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For further information on Pillsbury's Affordable Housing & Community Development Practice, please contact:

Gary P. Downs | Partner—San Francisco
gary.downs@pillsburylaw.com
415.983.1835

Craig A. de Ridder | Partner—Washington, DC
craig.deridder@pillsburylaw.com
202.663.8712

Dana P. Newman | Partner—Los Angeles
dana.newman@pillsburylaw.com
213.488.7334



Using Solar Power to Achieve the Triple Bottom Line

by Gary P. Downs

The renewable energy and affordable housing industries have lived side by side for years. They have come together recently to produce a tax subsidy and, in certain structures, economic subsidy for affordable rental projects. The solar investment credit provides investors a tax credit to apply dollar-for-dollar against tax liability equal to 30% of the cost of the solar hardware and installation in the tax year that the solar equipment is placed in service. Although the credit looks attractive at first blush, affordable housing developers have wrestled with how to maximize this subsidy's benefits.

Where the low-income housing tax credit ("LIHTC") investor will pay top dollar for the solar investment credit, structuring solar credits into the transaction appears straightforward, especially in transactions financed without tax-exempt bonds. In tax-exempt bond-financed projects where investors either do not want the credit or are unwilling to pay top dollar for the credit, structuring becomes complex. Tax

Using Solar Power to Achieve the Triple Bottom Line

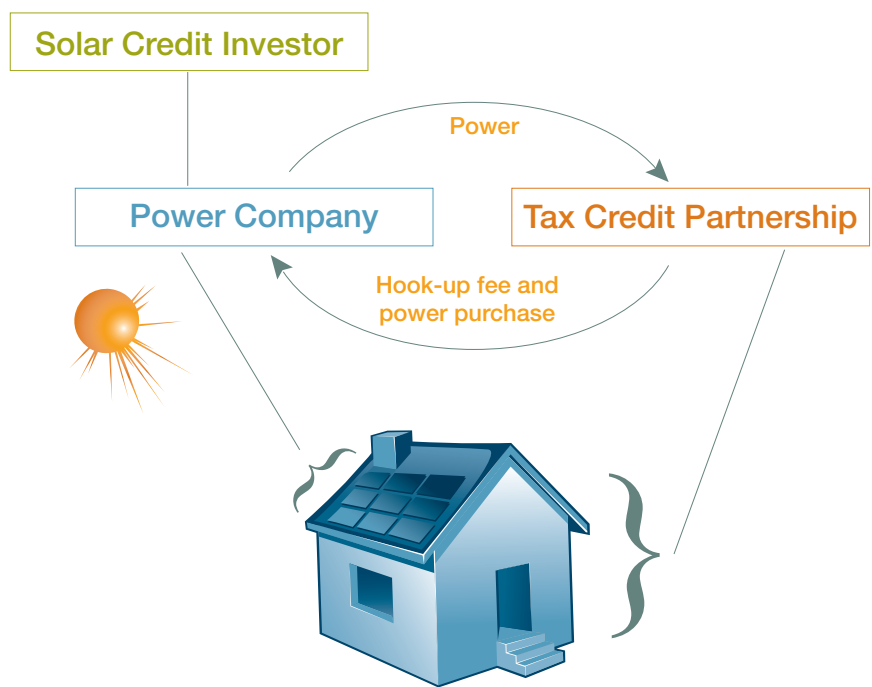
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benefit special partner allocation, direct tracing, mismatches between income and deductions, investor desires and basis and credit reduction rules combine to drive transactions into three basic structures. This article provides an overview of the risks and benefits associated with each structure.

The Model for the Investor Taking the Solar Credit

Whether the LIHTC investor should receive the allocation to take solar credits depends on whether tax-exempt financing is involved. In projects that sell LIHTCs and are conventionally financed, the most efficient structure for harnessing the value of the credits will be through monetization by allocation to the investor. Although this structure will reduce LIHTC-eligible basis, the cost associated with the reduction will be less than the value reduction associated with competing structures. However, not all tax credit syndicators have investors willing to pay for these credits, and some investors may be interested, but unwilling to pay top dollar. We have found that investor interest must be tested up front because in transactions where solar is an afterthought, investors are rarely interested in paying top dollar.

Projects should also monetize solar credits by allocation to the investor in



bond deals if the investor is interested in the credits at a sufficient price. The Internal Revenue Code provides that if the solar costs are financed by bonds, the bond-financed portion of the solar property basis is not eligible to produce the solar credit. Because bond-financed projects are at least 50% bond-financed, this creates a potential loss of at least 50% of the solar credits—a costly tax hit. If the solar costs are financed solely by equity and the solar hardware does not act as security for the bond loan, some indirect authority suggests that the tainting bond proceeds can be traced away from the solar credit, providing eligibility for 100% of the solar costs.

In projects where the investor is not excited about solar energy credits, two additional structures are available. The second and third structures discussed below involve allocating the credits to the sponsor or forming a sponsor-owned energy company to own and install the solar equipment.

Allocating Credits to the Sponsor

Where solar equipment is owned by the tax credit partnership, the parties may attempt to use the direct tracing discussed above and special allocations to allow the general partner to take the credits. If the structuring is successful, the project sponsors that own the general partner can take the credit directly or attempt to monetize the credits by “selling” to a third party. Like all of the structures discussed here, this model is not without tax risk. Only some indirect authority supports using tracing to avoid the tax-exempt bond taint, and whether the tax benefits on the solar equipment can be allocated to the general partner is controversial in an LIHTC transaction where the building tax benefits, including the LIHTC, are allocated to the limited partner/investor. One might argue that

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From the Chair

James M. Rishwain, Jr.

Pillsbury Winthrop Shaw Pittman LLP is proud to present its seventh annual Newsletter on Affordable Housing & Community Development. Our Affordable Housing & Community Development Group experienced an exciting and rewarding year in 2007 as it handled hundreds of matters in diverse, and sometimes unprecedented, areas of service. It was also a busy year in which our San Francisco office alone helped close over \$800 million in financing of affordable housing transactions. We are already off to a fast start in 2008 as we continue to expand our practice to serve the needs of our growing number of clients.



