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Pillsbury Winthrop Shaw Pittman LLP

# Pillsbury on affordable housing & community development

**Pillsbury's Real Estate Practice provides legal services to top real estate professionals across the globe.**

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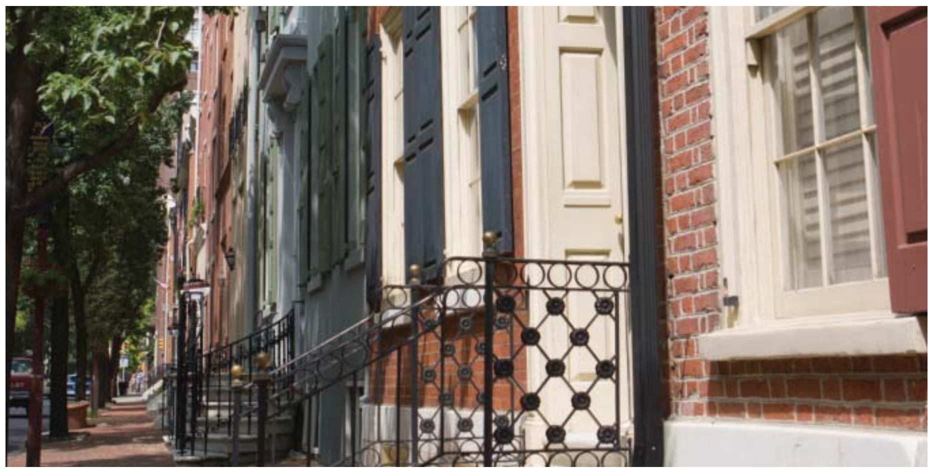

## IRS Reopens the Door on Tax Credits for 80-20 Projects

**by Gary P. Downs**

That which was lost has now been found. With careful structuring, low-income housing tax credits under the IRC are once again viable for developing tax-exempt bond-financed mixed-income apartment projects with only 20% of the units affordable. For many years, the affordable housing industry has struggled to develop an ownership structure that allows tax credits to be sold for projects meeting the minimum affordability requirements for tax-exempt bond financing. The federal tax-exempt bond rules require an owner to rent some of the apartment units to tenants making below certain income levels: either 20% of the units to tenants making 50% or less of area median income or 40% of units to tenants making 60% or less of area median income. Historically, owners have elected the 20% of 50% test, and these projects have become known as 80-20 deals, referring to the ratio of unrestricted units to restricted units. The renewed availability of these credits means big additional dollars to project owners. This development tool is so valuable that one tax credit syndicator is rumored to be in application for a U.S. patent on its allegedly unique structure to produce these credits. This article will discuss the history of tax credits and 80-20 deals, the Private Letter Ruling that reopened the door, variants on structures and related economic and regulatory concerns.

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## IRS Reopens the Door on Tax Credits for 80-20 Projects

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### History

Years ago, a number of tax lawyers concluded that partnerships could specifically allocate tax depreciation of certain apartment units, like affordable units, to a certain class of limited partner. Those attorneys also advised that all the tax credits attach to the specifically allocated depreciation of the affordable units. Based on this advice, a number of partnerships were structured with class A partners receiving the economic and tax benefits from the unrestricted units and class B partners receiving the economic and tax benefits, most importantly the depreciation, from the restricted units. This structure fell out of favor when the tax attorneys for a number of the end-credit users criticized the legal analysis upon which these conclusions were based. First, no authority exists allowing for depreciation to be allocated to certain units in a building on a parcel. Second, no authority exists supporting the position that tax credits attach solely to the depreciation produced by the affordable units.

Prior to the groundbreaking Private Letter Ruling No. 200601021 dated December 28, 2004, the industry struggled with various alternative structures to the class A / class B partnership. One structure involved allocating all the depreciation to the tax credit investor limited partner with a special gross income allocation, leaving the non-tax credit partner in the same net tax position as if they had received the depreciation from the market rate units. The tax rules required certain economic allocations with this structure that many parties could not stomach. The structure never developed legs.

**Pillsbury advises negotiating roll-up provisions with the tax credit investor allowing for a buyout at fair market value at any time.**

We also played with the structure that was ultimately blessed by the Private Letter Ruling: transferring ownership of the affordable units to a separate entity. Prior to the Private Letter Ruling, bond counsel struggled with various bond tax rules raised by separate ownership of the affordable units. Concerns included how the first available unit rule was satisfied and whether the Bond financing of the market rate units remained tax-exempt if the affordability compliance was an obligation of a separate owner, due to how the Treasury Regulations define a qualified residential project.

### The Private Letter Ruling

The Private Letter Ruling tackled the primary issue of whether, in a split-ownership structure, the Bonds financed something other than a qualified residential rental project that meets the income qualifications. The IRS focused on the issue of whether the affordable units could be considered a separate building under the Treasury Regulations. Because the affordable units are dispersed throughout the project, and low-income tenants and market rate tenants jointly use the common facilities, the IRS concluded that split ownership of a Bond-financed project is permissible under the tax rules.

### Structuring Variants

Although the Private Letter Ruling does not address tax credits, it reaches favorable conclusions on a number of tax-exempt bond issues regarding separate ownership structures that troubled bond counsel. The Private Letter Ruling also does not indicate whether it applies to separate real estate mapping of the affordable portion of the project. There is no tax authority that supports allocating all the credits to a part of a parcel that is separately owned. Moreover, separately owning a single parcel may violate state map act requirements. Pillsbury is actively advising clients that the first step to this structure is to condominiumize the affordable units as a separate parcel. Once mapped, those units can be sold or leased in a long-term lease that transfers tax ownership to a separate entity. In a project where the current ownership does not want to lose ownership control of the affordable portion to a third party, the project owners can be managing members or general partners of the affordable owner. The tax credit limited partner or member can be admitted and allocated almost all the depreciation from the affordable portion of the project with almost all the tax credits attached. The general partners will receive most of the economic benefits of the affordable units. However, in our experience, once the affordable owner pays its portion of debt service and expenses, cash and expected sales proceeds from the affordable operations are not significant. What is significant is the amount of capital contribution raised by admitting a partner receiving the benefits of the credits. This amount can then be transferred through myriad possible mechanisms to the original project owners to decrease their equity requirements.

