PILLSBURY WINTHROP LLP
on affordable housing
2002 • Premiere Issue | a publication of the affordable housing group

NAPICO has finished the rehabilitation and stabilization of Park Vista Apartments, a project which was two years ago in need of new ownership and recapitalization.

# Park Vista Apartments

## Bonds and Tax Credits Finance a Much Needed Facelift

PILLSBURY WINTHROP LLP
on affordable housing

Editor-in-Chief:
Jason C. Vargelis (415) 983-1861
Senior Attorney – San Francisco Office
jvargelis@pillsburywinthrop.com

Editors:
Gary P. Downs (415) 983-1835
Partner – San Francisco Office
gdowns@pillsburywinthrop.com

Gary L. Sutton (415) 983-1923
Senior Corporate Paralegal –
San Francisco Office
gsutton@pillsburywinthrop.com

Production:
Mary Margaret Healy, Mark Snyder

For further information on Pillsbury Winthrop LLP's Affordable Housing group, please contact:

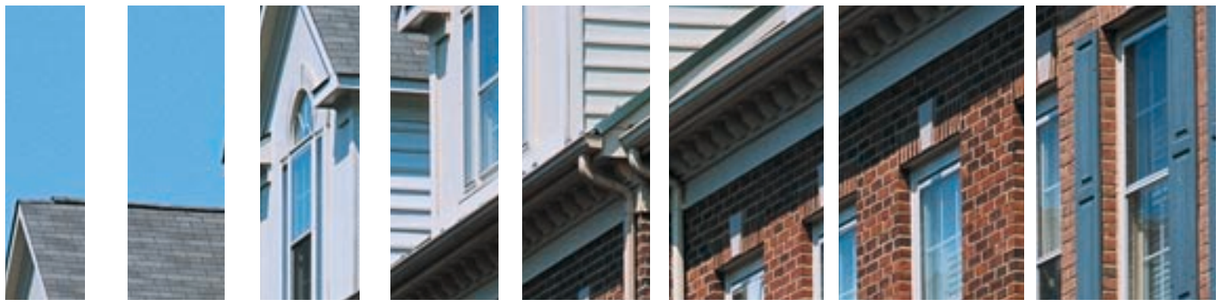
Gary P. Downs (415) 983-1835
Partner—San Francisco Office
gdowns@pillsburywinthrop.com

Lewis G. Feldman (310) 203-1188
Partner—Century City Office
lfeldman@pillsburywinthrop.com

Dana P. Newman (213) 488-7334
Partner—Los Angeles Office
dnewman@pillsburywinthrop.com



www.pillsburywinthrop.com



PILLSBURY WINTHROP LLP
on affordable housing
2002 • Premiere Issue | a publication of the affordable housing group

# Another Subsidy Worth $15 Billion for Low-Income Communities

by Gary P. Downs

"Many see the New Markets Tax Credit as being the single-most powerful tool to come along in a long time, " says Tony T. Brown, Director of the Treasury Department's Community Development Financial Institutions Fund. Mr. Brown, who administers the New Markets Tax Credit (NMTC) program, is not alone in his optimism. Others predict that the NMTC will revolutionize community and economic development in the same way that the Low-Income Housing Tax Credit (LIHTC) affected affordable housing.

The NMTC is an important additional asset for an affordable housing developer to consider using for a mixed use project. Unlike the LIHTC, the NMTC can be used to subsidize the financing of the non-residential portions of a development. Due to the unavailability of federal and local subsidies for the commercial part of a development, many developers have struggled to plan projects with minimal non-housing components. The NMTC is designed to address this problem. This Article briefly describes the NMTC program and provides an example of how the subsidy might be used in the financing of a specific project.

### Overview of the Program

On December 21, 2000, the Community Renewal Tax Relief Act of 2000 was signed into law. The landmark legislation includes the NMTC, which will spur the investment of $15 billion of new private capital into a range of privately managed investment vehicles that make loan and equity investments in new market businesses. By making an equity investment in an eligible Community Development Entity (CDE), investors can receive over a seven year period a tax credit worth more than 30 percent of the present value of the amount invested over the life of the credit. CDEs then must invest at least 85% of their contributed capital into eligible businesses in the qualified inner city or distressed rural or suburban community. Unlike the LIHTC (which is controlled by the state), eligible CDEs apply to the Treasury Department for an award of the credit.

