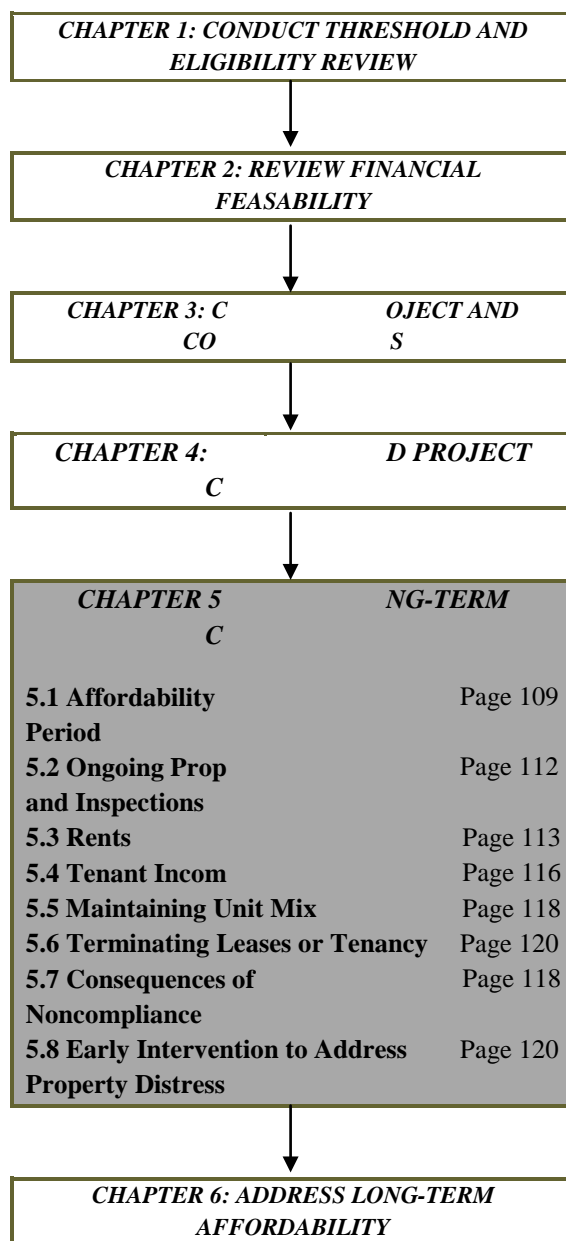
## CHAPTER 5: ENSURE LONG-TERM COMPLIANCE

This chapter discusses the long-term compliance requirements of the HOME and LIHTC programs during the property's operation and management. Specifically, it explains:

- HOME affordability period and LIHTC compliance and extended use periods
- Requirements for ongoing property inspections and standards
- Rent restrictions, income limits, and unit mix requirements that apply to assisted units during the affordability/compliance period
- Consequences of noncompliance
- Early intervention when a property is financially distressed.

### 5.1 Affordability/Compliance Period

Both the LIHTC and the HOME Programs have periods after project completion, during which their respective program requirements apply to the assisted units in the property. During this period, requirements related to rent limits, tenant income limits, tenant lease protections, affirmative marketing, and property standards apply. This period is generally referred to as the **affordability period** under the HOME Program, and the **compliance** and **extended use** periods for the LIHTC Program.



*For more information on managing HOME rental properties during the affordability period, see HUD's publication Compliance in HOME Rental Projects: A Guide for PJs (HUD-2009 HOME Rental PJ, issued January 2009). This publication is available from the HOME Program website at <http://www.hud.gov/homeprogram/>.*

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## Duration of the Affordability/Compliance Period

The HOME and LIHTC Programs determine the duration of the affordability/compliance period differently. Therefore, the duration of these periods are not necessarily the same for any given project, although they may be.

### ***LIHTC Compliance and Extended Use Periods***

Generally, the LIHTC program imposes a 30-year period during which LIHTC requirements apply. These 30 years are comprised of a 15-year compliance period and a subsequent 15-year extended use period. This distinction is the result of a change in the tax code in 1990 that amended the compliance period from 15 to 30 years. Note that the state allocating agency may make this period longer.

In practical terms, the LIHTC investor must stay in the project for 15 years (the compliance period). For the extended use period, the Code permits investors to “opt out” under certain conditions. Although the state allocating agency continues to monitor compliance during the extended use period, there may be no tax implications in the event of noncompliance.

### ***HOME Affordability Period***

The minimum duration of the affordability period for the HOME Program is based on the per unit amount of the HOME investment in the project and the nature of the activity funded, as summarized in Exhibit 5-1.

**Exhibit 5-1: HOME Period of Affordability for Rental Housing**

HOME Investment Per Unit	Length of the Affordability Period
Rehabilitation less than \$15,000	5 years
Rehabilitation between \$15,000 - \$40,000	10 years
Rehabilitation more than \$40,000	15 years
New construction of <i>rental</i> housing	20 years
Refinancing of <i>rental</i> housing	15 years

### ***Compliance Period When HOME and LIHTC Are Combined***

When HOME and LIHTC are combined in a property, the property has to comply with the requirements for each program for the duration of that program’s affordability/compliance period. For the time during which these periods overlap, the property must satisfy both sets of

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requirements. It generally does this by *adhering to the most restrictive requirement in any given circumstance*.

PJs should be especially aware of the compliance periods for new construction projects. New construction triggers a minimum 20-year compliance period under HOME, while investors may be looking to “exit” the project after the 15-year compliance period of LIHTC. Under normal circumstances, a succeeding owner takes over the responsibilities and continues affordability compliance, but PJs may need to work to ensure that this happens when a buyout occurs. See [Chapter 6](#) for additional discussion on this issue.

## 5.2 Ongoing Property Standards and Inspections

The property standards and inspection requirements for HOME and LIHTC differ, and a HOME-LIHTC property must meet the property inspection and property standards requirements of both programs. The PJ is responsible for conducting the property inspections of the HOME-assisted units, and the state allocating agency is responsible for conducting the inspections of the LIHTC-assisted units.

The two agencies should share inspection information. There may be some limited opportunities for the two agencies to coordinate inspection activities; this depends on the project, the number of units in the property, and the unit mix.

### HOME Property Standards

For ongoing occupancy inspections by the PJ, HOME requires the property to meet state or local housing codes or standards applicable to the housing, or, in the absence of such local codes, Housing Choice Voucher Program Housing Quality Standards (formerly Section 8 HQS). The applicable HOME property standards are described in [Chapter 3](#).

HOME-assisted units that were built to be accessible for persons with mobility or sensory impairments using the *UFAS standard*, in order to comply with Section 504, must be maintained to that standard during the affordability period.

Additionally, owners of properties that were constructed prior to 1978 are required to conduct ongoing lead-based paint maintenance. Ongoing maintenance standards are at 24 CFR 35.1355, and include (if the property has not been previously determined to have lead-based paint):

- Visual assessment for deteriorating paint by trained personnel
- Lead hazard reduction of identified surfaces by trained personnel
- Clearance of any completed work by certified risk assessor

- Notification of tenants
- Recordkeeping.

Property standards apply to the HOME-assisted units. However, in a property with floating HOME-assisted units, it is prudent to maintain all units in accordance with the applicable property standards since a non-HOME-assisted unit might be designated as HOME-assisted at some later time.

### HOME Property Inspections

Under the HOME Program, the frequency with which the PJ must conduct *onsite inspections* of HOME properties throughout the affordability period is based on the total number of units in a project (not just the HOME-assisted units), as identified in Exhibit 5-2.

**Exhibit 5-2: Frequency of HOME Property Inspections**

Total Number of Units	Inspection Required
1-4	Every 3 years
5-25	Every 2 years
26 or more	Annually

The purpose of the property inspections is to ensure that HOME-assisted units, shared common areas, and the building’s exterior meet the applicable HOME property standards throughout the affordability period.

As part of the onsite monitoring, the PJ must do two things: (1) inspect units to verify compliance with HOME property standards, and (2) review records to verify the accuracy of the annual rent and occupancy reports submitted by owners. Note that the onsite records review is discussed in the following sections.

HOME requires the PJ to inspect the common areas, the building’s exterior, and a “sufficient sample” of HOME-assisted units (not all units in the project). HUD recommends that the PJ inspect 10 to 20 percent of the HOME-assisted units in a project, and a minimum of one unit in every building. If the PJ identifies any problems, it should inspect the remaining HOME-assisted units to ensure that these units comply with established property standards.

HOME also requires that the person or entity conducting the inspections be PJ staff or have a contractual relationship with the PJ to conduct such inspections.

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PJs should consider inspecting a greater number than the minimum in the following circumstances:

- The project is financially stressed.
- The property manager has limited experience.
- Development activities were completed more than ten years ago (since projects tend to have more maintenance problems in later years).

### LIHTC Property Standards

At a minimum, the LIHTC property standards must meet local health, safety, and building codes; and the Uniform Physical Condition Standards for public housing established by HUD at 24 CFR 5.703. Note that the HUD Uniform Physical Condition Standards do not supersede or pre-empt local health, safety, and building codes. State allocating agencies may impose additional property standard requirements as well.

### LIHTC Property Inspections

Under the LIHTC regulations, allocating agencies must inspect:

- All buildings and at least 20 percent of the LIHTC-assisted units in the project by the end of the second calendar year following the year the last building in the project is placed in service. For instance, if the property is placed in service in June 2009, then the allocating agency must inspect it by December 2011.
- After that, all buildings and at least 20 percent of the LIHTC project's assisted units must be inspected at least once every three years during the compliance and extended use periods.

The LIHTC regulations specify that property owners are required to annually certify that, for the preceding 12-month period, each building in the project was suitable for occupancy, taking into account local health, safety, and building codes. Generally, this certification is based on a review of reports that the owner submits.

### Property Inspection Requirements for HOME-LIHTC Properties and Units

Both LIHTC and HOME rules specify a sample of assisted units must be inspected. The LIHTC regulations require a larger sample of LIHTC units be inspected than the sample required by the HOME Program.

Although it may vary from project to project, and may depend on any state-imposed requirements, in most instances, HOME requires properties to be inspected more frequently than the LIHTC program.



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Since both the PJ and the state allocating agency have inspection obligations, there may be opportunities for limited coordination that could benefit the PJ. However, at a minimum, the PJ should ask the state to forward copies of inspection reports for all HOME-funded properties to help the PJ identify any potential problem properties.