Housing for Educators Attracting and Retaining University Professors and Schoolteachers with Affordable Homes

by Jon E. Goetz

In the national battle to recruit talented academic faculty, colleges and universities located in high-cost housing areas find themselves at a competitive disadvantage. Housing cost is a significant issue for young PhDs with loads of student loan debt, as well as more experienced professors who often have choices between positions at universities located in pricey areas and less expensive housing markets. Many universities in expensive regions, like the coastal areas of California, report losing faculty recruits once they learn how difficult it is to purchase a home near campus on a professor's salary.

It is no wonder that many universities now see the availability of reasonably priced housing as a key factor in their recruiting and retention efforts. Affordable housing not only enhances recruiting, but also acts as the proverbial "golden handcuffs" that discourage faculty from leaving to take jobs at other universities. Affordable housing near campus also

has beneficial quality-of-life effects on faculty and staff by reducing commutes, improving productivity and increasing participation in campus activities.

Many universities adopt the "community land trust" model of ownership housing to create affordable housing for their faculty and staff.

Many universities adopt the "community land trust" model of ownership housing to create affordable housing for their faculty and staff. Under this model, the university or a nonprofit affiliate builds housing on campus or on nearby land acquired for the project. The university or its affiliate retains ownership of the land, sells the homes to faculty at a below-market price and simultaneously ground leases the underlying land or common area interests to the homebuyers. The university gives purchase rights to faculty and staff based on a

priority system that may favor new recruits. If there is insufficient demand, homes may be offered to employees of other universities and public agencies. The terms of the leases are typically 99 years or a similarly long period. Rents may be set at nominal levels, or may be established at market levels to avoid imputed income to the residents.

Typically, the university retains an option to repurchase the home at an indexed price when the homeowner desires to sell, leaves university employment or no longer lives in the home and in other specified events. Some universities also have an option to reacquire the homes upon the retirement or death of the homeowner. The university maintains a waiting list of prospective homebuyers and takes other steps to facilitate resales. Resale prices are usually restricted, with appreciation based on such factors as increases in the Consumer Price Index or area median incomes. Such prices also take into account the value of improvements made by the homeowner.

The goal of the repurchase option is to keep housing prices affordable to future generations of faculty homebuyers, while allowing homeowners to make a reasonable profit on their investment. The ground lease format also ensures that the university will remain heavily involved with the housing long after the initial sales are closed, while monitoring the maintenance of the development and preserving it as a permanent affordable housing resource for university employees.

Universities that have on-campus land available for faculty housing do not need to recoup any land cost from homebuyers. Initial sales prices may be set at levels sufficient to cover only the cost of the improvements, allowing universities to establish prices far below market levels. For example, one of the best-known university faculty housing projects is the University Hills development on the campus of the University of California, Irvine, where the University's nonprofit affiliate constructed approximately 900

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140.1 Redux? BOE Hints at Additional Review of MGPs

by Byron A. Rodríguez

As industry participants are well aware, 2005 and 2006 saw a long and involved rulemaking process by the California Board of Equalization (“BOE”). Concessions by all stakeholders eventually resulted in the issuance of BOE Rule 140.1. Recent murmurings at the BOE suggest that it may be preparing to upend the Rule 140.1 compromise and again create uncertainty around a subsidy upon which most affordable housing development budgets rely and in an area that the industry had thought to be settled.

Rule 140.1 describes the management responsibilities that must reside with the nonprofit corporation owner of an affordable housing project for the project to benefit from the “welfare exemption”

from California property taxes available under Section 214(g) of the California Revenue & Taxation Code (“Cal. Tax Code”).

The Rule 140.1 rulemaking process created a divide between large nonprofit developers seeking to be the sole beneficiaries of the welfare exemption, and the for-profit development community, which wanted to continue to partner with nonprofits to be eligible for the welfare exemption. Large nonprofits wanted the welfare exemption to be exclusive to nonprofit developers for the competitive advantage it would provide in development budgets. They argued for the exclusivity based on the higher levels of services often provided by the

nonprofits. For-profits challenged the large nonprofits on policy grounds by pointing to more efficient per-unit development costs and the purpose of the welfare exemption in incentivizing housing units, not services.

In the end, the BOE settled on a set of requirements for nonprofit partners in for-profit deals whereby the nonprofits would need to elect ultimate responsibility for 5 out of 12 “substantial management duties” related to the operation and ownership of the project.

The BOE indicated that it was re-evaluating what would constitute an “eligible nonprofit” for purposes of the welfare exemption.

Rule 140.1 might not have satisfied anyone completely, but the expectation was that it would be a compromise allowing developers, for- and non-profit alike, to move forward with the development of new affordable housing projects urgently needed in the state.

For the uninitiated, the typical ownership structure for for-profit affordable housing projects has the project owned by a limited partnership in which each of the for-profit developer and an “eligible nonprofit” partner are general partners, with the nonprofit designated as the “managing general partner” and satisfying the management and oversight requirements of Rule 140.1.

By 2007, the perception in the industry was that Rule 140.1 was the settled approach of the BOE to determining project eligibility for the welfare exemption. Then, on a call in late November between the BOE and industry stakeholders regarding a separate issue, staff attorneys at the BOE indicated that they were re-evaluating what would constitute an “eligible nonprofit” for purposes of the welfare exemption.

On the call, the BOE staff and attorneys asked numerous questions of developers’ attorneys, with a focus on two specific

items. First, the BOE wanted to know whether the nonprofit managing general partners that were partnering with for-profit developers were involved in the development of affordable housing other than in partnership with for-profit developers. Second, the BOE wanted to know whether nonprofits were providing services at each of the projects for which they served as managing general partners.

Rule 140.1 does not impose specific “nonprofit” requirements on a managing general partner other than that it be a nonprofit corporation or eligible limited liability company meeting the requirements of Section 214 of the Cal. Tax Code. The prevailing position in the industry was that a nonprofit with a valid 501(c)(3) determination letter from the IRS that had applied for and received an “Organizational Clearance Certificate” from the BOE would meet the nonprofit requirements of Rule 140.1. However, the message from the BOE attorneys and staff on the call was that these qualifications might not be sufficient and that, regardless of whether the Rule 140.1 requirements were met, the BOE might engage in further review of a nonprofit’s qualification as an “eligible nonprofit” before approving a welfare exemption.