An eligible new market business must be located in a qualified census tract. Many census tracks in the country

(Subsidy **continued on page 4)**

# Relief At Last:

## IRS Releases Revenue Ruling Relating to Impact Fees and Eligible Basis

by Jason A. Hobson

The industry-wide confusion is over. On February 15, 2002, the Internal Revenue Service (IRS) released an advance copy of Revenue Ruling 2002-9 which resolves the confusion and debate over whether certain impact fees incurred in connection with the development of affordable housing are allocable to the building and thus includable in eligible basis for determination of low-income housing tax credits. This Article describes the revenue ruling and related legislative and administrative developments.

### The Revenue Ruling

The revenue ruling, which will be published on March 11, 2002 as Revenue Ruling 2002-10, concludes that "impact fees" incurred by a taxpayer in connection with the construction of a

(Revenue Ruling **continued on page 4)**

# No Termination Risk Interest Rate Swap for Affordable Housing Transactions

by Gary P. Downs and Jason C. Vargelis

Interest rate swaps have been used by borrowers in a variety of real estate financings to protect against rising interest rates. Interest rate swaps have not been widely available in affordable housing bond financings, which typically include a borrower with no significant assets other than the housing project. The borrower's ability to make payments under a swap would be dependent on the success of the project—which is not generally ratable. For this reason, the risk of borrower default has been difficult to quantify, and most swap providers have not been willing to assume the risk that the swap will be terminated early due to a borrower default.

Chambers, Dunhill, Rubin & Co., a California-based derivatives advisory firm, has developed for affordable housing transactions a current or forward start interest rate swap with no termination risk to the guarantor (the No Termination Risk Swap). The No Termination Risk Swap has been used in recent credit enhanced multifamily affordable housing transactions. This Article describes the No Termination Risk Swap and some of its benefits and drawbacks.

Construction Period Savings

The primary benefit to developers of the No Termination Risk Swap is construction period savings. During the construction period, the swap is not in effect and the borrower makes payments based on a variable bond rate. At the end of the construction period, the swap takes effect (for a period of 15-18 years), allowing the borrower to make net payments based on a pre-determined fixed rate. To the extent that the interest rate relating to the bonds exceeds that fixed rate, the swap provider receives the difference.

The No Termination Risk Swap allows a borrower to benefit from low-interest rates during the construction period by avoiding payment of some of the negative arbitrage that would be necessary for conventional fixed rate debt. The risk to the borrower that interest rates will rise only continues until the end of the two-year construction period. At that time, the borrower is protected against rising interest rates by the swap. (It is important to note that while the swap may be based on a BMA index, the actual bond rate is based on the remarketed bond rate. The No Termination Risk Swap therefore may not be an exact hedge against rising interest rates.)

The credit enhancer of a conventional affordable housing variable rate bond financing will typically require that the borrower enter into an interest rate cap. Under a traditional interest rate cap, a counterparty is obligated to make payments that hedge against interest rate increases. The counterparty, however, is not entitled to receive payments from the borrower if interest rates decrease. The No Termination Risk Swap structure can in this context also result in savings over conventional tax-exempt bond financing.

(Swap **continued on page 6)**

# Two-Tier Mezzanine Loans

by Jason C. Vargelis

Mezzanine lending is a form of real estate financing in which the lender's right to repayment is after or subordinate to a senior lender but above or senior to traditional equity. Mezzanine loans bear interest at a rate that is significantly higher than the interest rate on senior loans. Since mezzanine lending first emerged during the 1980s, the structure of mezzanine loans has evolved to cover a wide variety of forms.

Developers of multifamily affordable housing financed with tax exempt bonds may need to structure a mezzanine loan at the time of the bond closing. Draws on the mezzanine loan would typically be made during the construction or rehabilitation period to account for a timing or permanent gap in project funds. In order to structure a mezzanine loan, however, developers will need to address the interests of the senior lender or credit enhancer for the financing. This Article provides some background on lender concerns and describes how a specific "two-tiered" mezzanine loan has been used in certain affordable housing transactions.

Limits to Mezzanine Loan Security

The senior lender in a mezzanine financing will typically limit the security of the mezzanine loan. Types of security for a mezzanine loan include second mortgages, first mortgages and pledges of equity interests. Limits to the security arise when a senior lender requires that certain rights of the mezzanine lender be subordinated, or subject, to the rights of the senior lender.

A senior lender will limit the security for a mezzanine loan because the senior lender and the mezzanine lender are likely to have competing interests. Upon a default by the borrower, the senior lender may find it difficult to exercise its rights if the security for the mezzanine loan is not limited sufficiently. For example, the senior lender may need to obtain the consent of the mezzanine lender in order to workout a troubled loan.