While the state allocating agency may be willing to use the PJ's inspection as verification of the tax credit property standards, this would not generally work in reverse because the state LIHTC program's property inspectors may not have the appropriate training to inspect for compliance with the HOME property standards (local codes or Housing Quality Standards) or the UFAS standard for accessible units, which does not generally apply to LIHTC projects that are not also HOME-funded. PJs also should remember that HOME inspections must be done by a person/entity with direct programmatic relationship to HOME, by employment or agreement. In addition, for most projects, the PJ is required to inspect the property more frequently than the state.

The state allocating agency and the PJ should also be aware that the different units may need a different type of inspection, depending on their designation as HOME-assisted only, LIHTC-assisted only, or both HOME- and LIHTC-assisted. HOME-assisted units must meet the HOME property standards; LIHTC-assisted units must meet the LIHTC property standards; and any units that carry both designations must meet the requirements of both programs. When the HOME requirements are more restrictive, this property standard should be used in these units.

### **5.3 Rents**

Rent affordability for some period of time is required by both LIHTC and HOME Programs. Throughout the affordability period, both HOME and LIHTC require that assisted unit rents comply with the respective program rent limits. [Chapter 2](#) provides a detailed discussion on program rent limits and how they apply to HOME-LIHTC projects, including how they are calculated for each program. The guidelines offered in [Chapter 2](#) apply throughout the affordability period, as do the rent requirements of each program.

#### **HOME Rent Limits**

HOME rent limits are updated every year by HUD. HUD calculates and issues the HOME rent limits along with the HOME income limits early in the year (approximately March). The rent limits go into effect 30 days after they are posted on the HOME website at <http://www.hud.gov/homeprogram/>.

The calculations that are used to compute the High and Low HOME rent limits are explained in [Chapter 2](#). PJs should be sure to notify all property managers of the new income and rent limits when they become effective.

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## LIHTC Rent Limits

HUD issues the income limits applicable to the LIHTC Program annually. State allocating agencies compute the rent limits from the HUD-issued income limits and notify the tax credit project owners.

### Rent Limits in HOME and LIHTC Units

- **Establishing rents.** Each time the rent limits are updated, the property manager must determine the maximum rents that can be charged for each program. This is done in the same way that the rents are initially determined (discussed in [Chapter 2](#)) and the new rent limits apply in the same way:
  - The High HOME rent limits (minus tenant-paid utilities) apply to High HOME Rent units; the Low HOME rent limits (minus tenant-paid utilities) apply to Low HOME Rent units.
  - The LIHTC rent limits (minus tenant-paid utilities) apply to the LIHTC-assisted only units.
  - The *lesser of* the two program rents (minus their respective utility allowances for tenant-paid utilities) applies to the HOME- and LIHTC-assisted units.

Keep in mind that tenant-based rental assistance is treated differently by the two programs. HOME is more restrictive, limiting the total rent – including tenant contribution and housing assistance payment – to the HOME rent limit. LIHTC limits tenant contributions, and does not restrict the housing assistance payment portion of total rent.

- **Rent increases.** Under both programs, property owners can raise rents up to the new rent limits (minus any tenant-paid utilities) that apply to the unit. Rent adjustments for occupied units are subject to the terms of the tenant's lease.
  - Under HOME, PJs must approve all rent increases in HOME-assisted units, in accordance with an approval process prescribed by the PJ and documented in the written agreement between the PJ and the owner.
  - PJs should note that the calculation of LIHTC rent limits, which is explained in [Chapter 2](#), is slightly different than the HOME rent limits, and that they take effect at different times of year. PJs should remind owners and managers of this difference each year, so that adjustments permitted by new LIHTC rent limits do not violate the HOME requirements.

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- **Rent decreases.** The rent limits for either of these programs might decrease, depending on area market conditions or increasing utility costs. Both programs offer some financial protection to owners to ensure that rents do not drop below the rent limits established early in the project.
    - The HOME Program does not require the owner to decrease rents below the HOME rent limits that were in effect at the time of project commitment.
    - Similarly, LIHTC establishes a floor rent which keeps the applicable LIHTC rent limits from dropping below the rent limits that were in effect on the date the initial LIHTC allocation was made to the project.

Practically speaking, this is useful in the first few years of the project, although as the project ages and rent limits slowly increase, these floor rents are less likely to be a factor.

## 5.4 Tenant Income Eligibility

The HOME and LIHTC Programs restrict occupancy to income-eligible tenants throughout the affordability period. On an annual basis, HUD issues income limits for both programs, although these limits are calculated differently for the two programs, are issued separately, and take effect at different times.

The PJ must provide instruction to property owners on the owner's responsibility to comply with the income requirements. Owners/Managers of rental housing must determine the occupant's income-eligibility on an annual basis in accordance with these limits and verify that the tenant household has an annual gross income that is at or below the applicable and current income limit for the type of unit it occupies (High HOME Rent, Low HOME Rent, LIHTC, or both HOME and LIHTC). In the event that a tenant's income has increased over the current income limit for the applicable program, depending on the type of unit the tenant occupies, the owner/manager must take certain steps to restore compliance in the building.

The steps to restore compliance are described throughout this chapter. The income limits are discussed in detail in [Chapter 4](#) and apply throughout the affordability period.

### Annual Income Recertification

Each year, the property manager of a HOME-LIHTC property must be sure that the tenants of assisted units do not have incomes that exceed the current income limits. This process is called **income recertification**. The income recertification requirements for HOME and LIHTC are slightly different.

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## HOME Annual Income Recertification

The HOME Program requires the property manager to recertify each tenant household's income on an annual basis throughout the affordability period. Initially, and every sixth year during the affordability period, the property manager must use *source documentation* to verify the household's income. In alternate years, the PJ can choose one of the following three methods for the owner to use:

- Source documentation
- Self-certification
- Written statement from the administrator of another government program under which the family receives benefits and that examines the annual gross income of the family each year.

## LIHTC Annual Income Recertification

Generally, LIHTC requires owners/managers of LIHTC properties to reexamine the annual income of a household residing in a tax credit unit on an annual basis as well. However, these reexaminations of income must be performed with third-party source documentation each year.

Under Internal Revenue Code (IRC) §42(d)(3)(A) and IRC §42(g)(4), owners of 100 percent low-income projects are no longer required to complete annual income recertifications. State agencies, however, have authority to impose additional requirements upon LIHTC projects and may require income recertifications after completing the initial income certification at the time the household moves into the low-income unit.

## Annual Income Recertification for Occupant of a HOME- and LIHTC-Assisted Unit

The property manager must ensure that the occupant of any unit that carries both the HOME- and LIHTC-assisted designation has an annual gross income that meets the income limits of both programs. This would be the lesser of the two income limits. See [Chapter 4](#) for a discussion of the applicable income limits.

In addition, the property manager must use the most restrictive *process* of the two programs to determine the tenant household's income eligibility. This means that:

- For units that are designated as both HOME- and LIHTC-assisted, the manager must examine third-party source documentation of tenant incomes to verify tenant income-eligibility, unless one of the following is true:
  - There is an LIHTC waiver in a project with 100 percent tax credit units.
  - There are no new residents that exceed the LIHTC income limits.

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- For HOME- and LIHTC-assisted units where third-party source documentation is not required by LIHTC, the PJ can determine what type of documentation is required for income recertification. However, source documentation is required every sixth year during the HOME affordability period.

### Over-Income Tenants

When conducting the annual income recertification, if the property manager determines that a tenant's income has increased above the income limits for the applicable program, it must take certain steps to restore compliance in the property.

- **For a unit that is HOME-assisted only**, the tenant is considered over-income when its income exceeds the HUD-published income limit for the unit. That is, a tenant that occupies a High HOME Rent unit becomes over-income when the household's income exceeds 80 percent of AMI. A tenant that occupies a Low HOME Rent unit becomes over-income when the household's income exceeds 50 percent of AMI. When a tenant is over-income, the owner/manager must adjust the rent. These adjustments are explained in more detail in Section 5.5, below.
- **For a unit that is LIHTC-assisted only**, the tenant is considered over-income only when the household's income increases to above 140 percent of the current qualifying income limit for the unit. LIHTC rules require the rent to remain restricted until that unit is replaced.
- **For a unit that is both HOME- and LIHTC-assisted**, the HOME Program (at 24 CFR 92.252(i)(2)) states that the tenant pays the rent governed by the LIHTC program. This means that the tenant's rent is not increased under the HOME over-income rules, but that the rent is restricted to the LIHTC rent until the LIHTC unit is replaced.

## 5.5 Maintaining Unit Mix

Maintaining unit mix to comply with HOME and LIHTC requirements is one of the more complex management functions during the affordability period. Owners/Managers must maintain the proper mix of HOME- and LIHTC-assisted units, as specified in their written agreements with the PJ and the state allocating agency. This requires making income-eligibility determinations annually and keeping track of unit occupancy and rents whenever there is turnover or changes in tenant income.

The steps the owner must take to maintain compliance with unit mix requirements will depend on:

- **The property's written agreements.** Owners of HOME- and LIHTC-assisted properties execute written agreements that state the terms and conditions of funding with the PJ and the

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state allocating agency, respectively. These written agreements specify the unit mix requirements for each program. The owner/manager must strive to maintain the property in compliance with these unit mix requirements throughout the affordability/compliance period.

- **Whether HOME-assisted units are fixed or floating.** HOME units may be fixed or floating, as described in the following section. This gives the owner/manager more or less flexibility in changing unit designations to maintain the required unit mix.
- **The number and types of units in the property (such as HOME-assisted, LIHTC-assisted, HOME-LIHTC, and market rate).** The greater the variety of unit types, the more options the owner/manager has to comply with unit mix requirements. For instance, in a property with a mix of HOME, LIHTC, and market rate units, the owner/manager has more choices to maintain or restore unit mix than in a property with only LIHTC units.

PJs must provide detailed instruction to owners/managers on how to ensure that HOME income-eligible tenants occupy HOME-assisted units and are charged the appropriate rents throughout the affordability period. State allocating agencies provide similar direction to LIHTC owners.

### HOME Unit Mix Requirements

The HOME written agreement between the PJ and the owner specifies:

- The number of HOME-assisted units that the owner/manager must maintain throughout the affordability period
- Which units are initially designated as High HOME Rent units or Low HOME Rent units
- Whether the HOME units are fixed or floating.

These decisions must be made at the time of project commitment.