Section 214(g) of the Cal. Tax Code allows the welfare exemption for “religious, hospital, scientific, or charitable funds, foundations, limited liability companies, or corporations, *including limited partnerships in which the managing general partner is an eligible nonprofit corporation or eligible limited liability company.*” (emphasis added) To be eligible for the welfare exemption, nonprofits must apply to the BOE for an Organizational Clearance Certificate. The BOE’s review role in determining whether to grant an Organizational Clearance Certificate is described at Section 254.6(b) of the Cal. Tax Code and appears intended to belt-and-suspend the IRS requirements that director salaries and expenses be reasonable and that the nonprofit’s operations do not result in private gain.

The position of the BOE attorneys appears to be that the word “eligible” allows the BOE substantive review of the qualifications of the nonprofit corporation over and above those requirements that must be met under Section 254.6 and Rule 140.1. Under this reading of 214(g), Rule 140.1 presumably deals only with defining what constitutes a “managing general partner” and not with an “eligible nonprofit.” This is surprising, as a more natural reading of the statute would suggest that to be “eligible” a nonprofit must be one of the earlier-mentioned “religious, hospital, scientific, or charitable funds, foundations, limited liability companies, or corporations.”

More surprising still is the implication from the BOE staff questions that what constitutes an “eligible nonprofit” can be determined by reference to whether services are provided, because the election to provide services is optional under Rule 140.1.

The BOE questions suggest that the conservative approach will be to elect provision of services as a substantial management duty.

We have not heard anything additional from the BOE on these issues since November, and we are hopeful that nothing more will come from their questions. However, given the relatively senior level of BOE staff and attorneys on the call, we caution the industry to be prepared to revisit these issues. In the meantime, the BOE questions suggest that the conservative approach will be to elect provision of services as a substantial management duty wherever project characteristics and development budgets so allow.



Byron A. Rodríguez is a Senior Associate in the San Francisco office and can be reached at 415.983.1265 or byron.rodriguez@pillsburylaw.com

Project Spotlight

Cal Poly Pomona Employee Housing



As part of an employee ownership housing program, the Cal Poly Pomona Foundation has acquired nearby condominium units that it will make available to Cal Poly Pomona faculty and staff as well as employees of neighboring institutions. Under the program, the Foundation will maintain purchase options and resale controls to ensure continuing availability and affordability of the housing to employees of the University, which is located in the Los Angeles metropolitan area. Pillsbury represented the Foundation in connection with the project. The proximity of the housing to campus will also help reduce commuting requirements for University employees.



Wasted Basis?

The Risks and Rewards of Taking Tax Credits from Decoupled IRPs

by Christian D. Dubois

As affordable housing developers try to make their projects pencil out, they may be missing a significant revenue source. For various reasons, the basis attributable to mortgages receiving decoupled Section 236 interest reduction payments (“IRPs”) is often excluded from basis that produces tax credits. Unfortunately, there is a lack of IRS guidance as to whether and how projects should take advantage of such tax credits. The IRS has an open regulation-making project on this issue; however, in the absence of direct guidance, project planners should consider certain steps that provide good arguments that their projects will generate IRP-related tax credits without recapture. With a little ingenuity and a cooperative lender, projects may reap substantial additional dollars, but not without risk.

The U.S. Department of Housing and Urban Development (“HUD”) originally established the Section 236 program to provide loans to qualifying affordable housing projects with annual subsidies

to interest payments known as “interest reduction payments” or “IRPs” that effectively reduced the debt service on such loans to 1%. In 2000, HUD allowed for the Section 236 loans to be replaced with private loans, and allowed the IRPs to be separated or “decoupled” from the initial Section 236 loans and applied to the new loans. Unfortunately, the IRS has not provided direct guidance as to whether new, IRP-assisted loans may be included in a project’s tax credit basis.

There are two potential problems with IRP-related basis. First, the IRS may argue that either the IRP-stream or the IRP-supported loan principal received up front is a federal grant under Section 42(d)(5) of the Internal Revenue Code (the “Code”), making the basis ineligible for tax credits. Second, if the result of applying the IRPs to project financing is that the overall loan rate is below the applicable federal rate (“AFR”), the IRS may classify the loan principal as being federally subsidized, in which case the

project may receive 4% credits, but not 9% credits under Sections 42(b)(1)(B) and 42(i)(2) of the Code. Either of these events may result in credit recapture. The typical approach has been to exclude the IRP-supported loan from tax credit basis to preserve the 9% credits; however, there are valid arguments to support inclusion.

The main arguments against classifying an IRP stream and IRP-assisted loans as “federal grants” involve some extrapolation and common sense. By reference to a 1976 IRS Revenue Ruling combined with an analogy to the treatment of IRPs under a similar program (USDA’s Section 515 Rural Rental Housing Program), some argue that the IRPs are not federal grants in and of themselves, but are simply interest offsets. The reasoning continues that IRP-assisted loans are the equivalent of federal loans and not grants, and to the extent that federal funds are used to amortize the tail end of the loan, that effect should be ignored as *de minimis*. Unfortunately, the 1976 ruling predated the allowance of IRP decoupling and the Section 42 low-income housing tax credit program, and the IRS has not issued more recent guidance on the matter.

With a little ingenuity and a cooperative lender, projects may reap substantial additional dollars, but not without risk.

There is also a logical argument that there is no federal grant at the time a project receives IRP-assisted loan funds. The IRP-assisted loan is borrowed in anticipation of the receipt of federal monies (i.e., the IRPs as received) and if for some reason the project does not receive the IRPs, the loan payments will still be due and owing. The idea is that, in effect, the actual benefit of each IRP is not received until that IRP is received, so the “grant” does not take place until the IRPs are actually received and applied to principal. The IRS has not directly responded to this line of reasoning, leaving open the possibility

that all IRP-related tax credits may be subject to recapture.