(Mezzanine Loans **continued on page 6)**

(Mezzanine Loans **continued from page 6)**

Conclusion

Although a mezzanine loan is not an ideal source of funds, developers of multifamily affordable housing projects financed with tax exempt bonds may find themselves in a situation where mezzanine lending is appropriate or necessary. If that happens, developers of multifamily affordable housing projects should be aware that the "two-tier" mezzanine loan has been used in a way that satisfied the competing interests of Fannie Mae and the mezzanine lender.

Jason Vargelis is a Senior Attorney in the San Francisco office and may be contacted via e-mail at jvargelis@pillsburywinthrop.com or by phone at (415) 983-1861.

(Prevailing Wage **continued from page 3)**

loans, grants and credits from various agencies. Because using any of these traditional sources would make the narrow exemption unavailable, most affordable housing will be subject to the prevailing wage requirements of the new law.

Some affordable housing advocates believe that the California legislature actually "intended" to exempt fully all types of affordable housing from the prevailing wage requirements of the new law. The preamble to the final bill states that "public works" subject to the prevailing wage laws do not include "the construction and rehabilitation of affordable housing units for low or moderate-income people, as specified." As described above, the actual exemption in the new law will have very little practical effect. Some affordable housing advocates argue that these inconsistencies in the language of the new law are a result of the California legislature only approving at the "eleventh hour" an amendment affecting the new law's affordable housing provisions.

Conclusion

It is likely that another bill will be introduced in the California legislature to clarify the new law, especially as it relates to affordable housing projects. Affordable housing advocates that wish to be involved in this process may seek to amend the new law to be consistent with its preamble and exclude all affordable housing projects from the prevailing wage requirements.

Mariah Panza Garcia is an Associate in the San Francisco office and may be contacted via e-mail at mpanzagarcia@pillsburywinthrop.com or by phone at (415) 983-1862.





(Swap **continued from page 2)**

Termination Risk

Most swaps are subject to a "mark-to-market" fee. A mark-to-market fee requires that the party in default under a swap pay the other party the net payments the other party would have received (based on current market quotations) had the swap not been terminated as a result of the default. Under the No Termination Risk Swap, a borrower that is "legitimately" not able to make payments may not be fully subject to a mark-to-market fee. In prior transactions, the exact circumstances under which the borrower was required to pay the mark-to-market fee was the subject of substantial negotiation. The scope of the required guaranty of certain borrower obligations under the swap was also heavily negotiated. These negotiations led to increased transaction costs.

Conclusion

The No Termination Risk Swap can be a useful financing alternative for developers. Because the product is somewhat complex and still being refined in actual transactions, it is important that sophisticated counsel be involved. Investors, lenders and swap providers should also work through intercreditor issues prior to entering into a swap transaction.

Gary Downs is a Partner in the San Francisco office and can be reached via e-mail at gdowns@pillsburywinthrop.com or by phone at (415) 983-1835.

Jason Vargelis is a Senior Attorney in the San Francisco office and can be reached via e-mail at jvargelis@pillsburywinthrop.com or by phone at (415) 983-1861.

Information on the No Termination Risk Swap is also available from David Rubin at Chambers, Dunhill, Rubin & Company. David Rubin can be reached via e-mail at dave@cdrla.com or by phone at (310) 273-9384.

(Mezzanine Loans **continued from page 2)**

Similarly, the exercise of rights by the mezzanine lender may interfere with the security of the senior lender. An extreme example of this would be a mezzanine lender causing the bankruptcy of the borrower without the consent of the senior lender.

Over time, senior lenders and mezzanine lenders addressed their competing interests by developing a wide variety of mezzanine loan structures, which even today have not been standardized by industry.

Two-Tier Mezzanine Loans

Certain multifamily affordable housing transactions credit enhanced by Fannie Mae have included a similarly structured "two-tier" mezzanine loan. To the extent parties continue to use the "two-tier" mezzanine loan, it may help to bring some uniformity to mezzanine loans in multifamily affordable housing transactions.

The Fannie Mae "two-tier" mezzanine loans had the following characteristics: A limited partnership owned the property on which a multifamily affordable housing development was to be built. The mezzanine lender made a loan to the general partner of the property owner. At the same time, the general partner loaned to the property owner the proceeds of the loan from the mezzanine lender. The loan to the general partner had full recourse, while the loan to the property owner was non-recourse (with standard exceptions) and secured by a subordinate mortgage in favor of the general partner. The general partner then (a) assigned to the mezzanine lender its rights under the loan it made to the property owner and (b) pledged to the mezzanine lender its interests in certain accounts and capital contributions. The obligations of the general partner were guaranteed by a creditworthy guarantor.