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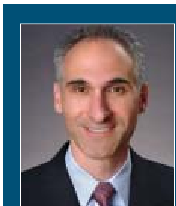

## From the Chair

James M. Rishwain, Jr.

Pillsbury Winthrop Shaw Pittman LLP is proud to publish its sixth annual Newsletter on Affordable Housing & Community Development with more contributors than in any year past. 2006 was an extremely busy year for the Affordable Housing & Community Development Group, which handled in excess of 300 matters. With the recent addition of several new members, the group continues to grow to meet the increasingly complex demands of our clients. We look forward to what promises to be another exciting year in 2007.

# Workouts in Troubled Affordable Housing Projects

**A recent study indicates that over a third of affordable housing projects operate below 1.0 hard debt coverage, but the foreclosure rate is less than 1%. Workouts clearly play an important role in many affordable housing projects. The following articles discuss various workout concerns and approaches from the perspectives of the developer and investor.**

## A Developer's Perspective

by Byron A. Rodríguez

Affordable housing projects do not always work out the way the parties expect. Markets change, managers underperform, and expenses unexpectedly increase. A 2005 Ernst & Young survey of approximately 5,500 affordable housing properties found that 34.7% of the projects operated below 1.0 hard debt coverage in 2004. 33.7% operated below the same threshold in 2003, with 17.7% below that threshold in both years. Yet, the same study indicated a foreclosure rate of only 0.02% in 2004. While many projects were in trouble, few were given back to lenders. The Ernst & Young numbers are good news for developers. In our experience, the avoidance of foreclosure is in part due to the complicated financing structures used in affordable housing deals and the competing incentives and uncertainty they create. Developers that are prepared to take advantage of these factors will achieve better results than those that are not.

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## An Investor's Perspective

by Kimberly Crowder Moore

The road to a successful affordable housing project is paved with good intentions, but a project may face market, construction or finance issues that necessitate changes to the project and finance structure, and an investor may find itself in discussions to save a troubled project, a situation commonly referred to as a "workout." Developers who build and rehabilitate affordable housing projects face many risks that may lead to workouts, including: changes in market conditions; lease-up difficulties; construction cost overruns; loss of a financing source; and loss of a real property tax abatement or exemption.

### Project Changes

A developer is often motivated to resolve matters quickly with project lenders to avoid foreclosure or loss of financing commitments. Proposals worked out with lenders may involve changes that

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# New Markets Tax Credit Update

The New Markets Tax Credit ("NMTC") program has been extended for another year. In December of 2006, the U.S. Department of the Treasury announced a fifth round of competition under the NMTC program for tax credits on $3.9 billion in investments. $400 million of this total has been earmarked for Hurricane Katrina Gulf Opportunity Zone projects. NMTC Program applications are due on February 28, 2007.

Established in 2000 as part of the Community Renewal Tax Relief Act, the NMTC program stimulates private sector investment in low-income communities by providing federal tax credits to taxpayers making qualified equity investments in Community Development Entities ("CDEs"). Investors claim these credits over a seven-year period at 39% of their investment cost. The CDEs use the equity to make qualified low-income community investments, such as loans and equity investments, and to provide financial counseling and other services to businesses in low-income or distressed communities.

The Community Development Financial Institutions Fund accepts applications to participate in the NMTC program, and has awarded $12.1 billion in tax credit allocation through the first four rounds. Efforts are underway to extend the NMTC program substantially beyond its current 2008 expiration date. Pillsbury is optimistic that these efforts will be successful. We have substantial experience in guiding our clients through the NMTC application process, and we welcome your questions.

# The Term Sheet Rider:

## Negotiating Terms at the Term Sheet Stage

by Byron A. Rodríguez and Christian D. Dubois

As the affordable housing industry has matured and secondary loan markets have developed, the "market" standard for loan documents has become less developer-friendly. Developers that want reasonable documents should consider addressing certain issues at the term sheet or loan application stage when searching for business partners; this is the time when developers have their greatest leverage. We are now advising clients to consider setting forth certain important business and legal points in riders to be attached to lender term sheets or loan applications. Over time, this approach can result in more reasonable loan documents and significantly reduced legal costs.

### Lender Selection Criteria

Developers rely on any number of criteria in selecting lenders, but personal relationships, successful past dealings and the combination of interest rates and loan fees tend to drive the majority of decisions. Although most lenders can become comfortable with various structuring and regulatory issues related to affordable housing development, a lender that is already experienced in affordable housing transactions will make the loan process faster and more cost efficient. Unfortunately, it is often the case that developers rely too heavily on such factors while paying too little attention to what a lender will do with a loan once made. This approach can lead to decisions that lack appropriate consideration of the merits of competing lenders' loan form terms.

**By having the lender agree to the rider at the term sheet stage, a developer can lock in reasonable terms and reduce costs incurred in negotiating against lender-friendly forms.**

### What Lenders Do with a Loan

After closing, lenders handle loans in several different ways and it is important for a developer to understand a lender's intent. Some lenders that provide construction and permanent financing maintain ownership of the loans and service the loans themselves. Others, particularly Fannie Mae and Freddie Mac delegated underwriting and servicing ("DUS") lenders, sell loans immediately after closing. Still others retain construction loans while selling off permanent loans. After sale, loans may be securitized or purchased in secondary markets as individual investments. Lenders' post-closing intent has important implications for the loan documents. Lenders that retain a loan for their own account generally have more flexibility with their document terms. DUS lenders and others selling loans typically attempt to hew as closely as possible to their standard forms, which generally are modeled after Fannie Mae documents.

When dealing with DUS lenders, it is usually possible to pass comments through to the ultimate lender. Some of these will be adopted. Fannie and Freddie are heavily involved in the affordable housing industry and will be familiar with, though not necessarily sympathetic to, developer concerns. Over time, Fannie and Freddie have adopted certain developer comments and concerns in their forms. However, passing comments through may be more difficult in deals with other lenders that sell or offer participations in loans. Purchasers and participants may be less familiar with development issues. They often are large financial institutions seeking to standardize their forms, and they may stand on terms that are far from reasonable. Lenders that deal with these players have responded by making their forms less and less developer-friendly. To obtain the most reasonable document terms, developers should consider lenders' intent regarding continuing ownership of a loan, and, if a loan is to be sold, the reputation of the purchaser.