There are two potentially helpful approaches to avoid a determination that IRPs are federal subsidies that would bar the receipt of 9% credits on the tainted basis amount. The first approach is to work with the new mortgage lender to ensure that the interest rate remains above AFR with the IRP stream pledged only to pay interest on the new mortgage. The IRP stream should be assignable only in the event that there is a default in the interest payment.

The second, and perhaps supplementary, approach still allows the general partner to take advantage of IRP-created basis if the investor does not want to take on the associated risk. Under this approach, the investor receives credits only up to the percentage of overall credits generated by non-IRP-related sources, reserving the remaining credits for the general partner to retain or sell on its own. Of course, tax credits cannot actually be earmarked to flow according to whether or not they were generated by an IRP-related source, so this scheme affects only the relationship between the members of the partnership and not the tax liabilities of the partnership. To protect the investor's position, the investor may require credit adjusters with a credit-worthy entity that will provide immediate indemnification for credits recaptured as a result of IRP-related issues.

We believe that there are viable arguments to support the inclusion of IRP-assisted loans in a project's tax credit basis where the new loan interest rate is above AFR and the IRP is solely pledged to interest. Project owners should carefully discuss with investing partners before a project begins what will and will not be included in a project's basis to ensure that each party estimates and measures tax credit generation similarly and to ensure the appropriate allocation of risk.



Christian D. Dubois
is an Associate in the
San Francisco office and can
be reached at 415.983.1542 or
christian.dubois@pillsburylaw.com



The Hidden Price of the Tax Credit Investor Exit

by Irene C. Kuei and Noa L. Clark

As many affordable housing projects near the end of the 15-year tax credit compliance period, the focus of tax credit investors is shifting from low-income housing tax credits ("LIHTCs") to the back-end distribution. At the same time, many general partners are contemplating whether or not to exercise their buyout options to take ownership of projects. Because of the increased attention to the back-end distribution and the investor's exit, it is important to understand how the investor's interest may be valued when the general partner decides to buy. This article provides a brief overview of a significant valuation issue that can arise toward the back end of the project when pricing the investor's interest in the project or in the partnership.

Background

General partners that enter into a partnership to provide affordable housing typically have the right to purchase either the project or the investor's interest in the partnership at the end of the 15-year tax credit compliance period. When the LIHTCs are exhausted, this buyout option allows the general partner to take ownership of the project. General partners want to be able to exercise their buyout options at the lowest possible price, but investors want

to make sure that they get the most out of the back-end distribution, particularly in today's market. As a result, general partners and investors often disagree over how the investor's interest should be valued.

Valuation Based on Waterfall Provisions

Whether buying the investor's interest in the partnership or the project, the general partner takes the position that the value of the investor's interest should be based on the capital proceeds waterfall provision. Waterfall provisions typically allocate capital proceeds first to the partnership's non-partner debts and liabilities, then to reserves and next to partner debts and liabilities and unpaid fees, such as developer fees. Of the remaining proceeds, generally 90% will be distributed to the general partner and 10% to the investor. Under the capital

The general partner takes the position that the value of the investor's interest should be based on the capital proceeds waterfall provision.

proceeds waterfall method of valuation, the value of the investor's interest is based on what the investor would receive if the project were sold at fair market value to a third party and the sales proceeds were distributed according to the partnership's waterfall provision.

Valuation Based on a Deemed Termination

Certain investors argue that their interest should not be valued based on the capital proceeds waterfall method, but should instead be based on the amount they would receive upon termination of the partnership. In the case where the general partner has the option to purchase the project, the investor's reasoning is that had the project been sold to a third party at fair market value, Section 704(b) of the Internal Revenue Code (the "Code") would require the

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Credit Market Decline Cools Financing for GP Interest Purchases

by Bradley D. Scheick

In past issues of this newsletter, we reported on the significant growth in multifamily affordable housing transactions structured as sales of partnership interests instead of direct property transfers. Such transactions, in which the buyer acquires the general partnership interests in the limited partnership that owns the target real property, allow for the transfer of the benefits of ownership of real property without jeopardizing low-income housing tax credit eligibility.

Although buyers and lenders continue to be interested in general partnership transfers, the market for such positions is in disarray following the weakening of the overall credit markets. Buyers are finding the necessary financing harder to obtain. David Smith, CEO of Recap Advisors, a financial services and consulting company specializing in multifamily residential properties, recently stated that “lenders are highly intrigued by GP positions, but the market has cooled considerably, mainly because the asset class is perceived as complex and

balance sheet and capital, which before were regarded as free resources, are now scarce commodities.”

“[L]enders are highly intrigued by GP positions, but the market has cooled considerably....”

—David Smith, CEO of Recap Advisors

This scarcity of capital is a product of the lending community’s response to the ongoing volatility in the credit markets. As the full impact of the subprime mortgage collapse becomes more evident and the capital markets adjust, lenders are finding it necessary to continually reevaluate their interest rate requirements and tighten their underwriting standards. Accordingly, buyers face significantly increased debt coverage and collateral requirements while available loan-to-value ratios slip.

As a result, the prior stability and predictability of the market for secured financing of general partnership interests is giving way to increased uncertainty,

making the pricing and closing of new loans difficult. “Before August we were talking about rates in the range of LIBOR plus two hundred,” says Smith, but “now there is no agreement on bid/ask.” In fact, the market has become so unsettled that some lenders are struggling to keep pace with the ever-changing conditions and have found it necessary to reprice or abandon deals after prices have been quoted or even after deals have been tentatively reached as they respond to market fluctuations.

Because of the difficulties in obtaining financing, the market for these general partnership interest assets is in the midst of what Smith calls a “delayed freeze,” as deals currently in the pipeline are processed and lenders continue to reprice the shrinking pool of available capital. Smith notes: “People who have portfolios pending are trying to close them. I think once they do, demand will slack off dramatically.”

Others in the industry are somewhat more optimistic, noting that supply and demand fundamentals of the overall multifamily housing market are generally positive and likely to improve during 2008. Whether or not such optimism ultimately proves to be well-founded, it is unlikely that the market for general partnership interest secured loans will recover as long as the overall credit market turmoil continues. Given that losses from the subprime mortgage collapse already top \$100 billion, as recently reported in *The Wall Street Journal*, and that many in the financial community are calling for an emergency economic stimulus package, it appears that this market will remain unpredictable and unstable for some time. As Smith cautions, “Anybody who says he’s certain about how these transactions will be priced or financed has a much better crystal ball than I do. We can expect a lot more change in a very short period.”