In addition, the Fannie Mae "two-tier" mezzanine loans were subject to a subordination agreement that restricted debt service payments on the mezzanine loan to 75% of excess cash flow and restricted the remedies of the mezzanine lender. The cost of the loans was LIBOR plus 5% to 7%, with additional origination and exit fees totaling 4% to 9% of the amount of the mezzanine loan. The loans had two year terms and were repayable from the project's cash flow with a balloon payment due at maturity.

The Fannie Mae "two-tier" mezzanine loans satisfied Fannie Mae, as the senior lender, because the borrower under the senior loan received a direct loan from its general partner instead of from a third-party. The mezzanine lender benefited from this structure because it received a subordinate mortgage, which is a form of security that many senior lenders have resisted allowing mezzanine lenders to take.

(Mezzanine Loans **continued on page 7)**

# Projects Subject to Prevailing Wage Requirements Are Expanded to Cover Affordable Housing

by Mariah Panza Garcia

On January 1, 2002, a new California law took effect expanding the types of projects at which contractors must pay the prevailing wage. The prevailing wage is approximately equal to union-scale levels of pay. Unless amended or otherwise modified, the new law is likely to have a future impact on certain California affordable housing projects. This Article describes the new law as it relates to affordable housing transactions.

How the Law Changed

Prior to January 1, 2002, California law required contractors to pay the prevailing wage on public works projects. The prior law applied to a variety of projects, including, for example, government buildings, schools, bridges, roads, highways, water treatment plants and sewer systems. Most types of commercial and residential construction, however, were exempt from prevailing wage requirements.

The new law (which can be found in Section 1720 of the California Labor Code) requires that certain "public works" projects "paid for in whole or in part with public funds" comply with the prevailing wage, hour and discrimination laws that govern employment on public works projects. Instead of fully exempting affordable housing projects, the new law only provides for a grace period for most affordable housing projects through the end of 2003. Qualified residential rental projects financed at least in part by tax exempt bonds that receive an allocation on or before December 31, 2003 need not comply with the prevailing wage requirement. In addition, low-income housing projects that are allocated federal or state low-income housing tax credits on or before December 31, 2003 are not subject to the new law. Thus, beginning in 2004, most California affordable housing projects must comply with prevailing wage requirements.

**Increased Costs**

The law was based on a bill introduced by Senator Alarcon. While the bill was in session, affordable housing advocates and builders lobbied against it—arguing that the prevailing wage requirement would subject developers of affordable housing projects to potentially prohibitive costs. The California Building Industry Association, for example, estimated that the bill would increase the cost of affordable housing by as much as 30 percent. This cost increase could arguably reach the level at which building homes for low-and moderate-income families would no longer be feasible. Alternatively, there would at least be a chilling effect on the future development of affordable housing in California.

Opponents of the bill also pointed out that expanding the prevailing wage requirement could actually disadvantage workers at affordable housing projects. This would occur if, for example, the same workers who are receiving higher wages have an even higher increase in housing costs due to the decrease in the availability of affordable housing.

An Exemption for Affordable Housing Is of Limited Effect

The new law contains a very narrow exemption for affordable housing projects. Under the new law, projects funded solely from private sources and low and moderate-income funds established pursuant to specific provisions of the California Health and Safety Code need not comply with the prevailing wage requirement. Almost all affordable housing, however, is subsidized by a combination of

(Prevaililng Wage **continued on page 7)**

# California Multifamily Revenue Bond Statute Sunset Jeopardizes Third Round Deals

by Jason A. Hobson

The statute authorizing cities, counties and other political subdivisions to issue multifamily housing revenue bonds in California has by its own terms expired. Due to a neglected "sunset provision" in the authorizing statute (California Health & Safety Code sections 52075-52098) there currently is no state law authority for cities, counties and joint powers authorities to issue multifamily housing revenue bonds. Emergency legislation has been drafted and introduced in the Senate through an existing bill, S.B. 369, which will ultimately be amended by its sponsors to provide for the authorizing housing law.