### Loan Terms to Avoid

Negotiating changes to certain terms can be difficult and expensive, requiring multiple document turns before the lender and purchaser take developer comments seriously. Indeed, many frustrated and anxious developers simply concede patently unreasonable legal provisions to get a deal closed. Examples in prominent lender forms include: provisions that allow lenders to accelerate loans on minor and curable condemnations without developer cure rights; "nervous clauses" that allow lenders to accelerate loans in the absence of default if they believe there has been a material change in the developer; provisions stating that any lender decisions not specifically requiring lender reasonableness do not need to be made reasonably; requirements that developers pay for environmental assessments they are not allowed to see; and requirements that developers pay for as many separate sets of lenders' counsel costs as there have been participations of a loan. Although such terms may not come into play in performing projects, they can create real problems for underperforming deals, especially when a project ends up in workout and the developer is dealing with a previously unknown loan purchaser that decides to play hardball as part of a settlement approach.

### The Rider Approach

Developers often have more leverage over loan terms when deciding to whom to give their business than after loan documents are produced. At the term sheet stage, lenders are eager to lock in a deal and are more likely to be flexible about document terms. At later stages, lenders are more likely to respond to proposed changes by hiding behind bank procedures, lawyers, and secondary market purchasers. Therefore, it is important to establish baseline terms as early as possible.

We believe that developers can better their chances of achieving reasonable loan terms by preparing a rider that addresses common problems in loan documents and provides reasonable compromises that should be acceptable to both sides. By having the lender agree to the rider at the term sheet stage, a developer can lock in reasonable terms and reduce costs incurred in negotiating against lender-friendly forms.

We are already working with a number of clients to draft term sheet riders and customize them to client-specific issues. Please contact us if you are interested in developing this negotiation tool.

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## Project Spotlight
## Hunters Point

**Rehabilitation will soon commence at Hunters Point in San Francisco. Pillsbury is representing AIMCO, which is incorporating resident input to renovate the interior and exterior of 604 units on 22 acres in Hunters Point. The development will capitalize on the inherent beauty of the site with views of San Francisco Bay, and it will enhance much-needed high-quality affordable housing in the city. The completion of the Hunters Point AIMCO Properties will be a significant step toward revitalizing this area.**

## Rural Development Project Bond Buyers Struggle with Capacity Limits

**by Gary P. Downs**

For years, Pillsbury has been representing numerous developers buying USDA Rural Development ("RD")-financed projects with expiring RD regulatory agreements. In most cases, developers have pooled these deals with other similar projects that have sources including privately placed tax-exempt bonds, assumption of the RD loan, low-income housing tax credits and various soft money sources. The most active bond buyers, such as Washington Mutual, report that a number of developers are reaching bank debt capacity limits. RD preservation developers can attack the limit issue by using the RD Section 538 Program, which allows government guarantees of loans made by private lenders. In 1998, Congress extended the program to allow guarantees of tax-exempt bonds. The bond buyers are reporting that for any federally guaranteed amount of a loan, such loan will not count against debt capacity limits. Interestingly, the bond interest rates may not be substantially lower due to the guarantee. Many bond buyer programs set below-market interest rates already driven down by the Community Reinvestment Act credits that come with the bond buyer's lending.

Pillsbury is proud of its role in these affordable housing preservation transactions and is always available to help address the many issues raised by the RD programs.

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# California Real Property Tax Abatement Update:

## New Requirements and Opportunities

by Mervyn E. Degaños

As we forecasted in our 2006 newsletter, last year the California Board of Equalization ("BOE") adopted the much anticipated Rule 140.1, requiring many developers to amend their partnership agreements and expand their involvement in day-to-day management to qualify for property tax abatement. Managing general partners must now materially participate and have substantial management duties, as specifically defined by Rule 140.1.

2006 also presented a new opportunity for projects to shield liability while continuing to qualify for property tax abatement. Nonprofits may now use BOE Rule 136 to appoint wholly owned, single-member limited liability companies ("LLCs") as managing general partners of their affordable housing projects. Nonprofits can take advantage of the flexible LLC structure and shelter their assets from direct risk. The BOE no longer limits applications for supplemental welfare tax-exemption certificates to previously certified nonprofits. Now a nonprofit may apply for a supplemental exemption through an LLC in which the nonprofit is the sole member.

To be a "qualifying organization" under Rule 136, an LLC must be wholly owned by an organization exempt under 501(c)(3) of the IRC or 23701d of the Revenue and Taxation Code, and it must qualify for exemption under Section 214 of the Revenue and Taxation code. The LLC must be operated exclusively by the nonprofit, limit its activities to exempt purposes and only transfer membership interests and assets to qualified entities. The organizational language must contain a dedication clause and limit distribution of assets upon dissolution to organizations engaged in exempt activities.

Pillsbury obtained the first welfare tax-exemption clearance certificate for an LLC as managing general partner. This structure affords our clients the flexibility of an LLC and offers them another layer of liability protection. Owners concerned with liability, whether for upcoming or existing projects, should consider the benefits of forming or converting to an LLC.

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Project Spotlight

# Garden Street Apartments


In late 2006, our client, Mental Health Association in Santa Barbara County, closed on financing for its Garden Street Apartments project. This mixed-use project, in planning since 2001, includes 51 low-income housing units for mental health clients and other downtown workers, a full-floor "Fellowship Club" for members, two floors of office space and a subterranean parking garage.

Financing sources included various community and foundation grants, 9% LIHTC equity, conventional construction and permanent financing, AHP funds, a loan from the City of Santa Barbara and proceeds from the sale of one of the office-floor condominiums at the project. When completed in 2008, this architecturally significant addition to downtown Santa Barbara will provide much-needed affordable housing and supportive services.