Bradley D. Scheick
is an Associate in the
San Francisco office and can
be reached at 415.983.1694 or
bradley.scheick@pillsburylaw.com

New Markets Tax Credit Update: Gearing Up for Another Round

by Josephine S. Lo and Lena Y. Hines

In December 2007, the Community Development Financial Institutions Fund ("CDFI Fund"), a branch of the U.S. Department of the Treasury, announced the availability of an aggregate amount of \$3.5 billion for 2008 New Markets Tax Credit ("NMTC") allocation authority. This is the sixth round of competition for NMTC allocations and the deadline for applications is March 5, 2008.

It has become customary for applicants to commit to standards that greatly exceed the basic NMTC program requirements.

The NMTC program is a federal program designed to stimulate economic development in low-income communities ("LICs"). Under the NMTC program, community development entities ("CDEs") apply for NMTC allocations and solicit equity contributions from private investors. CDEs then use the equity proceeds to make qualified LIC investments, which include equity investments in, or loans to, qualified businesses or other CDEs, acquisitions of qualifying loans made by other CDEs and the provision of financial counseling to businesses located in, or residents of, LICs. An NMTC investor in a CDE may claim the NMTC over seven years, totaling 39% of its equity investment, to offset its federal income tax liability.

The CDFI Fund has allocated 294 NMTC awards totaling \$16 billion over the first five rounds of competition. Revisions to the program for the sixth round include a reduction in the maximum award amount for each applicant from \$150 million to \$125 million, subject to exceptions for applicants that can demonstrate that their projects will have a

greater financial need for successful implementation or will provide an extraordinary community impact.

In the 2007 allocation round, the CDFI Fund designated a portion of the available allocations to be used for LIC development projects in the Hurricane Katrina Gulf Opportunity Zone. In the 2008 round, the CDFI Fund will ensure that a portion of the available allocations will be directed to projects located in non-metropolitan service areas (generally, rural LICs).

Over the term of the NMTC program, the CDFI Fund has become increasingly sophisticated in identifying NMTC applicants that show a strong potential and lasting commitment to stimulating economic growth in LICs. CDEs competing for the award must earn "excellent" scores in each category to advance past the first phase of the review process. It has become customary for applicants to commit to standards that greatly exceed the basic NMTC program requirements. For instance, CDEs that are awarded NMTC allocation authority are required to invest substantially all (generally 85%) of their private equity investments in LICs. All of the recipients of 2007 NMTC allocation awards committed to invest at least 90% of their equity investment dollars

into qualified LIC investments. Additionally, most applicants committed to make investments in areas that were more severely economically distressed than the LIC areas mandated by the NMTC investment rules. As the CDFI Fund refines the program criteria, and competing CDEs independently impose higher investment standards, the NMTC allocation awards become more competitive with each round. The CDE demands for NMTC allocations have been, on average, approximately 10 times more than the availability.

Pillsbury has advised CDEs, equity investors, lenders and developers in structuring and closing many NMTC transactions. We have expertise in various aspects of the ever-evolving NMTC program, including allocation applications, project developments, syndication, leverage financing, asset management and regulatory compliance.



Josephine S. Lo
is a Partner in the
Washington, DC office and can
be reached at 202.663.8196 or
josephine.lo@pillsburylaw.com



Lena Y. Hines
is an Associate in the
Washington, DC office and can
be reached at 202.663.8310 or
lena.hines@pillsburylaw.com

Attention Landlords

Effective January 1, 2008, California is the first state to prohibit landlords from asking tenants' immigration status. California AB 976 prohibits cities and counties from enacting any law that would require a landlord to take any action regarding a tenant or a prospective tenant based on the tenant's immigration status. The law also prohibits a landlord from independently asking about a tenant's immigration or citizenship status as a prerequisite to renting. AB 976 came as a relief to many landlord associations concerned about taking on the costs and liabilities of enforcing city- and county-enacted immigration laws. Despite these new prohibitions, landlords should not be concerned about their ability to comply with federal laws or regulations. California landlords are still permitted to comply with their legal obligations under any federal law, and landlords may still request information necessary to verify a tenant's identity or financial qualifications.



Litigating the Partnership Deal Terms

by Thomas V. Loran III

Pillsbury's representation of affordable housing developers does not end when the voluminous paperwork for the project is executed by the parties at the deal's closing. In fact, a new phase of our work begins at that point. And sometimes, though relatively rarely, the developer and investor limited partners ultimately find themselves at odds over the partnership deal terms as the affordable housing project moves forward. At that point, Pillsbury trial attorneys with extensive background in affordable housing disputes are available to assist the client resolve the controversy.

Our affordable housing litigation work is as varied as the projects that spawn it. There are recurrent issues, however. The most prevalent of these issues are: disputes regarding tax credit adjusters; delayed or disputed capital installment payments; and consent to project sale or sale or assignment of the limited partner interest or general partner interest. Pillsbury litigators have extensive experience in each of these paradigms of affordable housing partnership disputes.

Pillsbury has successfully litigated partnership disputes regarding upward and downward "adjusters." "Adjusters" are the standard provisions in affordable housing limited partnership agreements that operate to true-up the time/value of the delivery of tax credits and/or depreciation deductions to the investor limited partners. Essentially, the role of adjusters is to alter the investor's required capital contribution installment payment after the project is constructed and the units are leased. By that time, certain rate-of-return factors are known, including the total construction cost (for depreciation purposes), the total tax credits that the project will generate and the schedule at which depreciation deductions and tax credits will become available to the investors.

In our firm's experience, the resolution of disputes regarding adjusters is a two-pronged process. First, the unique provisions of the partnership agreement need to be carefully reviewed as they relate to the adjuster in question. Many times, adjusters that initially appear to be absolute are qualified or mitigated by competing adjusters in the same agreement. Second, a forensic accounting expert is needed to evaluate the competing cash flow and tax credit values over the anticipated life of the project to derive the true-up number specified in the particular adjuster. Through our significant experience in handling these cases, we have been able to develop some very creative arguments regarding interpretation of the limited partnership agreement. We have also established ongoing professional relationships with several firms that have great expertise in the economics of affordable housing development, which is a critical aspect of their credibility in presenting opinion testimony in the adjuster dispute cases.