This recent development is of particular concern to the developers, lenders and investors involved in multifamily housing bond financings that received private activity bond allocation and carry-forward election from the California Debt Limit Allocation Committee's (CDLAC) third round in 2001. According to information provided by CDLAC, approximately 23 projects, representing approximately $192 million in private activity bond allocation was awarded at CDLAC's December 19, 2001 meeting. CDLAC's procedures require most of its financings to be documented and closed within no more than 105 days from the allocation date or risk loosing the volume cap allocation. Unless otherwise extended by CDLAC, the emergency legislation would need to be in effect by early April 2002 so as to not cause forfeiture of the private activity bond allocation awarded.

Jason Hobson is an Associate in the San Francisco office and may be reached via e-mail at jhobson@pillsburywinthrop.com or by phone at (415) 983-1929.

(Subsidy **continued from page 1)**

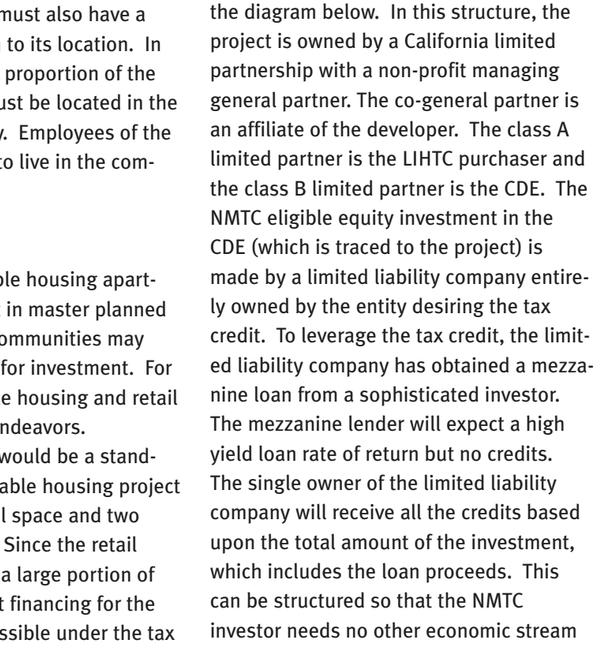
qualify. The business must also have a substantial connection to its location. In addition, a substantial proportion of the business's property must be located in the low income community. Employees of the business do not need to live in the community.

An Example

Many affordable housing apartment projects are built in master planned communities. These communities may have uses that qualify for investment. For instance, office, for sale housing and retail are eligible business endeavors.

One example would be a standalone four story affordable housing project with two floors of retail space and two floors of rental space. Since the retail component comprises a large portion of the project, tax exempt financing for the retail portion is not possible under the tax code. In any event, bond credit enhancement would be difficult to obtain due to the retail component. The available equity from the LIHTC would also be severely decreased. A developer could attempt to parcelize this type of project and conventionally finance the retail portion. Parcelization creates a tougher land use path and provides the developer with only market rate financing. If the project is located in a qualified census tract, the developer should consider raising equity through the NMTC.

A number of different financing structures will work to produce equity from both the NMTC and LIHTC. One such structure is shown by the diagram below. In this structure, the project is owned by a California limited partnership with a non-profit managing general partner. The co-general partner is an affiliate of the developer. The class A limited partner is the LIHTC purchaser and the class B limited partner is the CDE. The NMTC eligible equity investment in the CDE (which is traced to the project) is made by a limited liability company entirely owned by the entity desiring the tax credit. To leverage the tax credit, the limited liability company has obtained a mezzanine loan from a sophisticated investor. The mezzanine lender will expect a high yield loan rate of return but no credits. The single owner of the limited liability company will receive all the credits based upon the total amount of the investment, which includes the loan proceeds. This can be structured so that the NMTC investor needs no other economic stream other than the credits to meet its expected return.




Conclusion

The NMTC legislation is lengthy and complicated. There are a number of questions yet to be answered relating to the many details of the program. This Article intends to only provide a brief overview and one example of how the NMTC might benefit affordable housing. We are very excited about the program. Please contact us with your questions.

Gary Downs is a Partner in the San Francisco office and may be reached via email at gdowns@pillsburywinthrop.com or by phone at (415) 983-1835.

(Revenue Ruling **continued from page 1)**

new residential rental building are capitalized costs allocable to the building under Sections 263(a) and 263A of the Internal Revenue Code. The revenue ruling specifically identified a number of early development costs such as local jurisdiction impact fees and associated development costs as includable in the calculation of a taxpayer's eligible basis. Guidance for taxpayers who wish to change accounting methods to conform to the revenue ruling was also provided.