# Phase I Environmental Site Assessments:

## New Timing and Update Requirements

by Peter G. Koback and Stefanie M. Nelson

New federal EPA requirements for Phase I Environmental Site Assessments ("Phase I ESAs") became effective on November 1, 2006 (a year after their 2005 publication). Pillsbury has published summaries of these "All Appropriate Inquiries" rule ("AAI rule") requirements in the November 2, 2005 Client Alert titled *EPA Issues New "All Appropriate Inquiries" Rule for CERCLA Innocent Landowner Defenses* and in our Spring 2006 Real Estate Newsletter, both available at www.pillsburylaw.com. Instead of another comprehensive summary, this article highlights crucial Phase I ESA timing and update requirements in the AAI rule, which every developer and investor should keep in mind before property acquisition.

### Background

A Phase I ESA that complies with the AAI rule is a necessary part of the environmental due diligence that an acquirer of property must complete to qualify for certain "landowner liability protections," including the "innocent landowner defense," under the federal environmental Superfund law (commonly known as "CERCLA"). Without qualifying for such landowner liability protections, property owners may be liable under CERCLA for cleaning up contamination, even if caused by former owners or operators of the property.

The innocent landowner defense requires that the property owner "did not know and had no reason to know" about contamination on the property and conducted "all appropriate inquiries" into prior ownership and uses of the property before acquisition.

**Under the new requirements, the age of the Phase I ESA takes on increased importance. There is now a 180-day bright-line rule and a one-year expiration date.**

In addition to the EPA's AAI rule, the American Society for Testing and Materials ("ASTM") has issued a new Phase I ESA standard, ASTM E1527-05, which conforms with and satisfies the AAI rule requirements for Phase I ESAs. For practical purposes, one should look to the ASTM E1527-05 standard to determine whether a Phase I ESA conforms with the AAI rule.

### Phase I ESA Timing and Update Requirements

As always, a Phase I ESA must be conducted before title to the property is acquired by the ownership entity. For most affordable housing projects, the ownership entity is a partnership or limited liability company that acquires the property by deed. The date of that deed is key. Any Phase I ESA conducted after the deed is of no use toward qualifying the ownership entity for the landowner liability protections of CERCLA. This should not be surprising, given that the purpose of the AAI rule is to require environmental due diligence before property acquisition.

Under the new requirements, the age of the Phase I ESA takes on increased importance. There is now a 180-day bright-line rule and a one-year expiration date. If, on the date of the ownership entity's deed, a Phase I ESA is over 180 days old, but less than one year old, then the Phase I ESA remains valid only if there is also a Phase I Update that meets clearly defined update standards from the new requirements.

The Phase I Update must be completed during the 180-day period before property acquisition, and must now include updates to the following five components:

1. Interviews with past and present owners, operators and occupants of the property;
2. Visual inspections of the property and adjoining properties;
3. Reviews of federal, tribal, state and local government records;
4. Searches for recorded environmental cleanup liens; and
5. The declaration of qualifications by the environmental professional.

As noted, the new requirements also establish a one-year expiration date for each Phase I ESA. A Phase I Update can only be used to update a Phase I

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## Emerging Trend:
# The General Partnership Interest Sale

by Gregg Miller and Bradley D. Scheick

In response to increasing investor and developer interest in multifamily affordable housing projects, the frequency of transactions structured as a sale of general partnership interests in limited partnerships that own real property has increased. The desire to structure a transaction in this manner is driven largely by the need to retain the presence of investor limited partners, whose capital contributions in exchange for low-income housing tax credits make many affordable housing projects possible. Parties seeking to increase or decrease their investments in multifamily housing projects have turned to the general partnership interest sale as a means to transfer the benefits of ownership of such properties without jeopardizing the tax credit eligibility of the project or requiring the limited partners to sell their interests prematurely.

Such transfers present unique issues not regularly confronted in traditional direct real property purchases where one party simply sells the real property to the other and transfers title by means of a deed. Among the issues that arise in general partnership sales are:

1. The need to obtain the consent of the investor limited partner and any lenders to the transfer;
2. The need to identify all existing guaranties made by the selling general partners or their key principals, and to negotiate the extent to which the buyer will assume such guaranties or indemnify the existing guarantors if the existing guaranties must remain and one of the guarantors is required to perform under its guaranty;
3. The need to identify any debts owed to the selling general partners by the underlying partnership and the extent to which such debts will be repaid, if at all, at closing; and
4. The importance of detailed representations and warranties from the seller, and the financial ability of the outgoing seller to respond to any claim based on a breach of any such representation or warranty.

Buyers of general partnership interests also must be aware of the title insurance issues presented by such transactions. To insure themselves beyond closing coverage, such buyers will need to arrange for either new owner's title insurance policies or "date downs" of the existing owner's policy accompanied by a non-imputation endorsement protecting them from the possibility of coverage being refused based on imputed knowledge of the outgoing general partner and the remaining limited partners.

Transfers of general partnership interests may present a viable means for parties to cash out of or buy into the increasingly popular multifamily housing project market without disrupting the tax credit-driven structure supporting such projects and with minimal burden placed on limited partners. Given the unique issues presented by such transfers, parties seeking to sell general partnership interests in multifamily housing projects should spend time evaluating the partnership structure, credit facilities, guaranties, and the need to obtain the consent of various parties to any transfer of the general partnership interests before marketing the interests for sale. Purchasers of such interests should seek to understand the necessity of third-party consents and lender / guaranty issues as early in the transaction as possible.

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# Prevailing Wage Update

by Christian D. Dubois

In past issues of this newsletter, we reported on the ongoing struggle between the affordable housing industry and pro-labor interests over whether the use of affordable housing subsidies in California requires payment of prevailing wages. The most notable developments included the Department of Industrial Relations ("DIR") determinations that using low-income housing tax credits ("LIHTCs") or tax-exempt bonds does not subject a project to prevailing wage requirements, and the *Greystone* ruling that prevailing wage does not cover projects receiving certain subsidies that are not for actual construction. Unfortunately, recent case law and DIR policy have eroded the comfort that these developments provided the affordable housing industry with respect to California subsidies.