The flip side of an adjuster dispute involves a delayed or disputed capital obligation of the limited partner. In this situation, due to either external events or some express term in the affordable housing development project's partner-

ship agreement, the limited partner has delayed making a capital contribution or installment. Under the cash flow and time/value financial models that are inherent in the project's financial structure, a delay by the investor limited partner in making a required capital installment payment means that the investor will enjoy a greater rate of return on the capital already invested.

Accordingly, basic financial equity requires an upward adjustment in the amount of a capital installment payment if not timely made by the affordable housing project's investors. Pillsbury has had success in enforcing upwardly adjusted capital installment payment obligations against limited partners, without regard, in most cases, to whether or not the relevant project agreement expressly carved out the right to seek such an upward adjustment.

Another emerging area of our affordable housing litigation practice relates to the attempted sale of the project or of the limited partner interest or general partner interest in the project. This is an area that often is covered only in the most general terms in the project's limited partnership agreement. We have developed arguments for presentation at trial/arbitration regarding implication of good faith and/or reasonableness standards for agreement provisions requiring consent to the sale or interest. This is a developing area of the law, and our experience to date puts us on its cutting edge.

Although developers may avoid these issues through careful drafting and negotiation before the transaction begins, even well-drafted partnership agreements do not always prevent disputes. Pillsbury has the litigation experience to assist our clients in resolving a variety of issues that arise after the deal is done.



Thomas V. Loran III
is a Partner in the
San Francisco office and can be
reached at 415.983.1865 or
thomas.loran@pillsburylaw.com

The Hidden Price of the Tax Credit Investor Exit

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termination of the partnership as a single purpose entity left without its single asset and purpose (the project). Upon determination of the partnership, distributions of cash assets must first be made in accordance with the partner's capital account balances. Likewise, some argue that where the general partner has the option to purchase the investor's interest in the partnership, similar logic applies, despite the fact that the partnership still owns the project, because the purchase price for the investor's interest is based on a hypothetical sale of the project.

By the Numbers

For instance, take a scenario in which the total fair market value of the project is \$1,000,000, the partnership has no debt, the general partner has a negative capital account of \$1,000, the investor has a positive capital account of \$1,000,000 and there is no gain to

allocate upon the sale. If the investor's sale price is strictly based on the typical capital proceeds waterfall, the investor's interest will be valued based on its projected receipt of 10% of the \$1,000,000. If, however, the partnership's sale of the project is deemed to cause a termination of the partnership, the price of the investor's interest should take into account the \$1,000,000 the investor should receive for its capital account balance.

Even if the value of the investor's interest is based on the capital proceeds waterfall provision in the partnership agreement, such a provision may not be respected.

It is important to note that this valuation issue typically arises only in 9%-credit deals and not in most 4%-credit deals. In most 4%-credit deals, the investor is unlikely to have a large positive capital account at year 15 because there is less partner equity in the partnership and greater losses due to the higher debt leverage.

Know the Value Up Front, but Know That It Might Change

At this time, it is unclear whether the investors' termination argument or the general partners' waterfall method will carry the day. It is important that general partners be aware that even if the value of the investor's interest is based on the capital proceeds waterfall provision in the partnership agreement, such a provision may not be respected in light of Section 704(b) of the Code. To better understand the valuation of the investor's interest and to avoid any unnecessary surprises, we encourage our clients to contact their tax attorney to review capital account projections.



Irene C. Kuei

is an Associate in the San Francisco office and can be reached at 415.983.1855 or irene.kuei@pillsburylaw.com



Noa L. Clark

is an Associate in the San Francisco office and can be reached at 415.983.1298 or noa.clark@pillsburylaw.com



Project Spotlight

16th and Market, San Diego

Construction began last summer on 16th and Market Apartments in the East Village neighborhood of San Diego. Pillsbury represented Chelsea Investment Corporation, the co-developer of the project, in obtaining bond financing from the San Diego Housing Authority. The 12-story project, which is part of the affordable component of the Ballpark Village development, will consist of 136 affordable rental units, 114 underground parking spaces and approximately 5,000 square feet of retail space. Completion is scheduled for early 2009.



HUD Developments

by Mervyn E. Degaños and Victoria A. Shannon

This article recaps a few of the notable changes from 2007 in the policies and procedures of the U.S. Department of Housing and Urban Development (“HUD”).

Rent Caps for Project-Based Voucher Projects

Effective December 19, 2007, the low-income housing tax credit (“LIHTC”) program no longer imposes a rent cap on project-based voucher (“PBV”) projects with units receiving LIHTCs. This allows PBV projects to be eligible for the Mark-Up-to-Market Option for Section 8 rent increases (“MTM”). HUD deleted the reference to LIHTCs from the PBV program rent caps listed at HUD Section 983.304(c)(1) in response to concerns that, in high fair market rent

areas, the LIHTC rent cap could be less than the project-based rents allowed by the Section 8 program, which might, in the long run, actually reduce the supply of low-income housing. HUD also emphasized that PBV projects are subject to HUD’s subsidy layering review requirements that guard against the provision of excess subsidization. HUD chose not to exclude the LIHTC program completely, noting that a specific exclusion “would excessively limit HUD’s discretion to respond to changing economic and programmatic conditions.”

Facilitation of MTM Processing

HUD also issued a final rule to implement the Mark-Up-to-Market Act of 2001 and make changes to facilitate

MTM processing. Among the included changes are provisions that allow mortgages to be refinanced under HUD Section 223(a)(7) for terms up to 30 years, allow more flexibility for HUD-provided second mortgages and exempt transactions from transfer fees if a transfer of physical assets or a change in mortgagors occurs at the same time as a restructuring plan.