Many Low-Income Housing Tax Credit (LIHTC) developers applaud the ruling, as the IRS' guidance is in line with the purpose of the LIHTC program, to spur as much private equity investment into the development of affordable housing to lessen the burdens of government. According to James J. Schmid, President of Chelsea Investment Corporation, the developer of several nine percent projects in Southern California: "This is a very positive development for the industry, as developers and investors alike have had a hard time justifying an increased eligible basis with the impact fees. Depending on the project, the impact fees could represent a quarter to fifty percent of [a project's] early developments costs, which now can be used to increase basis and the amount of [tax] credits to increase the amount of equity financing."

The relief will be particularly welcome in high impact fee and high housing cost states like California, where the affordable housing problem has been most pernicious. The inclusion of impact fees in eligible basis will now generate greater amounts of credits, and thus larger equity investments into states plagued with high housing costs.

The 2000 TAMs

The revenue ruling brings much needed relief to the affordable housing industry and its often varied response to the IRS publication of its Technical Advice Memoranda (TAMs) in 2000 relating to eligible basis calculation for calculating LIHTCs. The 2000 TAMs held that certain costs in a proposed tax credit project – such as impact fees, certain land preparation costs, bond costs, construction loan costs and developer fees – may not be included in eligible basis. A TAM is a response by the IRS national office to a request by a revenue agent for clarification or interpretation of particular tax law and regulatory requirements as they apply to a "specific taxpayer." However, the positions have routinely been applied by cautious investors in the affordable housing industry to subsequent credit projects. As a result, many investors would not purchase credits relating to project costs targeted by the 2000 TAMs. Certain developers and investors of LIHTCs responded to the 2000 TAMs by lobbying federal lawmakers to bring about a legislative resolution of the confusion.

IRS Industry Issue Resolution

The IRS recently hinted that administrative guidance was likely in a set of four TAMs released on January 18, 2002 (TAM Nos. 200203013, 200203011, 200203012, and 200203014), which suspended the position in the 2000 TAMs on the basis that there was a pending IRS Industry Issue Resolution (IIR) program project on impact fees and a separate IRS business guidance plan project on eligible basis issues. The IIR program guidance resulted in Revenue Ruling 2002-9.

The IRS guidance represents the fifth of the seven identified issues resolved in the IIR program, the objective of which is to provide guidance to resolve frequently disputed tax issues that are common to a significant number of large or mid-size business taxpayers. The IRS undertook the IIR program to resolve issues in a manner other than the traditional post-filing examination process. The Large and Mid-Size Business Division of the IRS has much of the operational responsibility for the projects in the program. "The goal of the Industry Issue Resolution program is to move away from auditing frequently disputed industry issues on a case-by-case basis and toward solutions that apply to significant numbers of business taxpayers," said Larry Langdon, Commissioner, Large and Mid-Size Business Division.

Legislative Relief Remains Idle

Proposed legislation, H.R. 3324, introduced in the House of Representatives by Nancy Johnson, R-Conn, and co-sponsored by Charles Rangel, D-NY, and Mark Foley, R-Fla., will permit site preparation costs, various development fees and professional fees, and construction financing costs (all of which are termed "associated development costs") to be included in eligible basis. The proposed legislation is widely viewed by developers and investors of projects financed with LIHTCs as a significant and positive effort to clear up the confusion created by the 2000 TAMs. Legislation effecting a change in the law would give more definitive guidance than a revenue ruling, which merely interprets the law.

Legislative relief and clarity, however, will have to wait. Todd Funk, the Legislative Director for Congresswoman Johnson, the main sponsor for H.R. 3324 in the House, reports that with the demise of the economic stimulus package in the Senate in December 2001, so brought the demise of the anticipated legislative vehicle for H.R. 3324. Until an appropriate legislative vehicle is presented in the House, H.R. 3324 is expected to remain idle in the Ways and Means Committee, as it has since November 2001. Moreover, efforts by House members and lobbyists to find a sponsor of a corollary bill in the Senate remain unsuccessful.

Conclusion

In the meantime, the guidance in the revenue ruling is a positive development for LIHTC investors and developers alike. If legislation brings about an actual change in the tax code, then LIHTC practitioners will have and even stronger basis for including the fees in eligible basis to generate greater amounts of tax credits. This, in turn, will increase the amount of equity investment in multifamily housing developments financed with the LIHTC.

Jason Hobson is an Associate in the San Francisco office and may be reached via email at jhobson@pillsburywinthrop.com or by phone at (415) 983-1929.