## Woodhaven Manor Apartments

In 2005 the DIR published a determination that, as with federal LIHTCs, the use of California state LIHTCs will not subject a project to prevailing wage requirements. *Woodhaven Manor Apartments, PW Case No. 2005-034 (11/16/2005)*. The State Building and Construction Trades Council of California, AFL-CIO ("SBTC") appealed this determination to the Superior Court of California, County of San Francisco, which ruled in favor of SBTC. In its interpretation of California Labor Code Section 1720, the court held that *Woodhaven* constitutes a public work, subjecting it to prevailing wage requirements. The court reasoned that because a state tax credit is a "transfer by the state…of an asset of value for less than fair market price," projects using such credits are "paid for in whole or in part out of public funds." *SBTC v. John M. Rea, California Superior Court, San Francisco County, No. 506079 (08/04/06)*.

The DIR and the Sacramento law firm Cook Brown, LLP, representing the Coalition for Affordable Housing, have appealed the ruling to the First District California Court of Appeal. The court of appeal ruling may be appealed to the California Supreme Court.

## From *Grey* to Bleak

Another cause for optimism in 2005 was the decision in *Greystone Homes v. Chuck Cake, First District California Court of Appeal, No. A107763 (12/21/05)*. The *Greystone* court ruled that a project using subsidies such as gifts of public land and reimbursements of land acquisition costs was not subject to prevailing wage requirements because such subsidies did not pay for actual construction. The court interpreted Section 1720 as it existed prior to California SB 975, a measure that expanded the definition of "public funds," but left intact the definition of "public works" as "construction …paid for in whole or in part out of public funds." Until recently, many in the affordable housing industry believed that *Greystone* also applied to post-SB 975 projects. This belief was supported by legislative changes to the definition of "construction" to include design and preconstruction, but not other items.

Unfortunately, the DIR recently took the stance that prevailing wage requirements apply even if public funds are not directly linked to construction. In December 2006, the DIR wrote a non-precedential letter for a project in Oxnard, California, summarizing its position on SB 975. *Oxnard Marketplace Shopping Center, PW Case No. 2005-016 (12/01/06)*. The project involved a loan from the City of Oxnard to Quality Real Estate Management, LLC to acquire property to be rehabilitated by, and leased to, Fry's Electronics. The parties structured the loan agreement so as not to tie the loan directly to rehabilitation or construction efforts. Fry's was not a party to the loan; however, a pre-condition was Fry's intent to rehabilitate the property. Repayment was contingent upon the project meeting sales tax revenue and employment goals. The DIR deemed the repayment contingency a public subsidy and stated that the loan "need not pay for actual construction" to trigger prevailing wage requirements. It reasoned that SB 975 "changed the pre-existing law to provide that where there is a public subsidy to a development project in which there is a construction obligation, the project is a public work, regardless of whether the public subsidy pays for the cost of the actual construction." In the DIR's view, *Greystone* no longer applies. It was not enough to structure a loan so that funds were not directly tied to construction or rehabilitation—the DIR chose a broader view of the project to find a link between the public subsidy and construction efforts.

## Project Planning

Until *Woodhaven* appeals are exhausted, the applicability of prevailing wage law to projects financed with California state LIHTCs remains in doubt. Technically, the no-coverage determination letter remains good law until appeals are exhausted, and the DIR has stated that it will not assess penalties against a developer who relies on it. However, we would

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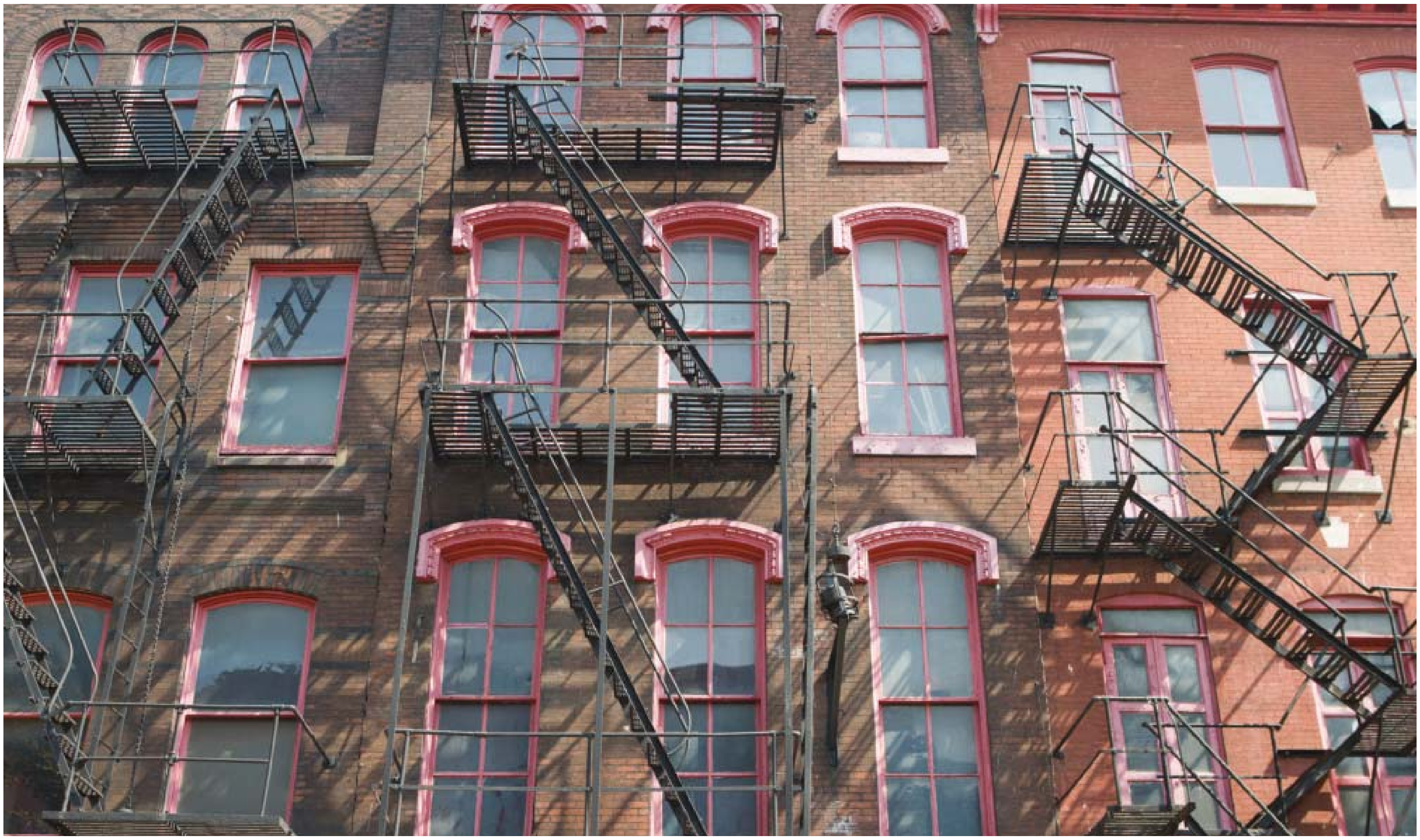