Form 2530 Filing Requirements

In June, the Preservation Approval Process Improvement Act of 2007 (the “Act”) passed into law, addressing concerns about HUD’s filing process for Form 2530 or the “Previous Participation Certification.” The Act exempts qualified limited liability corporate investors (“LLCIs”) from filing a 2530. HUD will continue to allow paper filings for all 2530 filers until technical issues with the “Active Partners Performance System” are resolved.

Two memoranda implementing the Act outline a few new requirements. The first memorandum requires that, at the time of submission, each principal provide a Social Security or tax identification number and that each paper 2530 contain an organizational chart or description from an attorney or the principal on the principal’s letterhead.

The second memorandum outlines the requirements for LLCIs to be exempt from filing a 2530. To be exempt, an LLCI must certify that: (i) it meets the requirements of the Act and the memorandum; (ii) it is investing in a specified entity that has either submitted a full application to the state tax credit allocating agency for LIHTCs, or has received an allocation or letter of intent to allocate LIHTCs from the agency; (iii) it is organized under state law; (iv) it has no control over day-to-day property operations or compliance with HUD requirements other than specifically exempted activities; and (v) it will notify HUD and explain any changes related to the above certifications or if the LLCI withdraws from participation.

HUD's Green Initiative

Also in 2007, amid a nationwide movement toward "green" building, HUD implemented a pilot "Green Initiative" and issued guidance on MTM properties eligible for refinancing through the Office of Affordable Housing Preservation ("OAHP"). The pilot program encourages owners to use HUD's "Healthy Housing" approach and other sustainable development approaches that reduce environmental impact, lower operating costs and improve the quality of residents' lives. Owners and purchasers are offered incentives to rehabilitate projects using "green" alternatives. OAHP will also start to collect data to validate impacts on utility consumption and indoor air quality. An owner that participates in the Green Initiative will be subject to an energy audit and review of "greening" opportunities as part of the MTM "Physical Condition Assessment."

Participation in the Green Initiative could lower an owner's required financial contribution to rehabilitation costs to as little as 3% of total costs. OAHP may also increase financial support for the maintenance of the green property if the owner shows that its property management company has a Leadership in Energy and Environmental Design ("LEED")-certified professional. The owner must prepare a "Green Operating and Maintenance Plan" that includes a resident involvement and incentive plan, a pest management plan, benchmark green requirements for property operations and a promise from the owner to cooperate with data-gathering and reporting of activities. If OAHP deems it necessary for preservation, OAHP may also use above-market/exception rents.

Any owner currently engaged in MTM that has not executed a "Restructuring Commitment" is eligible to participate in the Green Initiative. Owners that have already executed Restructuring Commitments may apply to OAHP for participation on a case-by-case basis.

Default of HUD-Insured Mortgages

Finally, we note that HUD recently implemented a new policy for HUD-insured mortgages that go into default. HUD took an aggressive stance, asserting that the Multifamily Mortgage Foreclosure Act allows HUD to require a defaulting borrower to fix physical deficiencies in a project before it can pay off an accelerated mortgage. Although there are credible arguments against this position, if HUD continues to implement this policy, owners declared in default may find it difficult to repay an accelerated mortgage.

Pillsbury will continue to stay abreast of HUD developments, and we stand ready to assist our clients in navigating HUD's policies and procedures.



Mervyn E. Degaños
is an Associate in the San Francisco office and can be reached at 415.983.1760 or mervyn.deganos@pillsburylaw.com



Victoria A. Shannon
is an Associate in the San Francisco office and can be reached at 415.983.1239 or victoria.shannon@pillsburylaw.com

Project Spotlight

San Antonio Neighborhood Health Center



Our nonprofit client, La Clínica de La Raza, has been providing low-cost, quality health care services for multilingual and multicultural populations in the Northern California Bay Area since 1971.

Last fall, we helped La Clínica close on New Markets Tax Credit ("NMTC") financing for a major renovation and expansion of its San Antonio Neighborhood Health Center, one of 24 sites at which

La Clínica addresses vital community needs. After the renovation, the clinic will serve an additional 5,000 patients per year.

In addition to the NMTC financing, the project benefited from a number of generous grants and donations from government agencies, foundations, corporations and individuals. More information on La Clínica and their valuable community work is available at www.laclinica.org.

University Faculty Housing

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for-sale and rental units on a desirable hillside location. A high percentage of newly hired faculty purchase homes in the development at prices well below the prices of nearby homes outside of University Hills.

Other universities without on-campus land available for housing must be more creative in acquiring land and providing other assistance necessary to make the homes affordable. California State University Fullerton's nonprofit affiliate constructed its first faculty housing development on land in the City of Buena Park located adjacent to a flood control facility by obtaining the donation of the land from the county flood control district to the city's redevelopment agency. The University's Housing Authority was then able to acquire the land for a nominal price from the redevelopment agency. The redevelopment agency also provided Federal HOME Program assistance to reduce the cost of 11 homes in the 78-home project.

The Housing Authority's second project, constructed on hillside land acquired from the Fullerton Elks Club, also required some ingenuity. In that project, the Housing Authority built a turnkey 13,000-square-foot lodge on the site to replace the Elks Club's aging clubhouse in exchange for obtaining the remainder of the site for the 42-home faculty housing project. More recently, the Housing Authority took advantage of softness in the housing market to make a bulk purchase of 20 condominium units in a newly rehabilitated development.

University faculty housing projects may provide the best example of the new generation of workforce housing, updating and improving upon the longstanding concept of the employer-sponsored company town.

School Districts Getting into the Act

While housing is not a traditional concern of school districts, some districts are contemplating providing housing assistance because high housing prices and rents make it difficult to attract and retain teachers, especially from other, less expensive housing markets. Districts also find that when their employees have long commutes to housing in cheaper outlying areas, the commutes can cause fatigue, limit teacher participation in after-school activities and affect job performance.

University faculty housing projects may provide the best example of the new generation of workforce housing.

Declining student enrollment in many districts has freed up land at closed school campuses that some districts use to create affordable apartments for their teachers. For example, the Santa Clara Unified School District provided land on which to develop "Casa del Maestro," a 40-unit apartment complex for teachers and other district staff that is operated by an independent nonprofit foundation. Construction financing was provided through certificates of participation issued by the District. Rents are set far below market rents, but at a level sufficient to cover debt service, operating expenses and reserves. Tenants may remain for five years, at which point they must find housing in the open market. The District also makes mortgage loan assistance available for home purchases. Another example is the San Mateo Community College District, which developed its "College Vista" 44-unit apartment project using similar means. Other school districts, such as those in San Francisco, Los Angeles and New York, are in various stages of developing teacher housing projects.