### *Fixed vs. Floating HOME Units*

Properties with *fixed HOME units* have specific units (e.g., Units 101, 102, and 103) that are designated as HOME-assisted. Owners/Managers must maintain **these specific units** as HOME-assisted throughout the affordability period, consistent with the written agreement.

- The specific unit's designation as a HOME-assisted unit does not change during the affordability period. However, the owner/manager may find it necessary to change the unit's initial income targeting designation (High HOME Rent unit or Low HOME Rent unit) in order to maintain the required mix. If the property is out of compliance because of both a High HOME unit and Low HOME unit, the owner must always restore the number of Low HOME Rent units first.

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- For example, Unit 101 may initially be designated as a Low HOME Rent unit. If the tenant's income increases and the tenant is no longer very low-income, the owner/manager must designate the next High HOME Rent unit that becomes available as a Low HOME Rent unit in order to restore the required number of Low HOME Rent units. (The following sections discuss over-income tenants, including applicable rents for over-income tenants.)

Properties with *floating HOME units* do not have specific units that are designated HOME-assisted for the duration of the affordability period. Initially, the PJ designates specific units as HOME-assisted, and as High HOME units and Low HOME units. During the affordability period the owner/manager is required to maintain the *total number* of HOME-assisted and non-assisted units, and High HOME units and Low HOME units that are originally designated, not the specific units.

- The HOME-assisted unit designations can change, or “float,” among comparable assisted and non-assisted units in order to maintain the required unit mix, including the number of assisted and non-assisted units and the number of High and Low HOME units.
  - For example, at the time of annual income determination, if the owner/manager finds that the income of a tenant residing in a High HOME Rent unit has increased and the tenant is no longer low-income, then the owner must identify a comparable, non-assisted unit for a low-income tenant, and designate this unit as assisted. (The following sections discuss over-income tenants in more detail, including applicable rents for over-income tenants.)
- The goal is to maintain the initial (required) number of HOME-assisted units, and the initial (required) mix of High and Low HOME Rent units. The owner can change designations as needed, in order to maintain the required unit mix.
  - For example, if a tenant residing in a Low HOME unit moves out, and there is a comparable non-assisted unit with an existing very low-income tenant, the owner can redesignate the occupied non-assisted unit as a Low HOME unit, and redesignate the vacated unit as non-assisted.
- When redesignating a non-assisted unit as HOME-assisted, owners/managers must use a non-assisted unit that is comparable to the HOME unit. They may choose (but are not required) to substitute a “greater” non-assisted unit for a “lesser” HOME unit. A “greater” unit is one that might be considered preferable because of larger size, additional bedrooms, or amenities. Owners/Managers are not permitted to substitute a lesser non-assisted unit for a greater HOME unit, unless this restores the original unit mix specified in the written agreement.



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## ***Over-Income Tenants in HOME Units***

When owners/managers recertify a tenant's income, they may find that a tenant's income has increased. A tenant is considered ***over-income*** in the HOME Program when one of the following occurs:

- The tenant occupies a High or Low HOME unit and the household income increases over the current HOME low-income limit (80 percent of AMI) for its family size.
- The tenant occupies a Low HOME unit and the household's income increases above the current very low-income limit (50 percent of AMI), but is still below the low-income limit for its family size.

When a tenant is over-income, the property is considered ***temporarily out of compliance*** with HOME's occupancy and unit mix requirements. Temporary noncompliance due to an increase in an existing tenant's income is permissible as long as the owner takes specific steps to restore the correct occupancy and unit mix in the property as soon as possible. These steps are described throughout [Section 5.4](#) of this chapter and vary depending on the type of unit and whether the units are fixed or floating.

After making applicable adjustments to ensure the property has the required HOME unit mix, the owner/manager may also need to adjust the rents of affected tenants:

- A unit that is designated as a High HOME unit must be rented to low-income tenant at a rent that does not exceed the High HOME rent limit.
- A unit that is designated as a Low HOME unit must be rented to very low-income tenant at a rent that does not exceed the Low HOME rent limit.
- During a period of temporary noncompliance, if an over-income tenant (with income over 80 percent of AMI) is residing in a ***floating HOME***-assisted unit, that tenant's rent must be adjusted to be 30 percent of the household's adjusted income, or the market rent, whichever is less. If an over-income tenant (with income over 80 percent of AMI) is residing in a ***fixed*** HOME-assisted unit, that tenant's rent must be adjusted to be 30 percent of the household's adjusted income. This rent adjustment must be made as soon as the tenant's lease permits.

**Owners/Managers may not evict or terminate the tenancy of a household because its income increased.**



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### **Making Income Determinations for Replacement Units**

*When renting any vacant unit—including units that are used for replacement purposes to comply with unit mix requirements-- the owner/manager must verify that the tenant is income-eligible for the applicable program(s), prior to renting the unit. Income determination procedures are described in [Section 5.4](#) of this chapter.*

### **LIHTC Unit Mix Requirements**

The LIHTC Program also requires that the owner/manager maintain the required LIHTC unit mix, as specified in its agreement with the state credit allocating agency. This agreement specifies how many units are reserved for households with incomes at or below 50 percent of AMI, 60 percent of AMI, or possibly a deeper income targeting mix if the developer has agreed to it. LIHTC unit mix requirements are in effect for the duration of the LIHTC compliance period.

Like HOME, LIHTC requires that as LIHTC units are vacated, the owner/manager must verify that the next tenant is income-eligible. The LIHTC income limit for the new tenant depends on the income targeting requirements in the property's LIHTC agreement (50 percent of AMI, 60 percent of AMI, or deeper income targeting). Of course, the owner/manager must charge the new tenant the applicable LIHTC rent.

As households residing in LIHTC units become over income, the owner/manager must rent the next available non-LIHTC unit to an income-eligible tenant at the applicable LIHTC income limit in order to maintain the required number of LIHTC units.

- The LIHTC Program defines "next available unit" as any unit in the same building, as long as the LIHTC-eligible basis square footage is maintained. (This differs from the HOME Program, which uses the next available comparable unit, based on the number of bedrooms, unit size, and amenities.).<sup>7</sup>
- The LIHTC definition of "over-income tenant" differs from the HOME Program, as well. Under LIHTC, an over-income tenant has an annual gross income that exceeds 140 percent of the current income limit for the unit (i.e., over 70 percent of area median income (AMI) for units designated at 50 percent of AMI (50 percent X 140 percent) or over 84 percent of AMI for units designated at 60 percent of AMI (60 percent X 140 percent)).

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<sup>7</sup> Reminder: The applicable fraction is used to establish a building's qualified basis (for calculation of tax credits). The applicable fraction is the lesser of the percentage of units or the percentage of square footage occupied by eligible households. At no time can a building's applicable fraction drop below the first-year level.

- Unlike HOME, under the LIHTC Program, once a tenant is determined to be over-income, the owner/manager cannot adjust its rent until **after** it designates a replacement unit and the unit is rented to an income-eligible tenant at the applicable LIHTC rent. Then, the over-income tenant's unit is redesignated as a non-assisted unit. Once the unit is non-assisted, the owner/manager may charge any rent it chooses, likely to be the market rent.

Note, in properties that have 100 percent LIHTC units, there are no available “non-LIHTC units” that can be redesignated for replacement purposes when a tenant becomes over-income. Since the owner/manager cannot increase the rents above the LIHTC rent limits until a replacement unit is designated, this means that the owner/manager cannot adjust the rent of an over-income tenant in this situation. Compliance can only be restored when the tenant moves out and the unit is rented to an income-eligible tenant.

### **Timing of Rent Adjustments**

*Under both the HOME and LIHTC Programs, without exception, rent adjustments can only be made when the tenant's lease permits. At the time of lease renewal, owners/managers should double-check the type of unit the tenant is in (High or Low HOME, LIHTC-HOME, etc.) and verify that the correct rent is being charged for that unit type.*

*In most situations where there is an over-income tenant, owners/managers cannot adjust rents until there is a replacement unit that restores the unit mix. The only exception to this is when an over-income tenant whose income is above 80 percent of AMI resides in a HOME-only unit, the rent must be adjusted as soon as the lease permits, regardless of the status of a replacement unit. As described below, if the unit is an LIHTC-HOME unit, the LIHTC rents apply.*

*If the income of a household in an LIHTC-only unit rises to more than 140 percent of the then-qualifying income for that unit, and there are non-LIHTC units at the property, the property manager must lease the next non-LIHTC unit to a household with qualifying income. Only after that next available unit has been rented to an LIHTC-qualified household, may the unit with the over-income household be converted to market rent, subject to the terms of the lease. Additionally, once the next available unit has been rented to an LIHTC-qualified household, the over-income household is no longer counted towards the property's LIHTC set-aside, and is no longer considered an LIHTC household. Accordingly, the owner may choose not to renew the lease to the household which has been replaced by a qualifying LIHTC household, provided doing so is allowed by local and state laws.*

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## Maintaining the Unit Mix in HOME-LIHTC Projects

Maintaining the unit mix in HOME-LIHTC projects can be challenging. To simplify the rules around unit mix in HOME-LIHTC properties, the HOME Program adopts some LIHTC rules in HOME-LIHTC units. These are reviewed in the sections below.

### ***Maintaining the Unit Mix When a HOME-LIHTC Unit Is Vacated***

Generally, when a tenant vacates a HOME-LIHTC unit and the property is in compliance with the unit mix requirements (that is, there are no over-income tenants in any of the assisted units), the owner/manager complies with the unit mix requirements by maintaining the unit's HOME-LIHTC designation(s) and renting the unit to a tenant that meets the income and rent limits of both programs, as they apply to that specific unit (High or Low HOME unit; 50 percent or 60 percent of AMI, or other LIHTC applicable income limit).