# HUD IRP Decoupling and Rent Increases

by Irene C. Kuei

Over the past few years, Pillsbury has assisted developer clients in successfully completing several Section 236(e)(2) decoupling ("IRP Decoupling") transactions. Under the Department of Housing and Urban Development ("HUD") Section 236 program, a loan is made at market (typically 7%) with an annual subsidy, in the form of an interest reduction payment ("IRP"), that brings the effective debt service down to the equivalent of a 1% rate. In connection with the Section 236 mortgage, HUD establishes Basic Rent and Market Rent pursuant to the HUD regulations for the project and, to ensure project viability, the project owner is not allowed to charge tenants less than the Basic Rent unless there is Section 8 rental assistance or owner contribution to make up the difference.

In an IRP Decoupling transaction, which became available in May of 2000, the original Section 236 mortgage is prepaid and replaced by a new mortgage (FHA or non-FHA). The IRP stream is separated, or "decoupled," from the Section 236 mortgage and continued to the end of the mortgage term. Any project-based Section 8 subsidies are renewed. While the IRP Decoupling concept is familiar to housing professionals, one question frequently raised by our developer clients is whether in processing an IRP Decoupling with HUD, a developer may request increases to Basic Rent, Market Rent, and Section 8 Rent as established by the HUD regulations.

## Basic Rent and Market Rent Increases

In processing an IRP Decoupling request, HUD will establish a new Basic Rent and Market Rent for the project. Under the traditional approach, Basic Rent is the rent required to operate the project with a mortgage bearing interest at 1%, and Market Rent is the rent required to operate the project at the actual mortgage interest rate. An IRP subsidy makes up the difference. Section 236 now provides an alternative approach. HUD may establish a higher Basic Rent at an amount no greater than comparable market rent, provided that the calculation is derived from a budget-based procedure. Market Rent is capped at the comparable market rent if the owner agrees to additional restrictions on use and prepayment. Under this alternative approach, the owner may request a budget-based rent increase in connection with the IRP Decoupling transaction to cover debt service on any new financing for acquisition, rehabilitation, or equity takeout. This alternative approach, however, is not available for transactions involving equity takeout by an existing owner or for ownership transfers at an above-market price.

Additionally, Basic Rent for non-Section 8 units cannot be increased by more than 10%. This limitation does not apply to the Basic Rent for Section 8 units if the project is eligible for "Mark-Up-To-Market" (as discussed below). For preservation projects (financed under LIHPRHA or ELIHPA), the IRP Decoupling cannot result in a rent increase.

**Requesting budget-based rent increases or Mark-Up-To-Market requires navigation through complicated HUD regulations.**

### Section 8 Rent Increases

Rent increases for units receiving Section 8 assistance in a Section 236 project will be governed by the applicable rules and procedures of Section 8 contract renewal. Under HUD's Section 8 Renewal Policy, there are essentially two ways to obtain Section 8 Rent increases. Under Owner Option One, described in the Section 8 Contract Renewal Policy, an owner may renew a Section 8 contract and request Section 8 Rent increases under the Mark-Up-To-Market Option.

The Mark-Up-To-Market Option was introduced as an emergency initiative in June of 1999. It provides owners of certain below-market properties in strong markets an incentive to renew Section 8 contracts and continue providing affordable housing by allowing them to receive the equivalent of market rents and make distributions based on such rents. Because the cost of marking all below-market Section 8 projects up to market would likely exceed available HUD resources, Mark-Up-To-Market is available only to projects meeting certain criteria listed below. Additionally, to limit rent increases to reasonable levels, rents will generally be renewed at the lesser of comparable market rents or 150% of FMR (as defined and established by HUD).

To be eligible for the Mark-Up-To-Market Option, a project must meet the following criteria:

1. **Project Condition:** The project must receive a Real Estate Assessment Center physical inspection score of 60 or above with no uncorrected Exigent Health and Safety Violation;
2. **Ownership:** The project owner must be a profit-motivated or limited-distribution entity;
3. **Market Rent:** The Rent Comparability Studies ("RCS") must demonstrate that comparable market rents are at or above 100% of FMR potential; and
4. **Use Restriction:** The project does not have a low- or moderate-income use restriction that cannot be eliminated by an owner's unilateral action. Examples of use restrictions would be the existence of a rent supplement contract or low-income housing tax credits.

If a project does not meet these criteria, the owner may renew the Section 8 contract and obtain rent increases under Owner Option Two, as discussed in the Section 8 Renewal Policy, which allows a budget-based rent increase. Owner Option Two is available to owners who are not applying for Mark-Up-To-Market where the RCS indicate that Section 8 Rents are at or below comparable market rents. The rent under this option is capped at OCAF-adjusted RCS (as established by HUD).

While many developers are familiar with the processing of IRP Decoupling transactions and assignments and assumptions of Section 8 contracts, requesting budget-based rent increases or Mark-Up-To-Market requires navigation through complicated HUD regulations. Moreover, various HUD field offices may impose additional requirements. We encourage our developer clients to contact us with any questions regarding rent increases.