Because school districts may have only limited authority to build and operate housing themselves, some districts lease

or sell land to outside developers to construct their affordable housing projects. Surplus property requirements may make such transactions difficult, although some states, such as California, have statutes that provide a high priority for the disposition of surplus property for affordable housing purposes. Long-term leases allow the school district to reacquire possession and use of the land at some point in time. Agreements with developers, nonprofit owners and property managers can allow school districts to delegate day-to-day responsibilities while retaining control over the housing. Affordable housing funds may be available for school district housing, including redevelopment agency low- and moderate-income housing funds and Federal HOME funds. However, other sources of funding may not allow districts to restrict occupancy to school district employees.

Teachers have also been targeted for special mortgage assistance programs, such as the deferred payment loans provided by the California Housing Finance Agency's Extra Credit Teacher Home Purchase Program, discount home purchases available through the HUD Teacher Next Door Program and education and counseling programs like the Los Angeles Teachers Mortgage Assistance Program. Some localities, such as San Jose, also provide deferred payment mortgage loans to teachers, and New York provides targeted stipends for math, science and special education teachers.

Although they are cherished for providing the important service of educating our youth, teachers and other school district employees often do not receive salaries matching their value to society. Housing assistance programs targeted to educators can provide a well-earned reward to this critical group.



Jon E. Goetz
is Counsel in the
Orange County office and can
be reached at 714.436.6872 or
jon.goetz@pillsburylaw.com

Using Solar Power to Achieve the Triple Bottom Line

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certain authority supporting separate allocations on similar investments also supports a special allocation of the solar panels apart from the buildings because the panels depreciate on a different schedule, involve different investment risks and are financed separately from the buildings.

Not all tax practitioners agree that direct tracing and the special allocation necessary to meet the tax expectations of the parties would withstand an IRS challenge. An additional concern is that this structure most likely means that LIHTCs cannot be taken on the basis created by the solar equipment.

Projects should also monetize solar credits by allocation to the investor in bond deals if the investor is interested in the credits at a sufficient price.

Because the sponsor structure involves the LIHTC partnership qualifying for the solar credit, these tax issues must be resolved with the LIHTC investor's counsel and the partnership's accountants, each of whom will be focused on the LIHTCs and not the solar credits. This additional scrutiny may kill the solar credits in this structure.

Use of a Third-Party Energy Company

In bond transactions, we have most often used a structure in which solar panels are installed and owned by a separate energy company that is controlled by the sponsor. Under the most basic structure, the parties enter into a power purchase agreement, giving the energy company the right from the tax credit partnership to install the rooftop panels on its buildings, to sell the energy at a discounted fixed rate to the tax credit partnership and to charge a hook-up fee to pay for the installation and equipment costs. The energy company may admit a

third-party investor to monetize the credits or pass the solar credits on to the sponsor or its principals.

This structure has the advantage of avoiding the LIHTC and solar credit basis decrease and special allocation issues discussed above. However, the model raises a different issue. Money must be transferred to the energy company to pay for the installation and equipment costs. We have structured this transfer in the form of a hook-up fee. Certain accountants representing LIHTC partnerships have expressed concern that this fee is unreasonable and is not LIHTC-basis eligible. Other accountants involved in the practice of cost-certifying LIHTC-eligible basis have concluded that, with careful structuring, this fee is eligible to produce LIHTCs for the tax credit partnership. In any event, the structure will create a timing mismatch between income and deductions. The hook-up charge is income in the year charged. However, panel installation and purchase costs are capitalized, meaning they are depreciable over the useful life of the panel. This defers much of the deduction needed to offset the hook-up

income. Hook-up income will typically occur in the same tax year that the panels are placed in service, providing a credit to help with this tax impact.

Clearing the Clouds

Creating clean energy in bond-financed LIHTC projects should not involve so much controversy. Most projects still need significant subsidies to induce the installation of solar equipment. We are optimistic that, as with many LIHTC project hurdles, tax practitioners will become more comfortable with the structures that help maximize these subsidies. Otherwise, the quickest way is for sponsorship to pay for the costs of rule modification through the legislative process or seeking a private letter or revenue ruling. However, even without further certainty, many clients are finding that with the right team and structure, the use of solar credits already can provide significant benefits to low-income housing projects.



Gary P. Downs

is a Partner and Co-Leader of the firm's Affordable Housing Department in the San Francisco office and can be reached at 415.983.1835 or gary.downs@pillsburylaw.com

7th Annual Developers' Roundtable

Tuesday, February 12, 2008

Peninsula Beverly Hills

9882 South Santa Monica Boulevard
Beverly Hills, California 90212

Registration / Networking	12:00pm - 1:00pm
Roundtable Discussions	1:00pm - 5:30pm
Cocktail Reception	5:30pm - 7:00pm

RSVP by Monday, February 4

Tonya Nooner at tn@housingadvisors.com
Space is limited. Please register early.

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Project Spotlight

San Pedro Apartments, Los Angeles



Affiliates of MacFarlane Partners and Related have partnered to construct San Pedro Apartments in downtown Los Angeles. The multi-use project will consist of 7,500 square feet of commercial space and 230 multifamily rental housing units, 46 of which will be reserved as affordable housing. Pillsbury represented MacFarlane in obtaining financing from Goldman Sachs for bonds issued by California Statewide Communities Development Authority. San Pedro Apartments will provide Los Angeles with a welcome increase in the available housing stock in the downtown area.

Editorial Staff

Editor-in-Chief—Christian D. Dubois
christian.dubois@pillsburylaw.com

Editor—Noa L. Clark
noa.clark@pillsburylaw.com

For mailing list inquiries, please email
affordablehousing@pillsburylaw.com

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Pillsbury Winthrop Shaw Pittman LLP
P.O. Box 7880
San Francisco, CA 94120-7880

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