#### **Defining “Over-Income Tenant” and “Over-Income Unit”**

*An “over-income tenant” is defined differently for HOME and LIHTC.*

*For HOME, an “over-income tenant” is either one of the following:*

- *A tenant whose annual gross household income exceeds the current HOME income limit (80 percent of AMI) for its family size*
- *A tenant that occupies a Low HOME unit and whose annual gross household income exceeds the current very low-income limit (50 percent of AMI), but is still below the low-income limit, for its family size.*

*For LIHTC, an over-income tenant is an tenant whose an annual gross household income exceeds 140 percent of the current income limit for the unit, for its family size. For units designated for households with incomes at 50 percent of AMI, the household becomes over-income if its income exceeds 70 percent of AMI (50 percent X 140 percent). For units designated for households with incomes at 60 percent of AMI, the household becomes over-income if its income exceeds 84 percent of AMI.*

*An “over-income unit,” for the purposes of this guidebook, is a unit that is occupied by an over-income tenant.*

### ***Maintaining the Mix when a Tenant Is Over-Income***

When a tenant in a HOME-LIHTC unit becomes over-income, the owner/manager must take two steps to comply with the occupancy and unit mix requirements of both the HOME and LIHTC Programs:

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- 1) **Fix the Mix.** The owner/manager must restore the unit mix specified in the property's HOME and LIHTC agreements, as soon as possible. This is done using the same processes described for each program individually -- by renting vacant units and/or making unit redesignations -- but the owner/manager must be sure to comply with both programs. The specific actions vary, depending on the type of property (fixed or floating HOME units; and the number/percentage of LIHTC, HOME, and market rate units). These actions are described for different scenarios in detail below and illustrated in Exhibits 5-3, 5-4, and 5-5.
  - 2) **Fix the Rents.** When a tenant becomes over-income, and/or when unit designations change (e.g., from High HOME to Low HOME units, or from HOME-assisted to non-assisted), the owner/manager must adjust the rents to remain in compliance with rent requirements for each type of unit. The requirements related to making rent adjustments to comply with both programs are described for different scenarios below and illustrated in Exhibits 5-3, 5-4, and 5-5.

Using three common scenarios, the flowcharts in Exhibits 5-3, 5-4, and 5-5 illustrate how to maintain the unit mix and occupancy requirements of both the HOME and LIHTC Programs when a tenant in an LIHTC-HOME unit goes over income, as follows:

- Exhibit 5-3: The property has fixed HOME units and 100 percent LIHTC units.
- Exhibit 5-4: The property has floating HOME units, and 100 percent LIHTC units.
- Exhibit 5-5: The property has floating HOME units, and a mix of HOME, LIHTC, LIHTC-HOME, and market rate units.

In each scenario the decision process starts with two questions:

- Does the over-income tenant reside in an **LIHTC-High HOME unit or an LIHTC-Low HOME unit**? This determines which type of unit (High or Low HOME) must be replaced to fix the mix.
- If the over-income tenant is in an LIHTC-Low HOME rent unit, is the tenant's income **over 80 percent of AMI, or between 50 and 80 percent of AMI**? This determines if the over-income unit can be redesignated as a High HOME unit, or if the tenant is no longer income-eligible for any HOME unit.

Depending on the answers to these questions, the owner/manager takes slightly different steps to (1) Fix the Mix and (2) Fix the Rents, to restore compliance.

### Defining Comparable Units

*“Replacement units” must meet certain criteria in each program:*

*HOME units may only be replaced by units that are comparable in terms of size (square footage), number of bedrooms, and amenities. A HOME unit can be replaced with a unit that is “greater” (typically more preferred in terms of size, number of bedrooms, and amenities), but it cannot be replaced with one that is lesser.*

*LIHTC units may only be replaced by units in the same building with equivalent LIHTC-eligible basis square footage.*

### ***Maintaining the Unit Mix in LIHTC-HOME Properties When HOME Units Are Fixed and the Property Is 100 Percent LIHTC***

Exhibit 5-3 illustrates the course of action when a tenant’s income goes over income in a property where the HOME units are fixed and the property is 100 percent LIHTC. This is the most straightforward scenario because the owner/manager manages the unit mix with a relatively small inventory of units (only those that are HOME-assisted). Since all of the units are LIHTC, the owner/manager cannot take any action to restore LIHTC compliance until the over-income tenant moves out.

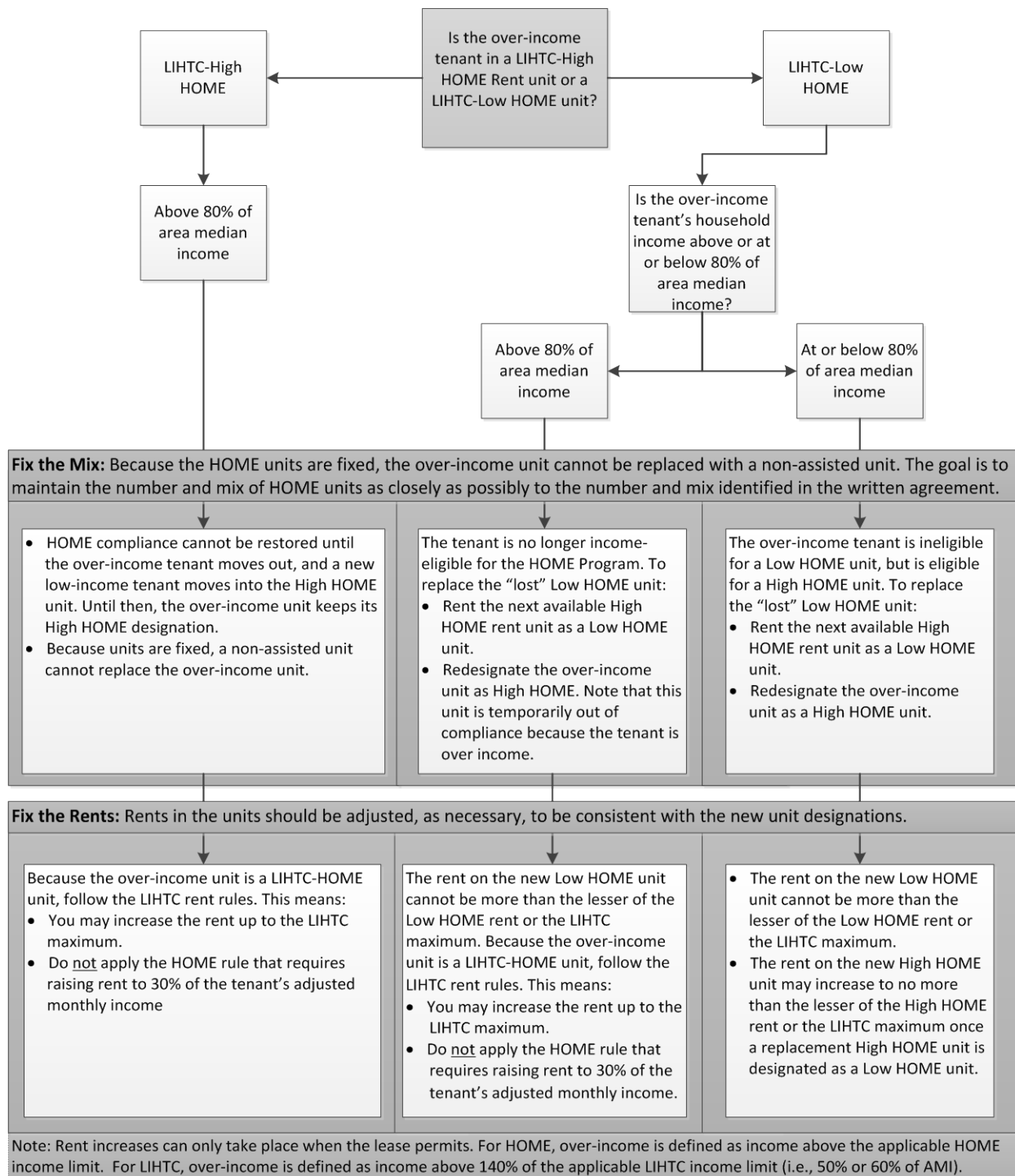
- (1) **Fix the Mix.** Because the HOME units are fixed, the owner/manager cannot replace the over-income unit with a non-assisted unit. One of three scenarios is possible:
  - a. **The over-income tenant resides in an LIHTC-High HOME unit.** Presuming that all the necessary Low HOME units in the property are compliant, the over-income unit remains designated as an LIHTC-High HOME unit. The owner/manager cannot restore the unit mix until the tenant moves out; the property is considered temporarily out of compliance until that time.
  - b. **The over-income tenant resides in an LIHTC-Low HOME unit and its income goes above 80 percent of AMI.** The owner/manager redesignates the next available LIHTC-High HOME unit as an LIHTC-Low HOME unit, and rents it to a very low-income household. This is because the owner must restore compliance to the Low HOME units before the High HOME units. Once an LIHTC-Low HOME unit has been designated, then, the owner/manager redesignates the over-income unit as an LIHTC-High HOME unit. Since the

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occupant has an income that exceeds the low-income limit, the property continues to be temporarily out of compliance until the over-income tenant moves out.

- c. **The over-income tenant resides in an LIHTC-Low HOME unit and its income goes above the HOME very low-income limit (50 percent of AMI), but does not exceed the HOME low-income limit (80 percent of AMI).** The owner/manager redesignates the next available LIHTC-High HOME unit as an LIHTC-Low HOME unit, and rents it to a very low-income household. The tenant must be income-eligible under both HOME and LIHTC. Then, the owner/manager redesignates the over-income unit as an LIHTC-High HOME unit. If there are no other noncompliant units, this step restores the unit mix and the property is compliant.
- (2) **Fix the Rents.** When unit designations change as a result of steps taken to fix the mix (described above), the owner/manager may need to adjust the rents to ensure that each unit has a compliant rent. **Rents can be adjusted only when the tenant's lease permits.**
- a. In an LIHTC-Low HOME unit, the rent may not exceed the lesser of the Low HOME rent or the LIHTC rent. If a rent adjustment is needed, it can only be made after a replacement unit is designated. The HOME rule that requires raising the rent to 30 percent of the tenant's adjusted monthly income does not apply.
  - b. In an LIHTC-High HOME unit, the rent may not exceed the lesser of the High HOME rent or the LIHTC rent. If a rent adjustment is needed, it can only be made after a replacement unit is designated. The HOME rule that requires raising the rent to 30 percent of the tenant's adjusted monthly income does not apply.
  - c. While the property is temporarily out of compliance, when an over-income (above 80 percent of AMI) tenant occupies an LIHTC-HOME unit, the rent may not exceed the maximum LIHTC rent for the unit type. (The HOME Program adopts the LIHTC rents in this situation.) If a rent adjustment is needed, it must be made *as soon as* the tenant's lease permits.

### Exhibit 5-3: Addressing Over-Income Tenants in HOME-LIHTC Units When HOME Units Are Fixed





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## ***Maintaining the Unit Mix in LIHTC-HOME Properties when HOME Units Are Floating and the Property Is 100 Percent LIHTC***

Exhibit 5-4 illustrates the course of action when a tenant's income goes over income in a property that has floating HOME units, and 100 percent of the units are LIHTC. This situation is a little more complicated than the one illustrated in Exhibit 5-3 because the owner/manager has all of the comparable units in the property at its disposal to manage the unit mix. These represent a mix of LIHTC-HOME units and LIHTC-only units (which are treated as non-assisted, for purposes of the HOME Program).