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## IRS Reopens the Door on Tax Credits for 80-20 Projects

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### Economic and Regulatory Concerns

These structures raise a number of unique economic and regulatory concerns. 80-20 project owners, many of which are pension funds, have investment horizons that are shorter than the typical 15-year exit strategy of a tax credit transaction. To address this concern, Pillsbury advises negotiating roll-up provisions with the tax credit investor allowing for a buyout at fair market value at any time. The parties should also negotiate transfer provisions allowing the market rate portion of the development and the general partnership interests of the affordable owner to be sold with limited tax credit investor consent rights. Teams working on these transactions have also developed various approaches to the first available unit rule issue. An additional concern involves the performance of the market rate units. Tax credit investors are comfortable underwriting affordable units but not market rate units. If rents on market rate units decline, the project, including the portion owned by the affordable owner, may suffer a foreclosure. Foreclosure wipes out future and possibly past credits. The investor must either underwrite the market rate rents or cover the risk through a developer guarantee.

In our experience, these structures are very complex, requiring a team of experienced developers, consultants, and investors. This article simplifies and generalizes a large number of devilish details. Pillsbury is available to help teams structure and close these transactions.

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# The Fine Print:
## Tax Credit Adjusters

**by Peter M. Bransten**

Limited partner investors in affordable housing projects that contribute capital in exchange for tax credits expect to be protected in the event their receipt of credits is delayed beyond initial projections in the limited partnership agreement. An investor's delayed receipt of tax credits can negatively impact its anticipated rate of return. In turn, project developers seek to be able to require tax credit investors to contribute additional capital to a project if the project delivers greater tax credits to the investor than the parties initially anticipate.

To accommodate the respective concerns of investors and developers, limited partnership agreements contain true-up provisions known as "Adjusters." In substance, Adjusters are used to adjust the capital contribution installment payment that an investor is required to make to the limited partnership after the project is completed and leased. At that point, variables affecting the investor's rate of return are known, such as the total construction cost of the project, the amount of annual tax credits the project will generate and the schedule on which those credits will be available to the investor.

Pillsbury is actively representing affordable housing developers in connection with disputes involving Adjusters. In one recently settled matter, due to construction delays, the project did not generate tax credits in accordance with the schedule projected in the parties' limited partnership agreement. The investor contended that it was entitled to decrease its final capital contribution to the limited partnership under an Adjuster that required the developer to make a penalty payment in the event of a credit deficiency (i.e., a shortfall between the tax credit initially projected for a calendar year and the tax credit actually available to the investor in that year).

Invoking a different Adjuster in the agreement, the developer contended that the investor could not reduce the amount of its final capital installment, notwithstanding a credit deficiency in certain years. The developer relied on a provision that the amount of the investor's final capital contribution installment would be adjusted as necessary to give the investor a rate of return consistent with the return the investor expected to realize based on the parties' projections regarding the investor's tax benefits and required capital installment payments. The developer contended that, due to the timing of the investor's installment payments, the investor's expected rate of return was not affected by the delayed credit delivery. Pillsbury successfully negotiated a settlement of the litigation.

Because the application of Adjusters is a potential subject of dispute between developers and tax credit investors, such provisions must be drafted with particular care. Pillsbury has substantial experience negotiating and drafting Adjusters and handling disputes involving such provisions when they arise.

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## Workouts: A Developer's Perspective

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Ultimately, neither lenders nor tax credit investors want to take ownership of troubled projects or sue on guarantees. To avoid such actions, lenders may be willing to write down debt or waive prepayment premiums to facilitate the stabilization or refinancing of a troubled project. Tax credit equity, particularly during the 10-year tax credit period, but also during the 15-year compliance / recapture period, may contribute additional capital to a project to avoid a loss of tax benefits. Negotiating the competing interests allows a developer to achieve concessions that can help turn a project around.

No one workout strategy will be right for all developers or projects. Important concerns in determining a workout approach include: the degree of project underperformance; whether it has converted to permanent phase; its value relative to the hard debt; accessibility of guarantor assets; whether the 10-year tax credit period and 15-year compliance period have expired; the existence of completion, operating deficit or tax credit guarantees; developer relationships with lenders and equity partners; whether lender and equity partners are affiliates; project location; and developer risk tolerance.

### The Underperformance Spectrum

The Ernst & Young survey indicates substantial variance in the extent of project underperformance. For example, in 2004, 45% of underperforming properties had occupancy rates between 85% and 90%. Approximately 13% had occupancy rates below 70%. During the same year, 28% had hard debt coverage ratios between 0.9 and 1.0 while 20% had hard debt coverage ratios of 0.5 or less. In the past two years, we have seen a substantial number of workouts in the Midwest and South but almost none in California.

Generally speaking, no matter the condition of the project, early notice to, and open lines of communication with, lender and equity partners are key to the success of a project turnaround. Moreover, open communication can be key to preserving a developer's relationships on unrelated projects and reputation for future deals. Beyond open communication, a developer's strategy in workouts can lie anywhere on a spectrum from handing over the keys to fully funding operating deficits from non-project assets.

## Narrowly Underperforming Projects

If a project is missing hard debt coverage targets by relatively narrow amounts but is in a geographic area with expected upside, the developer likely will want to maintain ownership of the project and, hopefully, its unrealized value. The main objective is to turn the project around as quickly as possible. Developers should create a plan to bring the project to hard debt coverage and vet the plan with lender and equity partners. Project turnaround generally involves a new management team, increased expenses for cosmetic, security or other purposes, and possibly new project policies. For example, some owners change policies to allow pets to attract more tenants. With such near-coverage projects, lenders or tax credit investors will make only minor concessions, if any, to assist in a turnaround. They may waive certain repair reserves or allow the developer to draw from other reserves for unintended purposes to meet increased expenses, but in these scenarios, lenders are unlikely to write down debt, and investors are unlikely to contribute substantial additional sums.

## Substantially Underperforming Projects

Projects missing hard debt coverage by larger margins are difficult to turn around with changes in a management team or cosmetic fixes. In many cases, these projects are located in markets where project problems are endemic. Early engagement of experienced professionals and analysis of various parties' loss positions are important steps to achieving the best possible outcome.