- 1) **Fix the Mix.** When HOME units float, and a tenant in a HOME unit becomes over-income, the owner/manager can draw from any comparable unit in the property (in this instance, all of which are LIHTC units) to replace the HOME unit and restore HOME compliance. Since all of the units are LIHTC, the owner/manager cannot take any actions to restore LIHTC compliance until the over-income tenant moves out. There are several possible scenarios:
  - a. **The tenant of an LIHTC-High HOME unit becomes over-income.** To restore the unit mix, the owner/manager can either:
    - i. Redesignate the next available comparable LIHTC-only (non-HOME-assisted) unit as an LIHTC-High HOME unit.
    - ii. Identify a comparable LIHTC-only unit that is occupied by a low-income (HOME income-eligible) tenant and redesignate it as an LIHTC-High HOME unit.

In both cases, once the replacement occurs, the owner/manager redesignates the over-income unit as an LIHTC-only unit.

- b. **The income of a tenant in an LIHTC-Low HOME unit exceeds the low-income limit.** To restore the unit mix, the owner/manager can:
      - i. Use a comparable LIHTC-only unit for replacement—this can be either the next available LIHTC-only (non-HOME-assisted) unit, or an LIHTC-only unit that is occupied by a very low-income tenant. Redesignate the LIHTC-only replacement unit as an LIHTC-Low HOME unit. Once the replacement occurs, redesignate the over-income unit as LIHTC-only.
    - c. **The income of a tenant in an LIHTC-Low HOME unit increases above the HOME very income-limit (50 percent of AMI), but is still less than the HOME low-income limit (80 percent of AMI).** The owner/manager can:

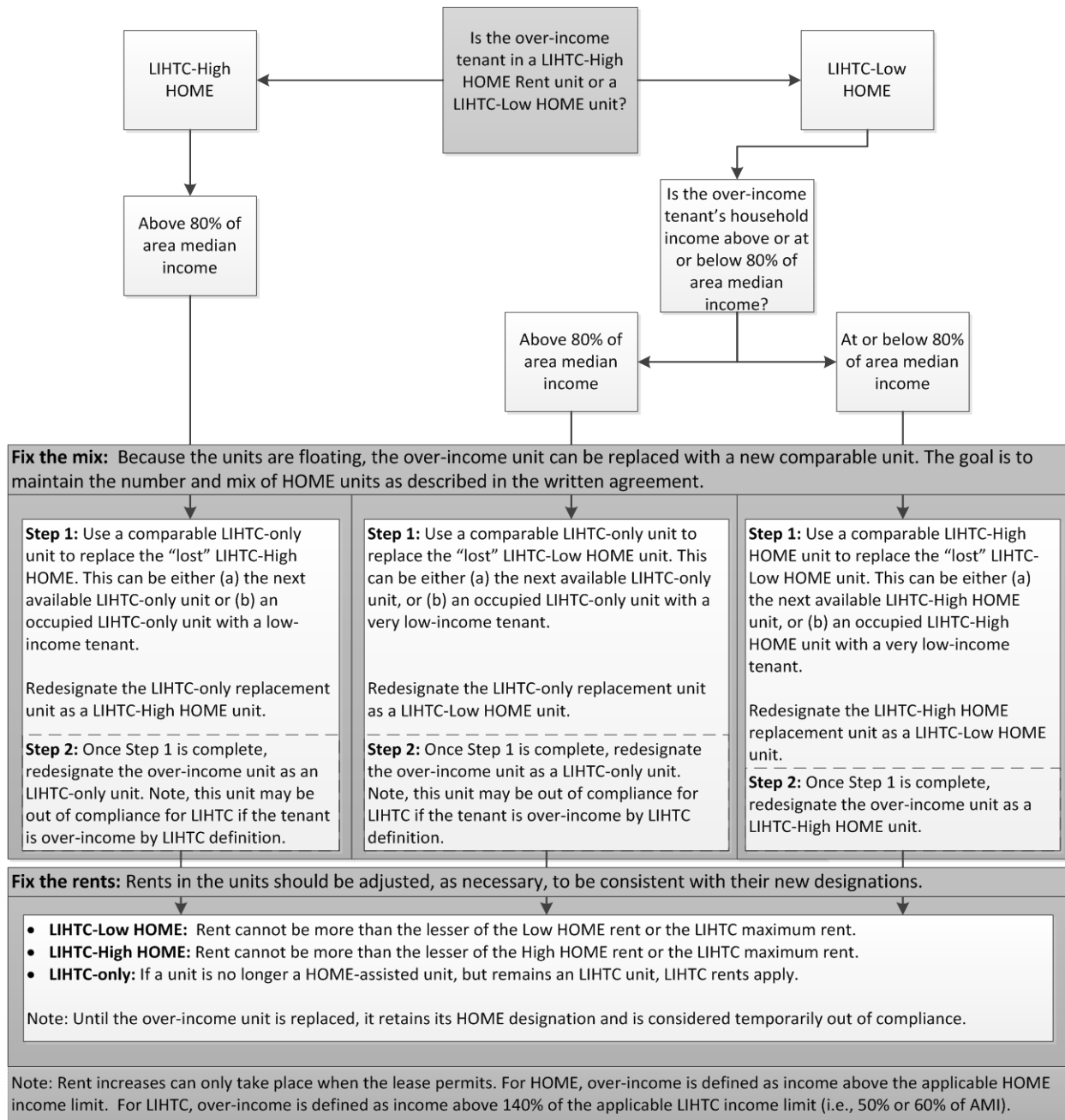


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- i. Use a comparable LIHTC-High HOME unit for replacement—this can be either the next available comparable LIHTC-High HOME or an LIHTC-High HOME unit that is occupied by a very low-income tenant. Redesignate the LIHTC-High HOME replacement unit as an LIHTC-Low HOME unit. Once the replacement occurs, redesignate the over-income unit as an LIHTC-High HOME unit.
  - ii. Use a comparable LIHTC-only unit for replacement—this can be either the next available LIHTC-only unit or an LIHTC-only unit that is occupied by a very low-income tenant. Redesignate the LIHTC-only replacement unit as an LIHTC-Low HOME unit. Once the replacement occurs, redesignate the over-income unit as an LIHTC-only unit.

(2) **Fix the Rents.** When unit designations change, as described above, the owner/manager adjusts the rents to ensure that each unit has a compliant rent. **Rents can be adjusted only when the tenant's lease permits.**

- a. In an LIHTC-Low HOME unit, the rent may not exceed the lesser of the Low HOME rent or the LIHTC rent. The rent is adjusted after the replacement unit is identified.
- b. In an LIHTC-High HOME unit, the rent may not exceed the lesser of the High HOME rent or the LIHTC rent. The rent is adjusted after the replacement unit is identified.
- c. In an LIHTC-only unit, the LIHTC rents apply.
- d. While the property is temporarily out of compliance because an over-income tenant occupies an LIHTC-HOME unit, the rent may not exceed the maximum LIHTC rent for the unit type. (The HOME Program has adopted the LIHTC rents in this situation.) If a rent adjustment is needed, it must be done as soon as the tenant's lease permits.

## Exhibit 5-4: Addressing Over-Income Tenants in HOME-LIHTC Units When HOME Units Are Floating and the Property Is 100% LIHTC



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### ***Maintaining the Unit Mix in LIHTC-HOME Properties when HOME Units Are Floating and the Property Has a Mix of LIHTC and Market Rate Units***

Exhibit 5-5 illustrates the course of action when a tenant becomes over-income in a property that has a mix of HOME-only, LIHTC-only, LIHTC-HOME, and market rate units. This last scenario is one of the most complex property management situations because the owner/manager has the most options for maintaining and restoring HOME compliance with unit mix requirements.

- (1) **Fix the Mix.** As in the scenario above (Exhibit 5-4), when a tenant in an LIHTC-HOME unit becomes over-income, the owner/manager can draw from any other available and comparable units in the property to “replace” it. The following situations are possible:
  - a. **The tenant of an LIHTC-High HOME unit becomes over income for both HOME and LIHTC (under both program definitions of over-income).** The owner/manager can do one of the following:
    - i. Use a comparable market rate unit for replacement—this can be either the next available market rate unit or a market rate unit that is occupied by a low-income tenant. Redesignate the market rate replacement unit as an LIHTC-High HOME unit and rent it to a tenant that is income-eligible for both programs. Once the replacement occurs, redesignate the over-income unit as a market rate unit, with no HOME or LIHTC restrictions. This restores compliance with both programs.
    - ii. Use a comparable LIHTC-only unit for replacement—this can be either the next available LIHTC-only unit or an LIHTC-only unit that is occupied by a low-income tenant. Redesignate the LIHTC-only replacement unit as an LIHTC-High HOME unit. Once the replacement occurs, redesignate the over-income unit as an LIHTC-only unit. This restores compliance with HOME only; the unit continues to be out of compliance under LIHTC because the over-income tenant resides in an LIHTC unit.
  - b. **The tenant of an LIHTC-Low HOME unit becomes over income for both HOME and LIHTC (under both program definitions of over-income), and the tenant’s income exceeds 80 percent of AMI.** Assuming the tenant is over-income for both programs, the owner/manager can:
    - i. Use a comparable market rate unit for replacement—this can be either the next available market rate unit or a market rate unit that is occupied by a very low-income tenant (and meets the income requirements of both

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programs). Redesignate the market rate replacement unit as an LIHTC-Low HOME unit. Once the replacement occurs, redesignate the over-income unit as a market rate unit.

- ii. Use a comparable LIHTC-only unit for replacement—this can either be the next available LIHTC-only unit, or an LIHTC-only unit that is occupied by a very low-income tenant. Redesignate the LIHTC-only replacement unit as an LIHTC-Low HOME unit. Once the replacement occurs, redesignate the over-income unit as an LIHTC-only unit. This restores compliance with HOME, but since the over-income tenant now resides in an LIHTC-only unit, it does not restore LIHTC compliance.

**When a Tenant is Over-Income for HOME, but not for LIHTC**

*In some circumstances, a tenant in a HOME-LIHTC unit may go over income for the HOME Program, but not for LIHTC. This is because over-income is defined differently for each program. (For example, in an LIHTC unit reserved for a household with an income at or below 60 percent of AMI, the household becomes over-income when its income exceeds 84 percent of AMI (60 percent X 140 percent)). When this happens, the owner/manager may need to find a replacement unit for the HOME unit, but not the LIHTC unit. This may result in two assisted units. The owner/manager redesignates (1) the unit with the HOME-over-income tenant as an LIHTC-only unit, and (2) a non-assisted unit as a HOME-only unit.*

- c. **The income of a tenant residing in an LIHTC-Low HOME unit exceeds 50 percent of AMI but is less than 80 percent of AMI.** In this situation, it is likely that the tenant is over income for the HOME Program, but not necessarily for the LIHTC Program (due to the different income limits and definitions of over-income for each program). The owner/manager can:
  - i. Use a comparable LIHTC-High HOME unit for replacement—this can be either the next available LIHTC-High HOME unit or an LIHTC-High HOME unit that is occupied by a very low-income tenant. Redesignate the LIHTC-High HOME replacement unit as an LIHTC-Low HOME unit. Once the replacement occurs, redesignate the over-income unit as an LIHTC-High HOME unit.
  - ii. Use a High HOME-only unit for replacement—this can be either the next available High HOME-only unit or a High HOME-only unit that is occupied by a very low-income tenant. Redesignate the High HOME-only replacement unit as a Low HOME-only unit. Once the replacement

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occurs, redesignate the over-income unit as an LIHTC-High HOME unit. (In other words, swap only the HOME designation, not the LIHTC designation.)

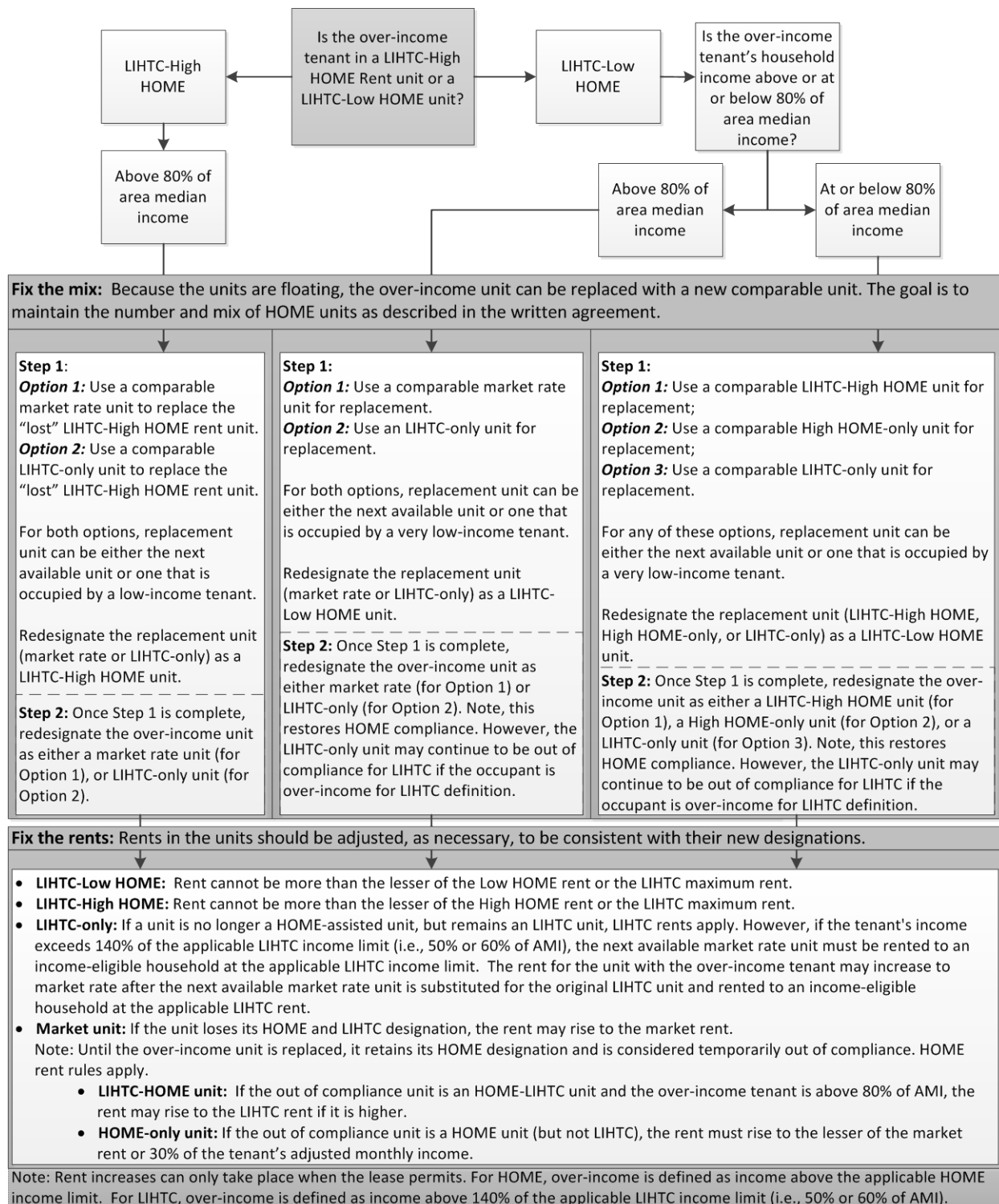
- iii. Use a comparable LIHTC-only unit for replacement—this can be either the next available LIHTC-only unit, or an LIHTC-only unit that is occupied by a very low-income tenant. Redesignate the LIHTC-only replacement unit as an LIHTC-Low HOME unit. Once the replacement occurs, redesignate the over-income unit as an LIHTC-only unit.

Note, since the over-income tenant is low-income, and continues to be eligible for the HOME Program, the unit cannot be replaced by a market rate unit.

**(2) Fix the Rents.** When unit designations change, as described above, adjust the rents to ensure that each unit has a compliant rent. **Rents can only be adjusted when the tenant's lease permits.**

- a. In an LIHTC-Low HOME unit, the rent may not exceed the lesser of the Low HOME rent or the LIHTC rent. If a rent adjustment is needed, it can only be done after a replacement unit is designated.
- b. In an LIHTC-High HOME unit, the rent may not exceed the lesser of the High HOME rent or the LIHTC rent. If a rent adjustment is needed, it can only be done after a replacement unit is designated.
- c. In an LIHTC-only unit, LIHTC rents apply. If a rent adjustment is needed, it can only be done after a replacement unit is designated. If the tenant is over-income (under LIHTC definition), the next available market rate unit must be rented to an income-eligible household at no more than the applicable LIHTC income limit. The rent for the unit with the over-income tenant may increase to market rate after the replacement unit is designated.
- d. While the property is temporarily out of compliance (until the unit with the over-income tenant is replaced), because an over-income tenant (above the low-income limit) occupies an LIHTC-HOME unit, the rent cannot exceed the LIHTC rent. (The HOME Program adopts the LIHTC rents in this situation.) If a rent adjustment is needed, it must be done **as soon as** the tenant's lease permits.
- e. In a market rate unit, rents are no longer regulated and can be adjusted without restriction. Typically, these rents will be set at market rates.

## Exhibit 5-5: Addressing Over-Income Tenants in HOME-LIHTC Units When HOME Units Are Floating and the Property is Mixed (Market and LIHTC)



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## 5.6 Terminating Leases or Tenancy

The HOME and LIHTC requirements related to refusing to renew leases or terminating an occupant's tenancy are substantially similar: both require that such actions require serious violations of the lease or applicable Federal, state, or local law. Tenant-landlord law and practices are heavily influenced by state and local law as well. Property managers should be sure that they understand when they can lawfully refuse to renew leases and terminate tenancy in their jurisdictions.

### **Using an Occupied Unit to Restore Unit Mix Compliance**

*The owner/manager can redesignate a unit with another that is occupied by an existing income-eligible tenant to restore unit mix compliance, for both the HOME and LIHTC Programs. However, both programs require that the terms and conditions of residing in an assisted unit be defined in the tenant's lease. Therefore, when using this type of substitution, the owner/manager must amend the tenant's lease to comply with the applicable program(s) requirements.*

*For instance, if a very low-income tenant resides in a market rate unit, and the income of a tenant in a Low HOME rent unit goes over income (income above 80 percent of AMI), the owner/manager can redesignate the market rate unit that is occupied by the income-eligible tenant as a Low HOME unit. The very low-income tenant's lease must be amended to include the applicable Low HOME rent, an explanation of the HOME income-eligibility requirements, and the HOME rent rules. The lease cannot include any of the lease terms prohibited by the HOME Program.*

*The owner/manager redesignates the over-income unit as a market rate unit. Rent adjustments must be made as soon as the tenant's lease permits, and the lease should be revised accordingly.*

The HOME Program specifies that property owners or managers can only terminate the tenancy or refuse to renew the lease of a tenant of a HOME-assisted unit for good cause. Good cause includes any of the following:

- Serious or repeated violation of the terms and conditions of the lease
- Violation of applicable Federal, state, or local law(s)
- Completion of the tenancy period for transitional housing.



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The owner can state other circumstances that would be considered “good cause” and should include these in the lease. The HOME Program further imposes notification and documentation requirements that must be met. A 30-day termination notice is required by the HOME statute.

The LIHTC rules specify that property owners/managers can terminate or refuse to renew the lease of a tenant in an LIHTC unit only under specific conditions, including any of the following:

- Material noncompliance with the lease
- Failure to carry out obligations under any state or local landlord and tenant law
- Other good cause. (Note, the conduct of a tenant cannot be categorized as “other good cause” unless the owner has given the tenant prior notice that the conduct shall, going forward, be a basis for terminating tenancy.)

*It is important for tenant leases to clearly identify the circumstances that are grounds for eviction or refusal to renew a lease. These policies should be implemented consistently, without regard to race, religion, national origin, sex, age, or disability, in order to comply with fair housing laws.*

## 5.7 Consequences of Noncompliance

The PJ is responsible for monitoring HOME-assisted properties for HOME compliance throughout the HOME affordability period, and the state allocating agency is responsible for monitoring tax credit properties for LIHTC compliance throughout the LIHTC compliance and extended use periods. Each agency monitors to ensure compliance with its respective program requirements. However, since these requirements are similar in many respects, and compliance problems under one program could indicate management or project problems that might affect compliance with the other program, it generally benefits both agencies to share monitoring information.

During the compliance period, the state allocating agency must report instances of noncompliance to the IRS. Failure to meet IRS terms and conditions could result in a loss of the investors’ tax benefits. Investors are highly motivated to protect these benefits, and are therefore highly motivated to comply with LIHTC rules. Under the HOME Program, noncompliance with fundamental rules about affordability can result in the repayment of HOME funds by the PJ and/or owner. While PJs do not want this end result, it does not necessarily carry the same motivation to the owner/investor as personal financial losses.



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## Noncompliance under LIHTC

State allocating agencies are required to review compliance certifications submitted by property owners. The allocating agency must choose one of several monitoring options, each of which combines inspecting a certain percentage of records on site with reviewing a certain percentage of annual income certifications and documentation that are submitted by the owner. The state decides which tenant records must be submitted or reviewed on site. The state must conduct records reviews at least annually.

If the allocating agency determines that a property is out of compliance with the LIHTC requirements, it must give notice to the owner of the project and an opportunity to correct the deficiency(ies). The correction period is no more than 90 days, unless otherwise extended by the allocating agency. During the compliance period, within 45 days of the correction period, the allocating agency must notify the IRS of the compliance issue and whether or not it has been corrected.

Based on the state's report, the IRS determines the consequences of noncompliance.

- If there is noncompliance with initial households' income-eligibility, it affects the applicable fraction on which the credits were awarded. This impacts the amount of credits the investor receives for the entire ten-year period. For instance, if the property gets credits based on a 60 percent applicable fraction, and it later turns out that one of the initial households was not income-eligible and the property should have had a 55 percent applicable fraction, then all the credit calculations are retroactively reduced and any prior claims of those credits that exceed a 55 percent applicable fraction are subject to repayment.
- If a subsequent household is found to be ineligible, this would impact only those tax credit claims for the period during which they were out of compliance.
- Persistent noncompliance can result in the recapture of all tax credit claims.

During the extended use period, each state allocating agency continues to monitor compliance with the LIHTC occupancy and rent restrictions. Each state determines the appropriate level of intervention and enforcement. This information is generally found in the QAP.

## Noncompliance under the HOME Program

Under the HOME Program, PJs monitor for compliance with HOME requirements. Owners are required to submit a Rent and Occupancy report for the PJ's review on an annual basis. In addition, the PJ inspects the property and tenant records on a specified schedule (see [Exhibit 5-2](#)).

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PJs use their judgment to tailor consequences to the severity and extent of the noncompliance with HOME requirements. The HOME written agreement between the PJ and the owner specifies the steps a PJ can take to enforce the terms of the written agreement. For serious and repeated violations of HOME requirements that are not corrected, including failure to rent to income-eligible tenants or failure to charge affordable rents, the PJ may be required to repay HOME funds to HUD. The PJ should impose a repayment obligation on to owners in its written agreement and recorded documents, such as the default conditions in a recorded note and mortgage.

## **5.8 Early Intervention to Address Property Distress**

In spite of best efforts to underwrite successful projects that remain financially viable over the long term, there are circumstances when properties fail. Typically, the earliest signs of problems are financial. Financial distress leads to physical distress because cash is insufficient to perform ongoing maintenance or address capital needs. Once a property fails to be maintained, it becomes harder for a property to retain and attract good tenants. This results in increasing tenant and possibly staff turnover. As the distress cycle progresses, it becomes more and more difficult and resource-intensive for the PJ to intervene and get the property back on track.

The earlier these property issues are addressed, the more likely the property can recover and become financially successful again. While initial signs of property distress may be financial, if left unaddressed, it becomes increasingly difficult for the property manager to operate the property in compliance with the affordability requirements.

If a HOME-LIHTC project shows signs of fiscal distress, it is important for the PJ to consult with the state allocating agency about appropriate interventions. In the first 15 years of the property's operations, in particular, the LIHTC investor is highly motivated to ensure that the property remains financially viable and in compliance with the LIHTC rules. The PJ and state allocating agency should work together to address the specific needs of the project.

For detailed information on what to do when a HOME-assisted property suffers financial distress, see the HUD publication *Compliance in HOME Rental Projects: A Guide for PJs* (HUD-2009 HOME Rental PJ, issued March 2009). This publication is available on the HOME Program website at <http://www.hud.gov/homeprogram/>.

## CHAPTER 6: ADDRESS LONG-TERM AFFORDABILITY

This chapter discusses what can happen at the expiration of the IRS compliance period. It explores the investors' options to exit the deal, and discusses how their exit options may affect the PJ's ability to enforce HOME affordability restrictions. This chapter further identifies steps the PJ can take at the funding stage to preserve affordability when investors exit the deal at the end of the compliance period.

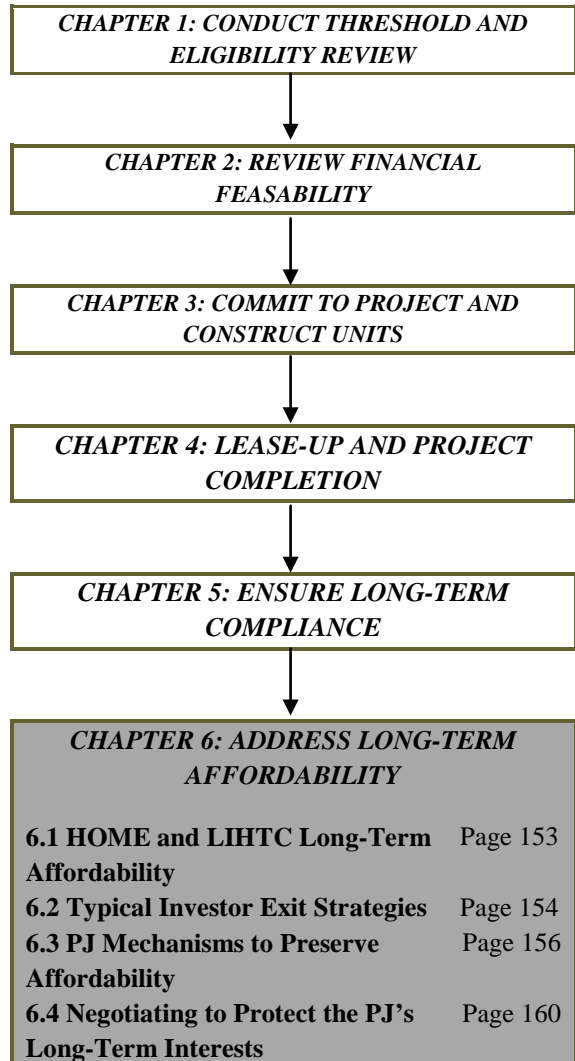
### 6.1 HOME and LIHTC Long-Term Affordability

While PJs are concerned with maintaining decent, safe, and affordable housing in their communities for low-income families, investors in LIHTC projects are interested in receiving a fair financial return on their investment. The development of affordable multifamily housing usually meets the objectives of both parties for a number of years. However, when the LIHTC tax benefits and their related use restrictions expire, a sale of the property may occur and it may become a challenge for the PJ to preserve affordability and enforce the HOME affordability restrictions.

It is important for PJ staff to understand the implications of the expiring LIHTC compliance period on the project, especially when the HOME affordability period is for more than the 15-year LIHTC compliance period. (This is true for many HOME and LIHTC new construction projects, where the HOME affordability period is a minimum of 20 years—five years beyond the expiration of the 15-year initial compliance period of the LIHTC.)

#### HOME Affordability Period

The HOME Program requires PJs to impose affordability restrictions for an affordability period that remains in place without regard to any other requirements of other lenders or programs. With the exception of new construction, a 5- to 15-year minimum affordability period is based



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on the amount of per unit of HOME investment, as shown in Exhibit 5-1 in [Chapter 5](#). For new construction, a minimum period of 20 years is required. During this affordability period, the compliance requirements discussed in [Chapter 5](#) apply. As previously noted, the PJ can impose longer term affordability periods.

The HOME affordability restrictions are enforced through the use of a deed restriction or restrictive covenant that runs with the land and is recorded in the appropriate jurisdiction (discussed in [Chapter 3](#)).

### LIHTC Compliance and Extended Use Period

The LIHTC Program requires the investor to hold the LIHTC investment for 15 years, during which time the investor's tax credits are subject to credit recapture by the IRS.

After 1989, the Internal Revenue Code (IRC, or the Code) requires an extension of the use restriction on the property that expires the later of 15 years after the tax credit compliance period ends or a date specified by the state. This is referred to as the *extended use* period. However, the Code also permits the investors to exit the project at that point, raising the possibility that ownership and financing may need to be restructured.

## 6.2 Typical Investor Exit Strategies

### Investor Exit Strategies

The tax credits are realized by the investor in the first ten years of the project. The Code permits investors to request to be bought out after the initial 15-year compliance period, and allow a successor owner to complete the extended use period. Therefore, most investors view their position in the project as a 15-year investment. An investor determines on the front end of the investment what *exit strategy* makes economic sense to optimize its return on its investment. At the end of the 15-year compliance period, the investor might have two options:

- Continue ownership and re-capitalize the project
- Exit its ownership interest.

Some investors may choose to continue ownership, but may require additional capital investment to address refinancing needs (on balloon mortgages) and additional capital investment to make improvements to the aging project.

However, most investors can be expected to opt to exit the ownership, as their tax credits have been used up. Under the Code, the state's allocating authority attempts to identify a successor owner. If it fails to find a successor, there are provisions to phase out the affordability restrictions.

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PJs with affordability requirements that extend beyond the IRS compliance requirement, especially in the case of new construction where the HOME affordability is a minimum of 20 years, should understand the options available to an investor and how they may affect a HOME-assisted project.

Up-front, and before negotiating the terms of the HOME investment, the PJs should know what exit strategy the LIHTC investor has selected. Information on the exit strategy may be contained in the partnership agreement (discussed in [Chapter 3](#)), or it may include options to be exercised later. PJs should assume that investors will wish to exit after 15 years unless otherwise committed in the partnership agreement, and negotiate appropriate protections in the HOME written agreement to ensure that the PJ will be able to enforce the HOME affordability requirements even if the investor exits the partnership.

In either case – recapitalization or exit – PJs need to keep in mind that HOME rules restrict the ability of the PJ to invest additional HOME funds in the project during the HOME affordability period.

If the PJ is unable to protect its affordability period beyond the expiring use of the LIHTC period or foreclosure, and the property does not continue to meet the HOME affordability requirements, the PJ is at risk of repaying the HOME funds invested in the project, whether or not those funds are recovered from the project.

### Effects of Exit Strategy on Pricing of Credits

The type of exit strategy affects the price investors are willing to pay for the credits. The investor calculates an anticipated rate of return on its investment, including the financial and tax effects of the exit strategy. If the PJ negotiates or requires a different exit strategy than what the investors plan, this might impact the syndication yield.

For a full understanding of the model used for a particular project, PJs should consult with the owners of the project and the owner's or PJ's tax and/or legal counsel. However, some of the investor's financial considerations related to its exit strategy are:

- Capital gains resulting from a sale
- Distribution of partnership assets other than the real estate
- Transaction costs related to a sale or transfer of title
- Potential tax benefits if the investor's interest is donated to a 501(c)(3) nonprofit organization
- Exit taxes.

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PJs need to find the appropriate balance between the investor's economic interests and the PJ's interest to preserve affordability. If the requirements of the PJ restrict the economic benefits to the investor, the PJ may need to provide more HOME funds to provide a better product.

### 6.3 PJ Mechanisms to Preserve Affordability

PJs need to think about three things as they contemplate structuring the deal in a manner to preserve long-term affordability and maintain enforcement of the HOME requirements:

- If the investors want to exit after 15 years, what mechanisms can help to ensure that a successor sympathetic to maintaining affordability can purchase the property?
- What terms of the HOME investment can help to induce the successor to maintain affordability?
- How can the financing needed to buy out the investors and make needed improvements to the units be achieved, especially if the HOME affordability period prevents additional HOME investment?

#### Mechanisms for Controlling Changes of Ownership

When the HOME affordability period extends beyond the 15-year LIHTC compliance period, **at a minimum, the PJ should require the LIHTC project owner to notify it when certain actions are taken or milestones are reached, including exit or change of ownership.**

However, there are additional protections the PJ can put into place to strengthen its ability to enforce the HOME affordability restrictions during the remaining years of the affordability period if a change of ownership is required, including:

- ***Right of First Refusal***
- Sale of units to tenant-occupants
- Option to purchase.

#### ***Right of First Refusal***

The Code allows the sale of LIHTC projects to certain qualified groups at a bargain price, known as the “Qualified Contract” price through a ***Right of First Refusal***. In this scenario, the Right of First Refusal gives the qualified group the right to purchase the property from the investor before the investor can sell the property to another party. The Code permits LIHTC project owners to offer the Right of First Refusal to the following groups:

- Government agencies

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- Qualified nonprofit organizations
  - Tenants
  - Resident management corporations.

If the investor plans to give a Right of First Refusal to a qualified nonprofit, the PJ should secure an agreement with that nonprofit regarding any HOME affordability that extends beyond the LIHTC expiring use agreement. If the investor has not identified a qualified nonprofit to act as owner of the project, the PJ should consider requesting a Right of First Refusal itself so it can ensure continued HOME compliance.

If a PJ or a qualified nonprofit elects to enter into an agreement that provides them with the Right of First Refusal, the bargain price imposed by the Code is the total debt on the project plus any exit taxes.

“Exit taxes” are the investor’s tax liability in the event that the cumulative tax losses on the project exceed the investor’s investment of capital in the project, resulting in the investor having a “negative basis.” For example, if an investor made an original capital contribution of \$1 million, received \$100,000 in cash distributions over 15 years, and recognized \$1.3 million in losses over 15 years, that investor’s tax basis would be negative \$400,000 at year 15. If this investor donated its limited partner position to a charity, or sold its investment for a penny, or lost its investment to foreclosure, the investor would have \$400,000 of taxable income and, in a 35 percent tax bracket, would owe \$140,000 of income taxes. This “exit tax” (\$140,000 in this example) creates a barrier to preservation, because it makes the investor reluctant to relinquish its partnership interest, even though selling may otherwise be the optimum strategy.

### ***Tenant Ownership***

Tenants are also able to purchase their units under a Right of First Refusal. Some tax credit deals are designed as longer term lease-purchase programs, whereby the initial tenants rent their units with the understanding that at the time the LIHTCs expire, they will have the option to purchase.

The long-term lease-purchase option is not what is contemplated under the HOME Program lease-purchase requirements; HOME requires that the tenant/buyer purchase the property within 36 months of signing the lease-purchase agreement. However, the HOME Program does permit a rental property owner to sell or otherwise convey rental units to existing income-eligible tenants under 24 CFR 92.255. To do this, the length of time that remains on the HOME affordability period for the rental property would be imposed on the tenant/buyer, and the tenant/buyer would be subject to the HOME homeownership requirements of 24 CFR 92.254. (If the tenant/buyer were provided additional HOME funds, the affordability period would be re-



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determined to include these funds.) Therefore, tenant purchase is possible even when the HOME affordability period extends beyond the 15-year tax credit compliance period.

This strategy is risky, however, since the investor will not be able to convey HOME-assisted units to any tenant whose income has increased above 80 percent of AMI. There may be opportunities to use this strategy in properties with only a percentage of HOME-assisted units. PJs should work with the owners and their legal counsel to see if it is appropriate to invest HOME funds in projects with this type of exit strategy.

### ***Option to Purchase***

Another expiring use strategy is an “Option to Purchase” the investor’s ownership interest in the project. This option provides the General Partner in the ownership entity the right to buy out the investor’s limited partnership interest at the time the requirements of the LIHTC expire. Since the ownership of the real estate remains the same, there are no sale transaction costs.

While the IRS at-risk rules do not permit a fixed price set in advance, up-front negotiation of formula approaches to sales price are permitted, and usually incorporate one or both of the following amounts:

- Fair market value of the partnership interest
- Investor’s unpaid benefits plus any exit taxes.

To protect the HOME affordability period, a PJ should require notification and the right to approve any change in ownership of both the property and the owner of the property prior to the transaction.

A variation on the Option to Purchase is what is referred to as a “Put,” which requires the General Partner to acquire the investor’s interest in the project. The price to acquire the interest is agreed to on the front-end by the parties. A PJ should know that this is part of the ownership structure prior to committing HOME funds to the project. If the PJ approves this arrangement, it should include a notification clause in the HOME agreement.

### **Terms of the HOME Investment**

When making decisions about the investment of HOME funds in a HOME-LIHTC project, PJs need to think about the potential exit of the investors and how to best invest the funds to ensure long-term affordability.

First, as said in other parts of this guide, the deed, covenant, or other mechanism should be recorded ahead of liens, as the restructuring of the financing will be required as part of the



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recapitalization or buyout of the investors, and the use restrictions need to survive the refinancing or sale.

Second, the HOME financing will need to be recorded as debt (through note and mortgage or deed of trust) to ensure that the PJ has a claim on the actual HOME funds in any restructuring of foreclosure that could trigger repayment. The lien position is an important consideration.

Third, the HOME debt is likely to be structured on a cash flow basis so that it can be included in the tax credit basis, and the accrual of debt increases the leverage of the HOME agency to influence the sale.

Fourth, the HOME debt should be due on sale, but assignable to an approved buyer, such as a nonprofit, that will continue to preserve affordability.

And, finally, if the use of some or all of the HOME funds might be directed toward acquisition of land, providing the funding to a land trust or nonprofit and a land lease keeps the ownership of the land in the hands of the nonprofit and removes land appreciation from the buyout price.

### Financing the Sale and Preservation

Refinancing is typically part of most exit or recapitalization strategies. Depending on the original loan terms and current lending market conditions, refinancing of the original debt may create some additional debt capacity, which is needed to raise funds for the required exit payment to the investors and for current rehabilitation needs.

After 15 years of operation, a project may require large capital outlays to replace or repair major building systems such as the roof or the heating and air conditioning system. If replacement reserves are distributed to the original investor as part of its exit strategy, and there are no funds in a reserve account to replace them, the existing general partner or new owner will need to find ways to fund the repairs or the property may fall into a state of disrepair. The property may not be able to support additional bank debt to pay for the repairs or rehabilitation.

Depending on the partnership agreement, the operating and replacement reserves in the project may be part of the distribution to the original owners at the time of sale or transfer of ownership. This is not in the interest of the project, as those reserves are needed for the project going forward.

Re-syndication is another option available to owners to raise capital for their project.

During the HOME affordability period, the PJ is not permitted to provide additional HOME funds, so the PJ and new owner will need to identify other sources of capital for these projects. Note that if the HOME affordability period has expired, PJs may make a new commitment of HOME funds, subject to the HOME requirements.

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PJs should be open to refinancing or recapitalization strategies that preserve affordability and HOME compliance, including re-subordination of new debt, assumption of the HOME debt by a new owner, and addition of new sources that enable the buyout and necessary rehabilitation.

## **6.4 Negotiating to Protect the PJ's Long Term Interests**

It is important for PJs to integrate the relevant preservation strategies into their HOME agreements whenever possible. This can be accomplished if the PJ understands the investor's exit strategy at the earliest stage of the development process.

Sometimes, the owner of an affordable housing development seeks HOME funds from a PJ after the LIHTCs are allocated, or shortly before an application deadline. The PJ may feel pressure to accommodate the owner's terms so that important tax credits are not lost to its community. However, even when this occurs, the PJ has a responsibility to understand the entire financing structure of the project, including the exit strategy, prior to committing HOME funds.

The best approach to ensure that all parties understand the terms, conditions, and needs of the other parties to the transaction is to bring all the stakeholders or their representatives together to discuss all aspects of the deal, including expected outcomes, and the investor's anticipated exit strategy.

The stakeholders include:

- PJ
- Managing General Partner of the ownership entity
- HOME sponsor, if different than above
- The state allocating agency
- Lender representatives
- LP investor or its representative
- Legal and tax counsel.

The PJ is investing HOME funds and it should expect, as a minimum return on its investment, compliance with HOME affordability requirements over the long term. Even when contacted late in the deal, the PJ must make sure that provisions are incorporated into HOME agreements to ensure compliance with HOME requirements throughout the affordability period.

Areas that PJs should consider in their negotiations are:

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- Agreements that survive foreclosure
  - Agreements with the owners that provide the PJ (or an appropriate successor) the Right of First Refusal in the event of a sale initiated by the LIHTC investor that precedes the expiration of the HOME and/or PJ affordability period
  - Agreements with the owners and all other lenders that provide the PJ notification in the event of default or noncompliance
  - Agreements with the owners and all lenders that allow the PJ the right to cure the event of default, and where possible, any identified noncompliance issue
  - A provision in any agreement(s) with the owner that any change in ownership and/or management must be approved by the PJ.