**To bring all parties to the table, a developer may need to stop funding deficits.**

Seriously underperforming projects in their post-conversion phase likely have nonrecourse debt and terminated debt guarantees. When this is the case, the best outcome with regard to the debt will often be turning over the keys to the project. However, even if debt guarantees have ended, a developer may be liable to its equity partner for operating deficit guarantees. If these have not been funded, a developer will generally remain liable to its equity partner even if it is able to walk away from the loan. Furthermore, if a project is still within its 10-year tax credit period, surrendering a project to a lender will result in a loss of future, and possibly past, tax credits, and developers have a fiduciary obligation to equity partners to allow them the opportunity to mitigate this result.

Worse is the scenario where a troubled project is still in its construction/lease-up phase. During construction, a developer generally has unlimited liability to both the lender and tax credit investor. With these projects, if a creditworthy developer walks away completely, there is a high likelihood of being pursued on guarantees. At the same time, foreclosure will be an administrative headache for a lender, who may have to prove up deficiencies from the value of the property to make a claim on a guaranty. Because the project will bring tax credits, the value of the property may exceed the outstanding loan amount. Furthermore, in many states, a contested statutory foreclosure can take at least a year from filing until transfer of ownership. For tax credit investors, handing over the property will mean a loss of tax credits and potential liability to the IRS under IRC Section 42(j) if the property does not remain affordable. Many equity partners are syndicators that wish to avoid the reputation loss that may come with failed projects. Furthermore, if a project is in a guaranteed fund, the syndicator may be especially sensitive to avoiding the loss of credits in foreclosure.

Faced with a choice of litigation and foreclosure, or a moderate debt write down or additional equity contribution, many lenders and investors will choose the latter. In our experience, meaningful concessions are unlikely while a developer is funding debt service and operating deficits. Therefore, to bring all parties to the table, a developer may need to stop funding deficits. This will create grounds for the lender to declare default and accelerate the property debt. It will also often trigger the limited partner's right to kick the developer out of the property partnership. Due to the legal risks involved, developers should carefully consider all options prior to stopping payments, and they should remember that any outcome will turn on factors other than strict enforcement of legal rights.

Developers must be confident in choosing their course of action in the face of a troubled project. We have seen a substantial uptick in workouts in the last few years, and anecdotal evidence suggests that, especially in certain regions, more are on the way. Developers can best mitigate their losses with open communication and a robust understanding of the legal backdrop and their partners' incentives.

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## Workouts: An Investor's Perspective

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adversely impact the project's risk profile to the investor, including changes to the development budget and/or financing structure, changes in the amount or timing of investor capital, changes to project reserves, and changes involving the development and management teams. Developers should bear in mind that a properly negotiated operating agreement will require the consent of the investor for these changes. In a workout situation, an investor should be brought into the process early before a proposal is worked out by the developer and project lenders, because such workout proposals often fail to take into account how changes adversely impact the risk profile of a property and the federal income tax consequences associated with the proposed workout.

### New Debt

Developers may also be motivated to take on additional debt to fund construction cost overruns to avoid having to make advances under construction completion guarantees. Whether the new loan has mandatory debt service or if repayment is contingent upon the project generating cash flow, additional debt may raise issues as to whether the loan is "bona fide debt" for tax purposes, particularly if the project is already highly leveraged. To the extent a loan is not "bona fide debt," the IRS could recharacterize it as a taxable grant, which, depending on the source of funds, could invalidate some of the tax benefits expected by the investor. To the extent the developer wants to fund a loan to the project, the investor will need to determine whether the loan constitutes "partner nonrecourse debt" for tax purposes, which may result in a loss of federal low-income housing tax credits ("Credits") and/or losses to the investor.

### Changes to Existing Debt

Problems typically arise during the construction and lease-up phase of a project. As long as the project's permanent financing has not closed, terms of the mortgage loan can usually be adjusted without an adverse tax impact to the investor. However, the investor will need to be comfortable that any business changes do not unduly increase the risk profile of the project or create issues under the investor's investment guidelines. If the project's permanent financing has closed, changes to the terms of the mortgage loans could result in adverse tax consequences, including recognition of income in the form of cancellation of indebtedness income with respect to any portion of the loan that is forgiven.

**In a workout situation, an investor should be brought into the process early before a proposal is worked out by the developer and project lenders.**

If terms of an existing loan are modified and the terms differ materially from the original terms of the loan, there could also be income recognition. Because the investor will likely have to recognize the income, the investor will need to understand the impact that any such income recognition has on its investment. Changes that impact the debt service coverage ratio or reserve structure should be discussed in advance with the investor, and the specific changes to any existing loans should be discussed in advance with the investor and its counsel to determine whether the proposal will have any adverse tax impact.

### Fee Deferral

Workout proposals often involve a deferral, or additional deferral, of a portion of the development fee earned on a project. Such development fees generally are payable from project cash flow in accordance with the local operating agreement. The investor will need to consider whether the deferred portion of the fee may still be properly included in the project's eligible basis and whether the deferred fee, as structured, is projected to result in a loss of Credits and/or losses to the investor.

### Adjustments to Capital

A principal issue that often arises in workout situations is the application of a so-called credit adjuster ("Adjuster"), the adjustment made to an investor's capital contribution obligation in connection with certain construction and lease-up delays if a project fails to deliver Credits as projected. A related concern may be whether a project that received a carryover allocation of Credits will meet the statutorily mandated placement-in-service deadline.

For a distressed property facing construction cost overruns, a downward adjustment to an investor's capital may seem contrary to a successful workout strategy, and an investor may be asked to waive Adjusters. However, making adjustments to the capital structure and deal may be the most appropriate course of action for a troubled project. An investor may agree to a partial waiver or restructuring of Adjusters to save a troubled project, but it will want to see that all participants in the workout make appropriate concessions. For instance, to the extent there is no adverse tax impact, the investor may want to see deferral, or additional deferral, of development fees. In addition, rather than waiving Adjusters, investors may agree to restructure Adjusters from must-pay obligations to obligations that are payable from project cash flow and capital proceeds. If the developer expects to receive incentive management fees from cash flow, or to the extent a project lender is looking to cash flow for loan repayment, these concessions will ensure that all parties are committed to the project and its success. As discussed, the investor will need to evaluate whether the change in the loan's debt service obligation creates any tax issues.

The mutual goal of all parties involved in a workout is to stabilize the property and get it back on a path to success, and the key to a successful workout is a proposal that reflects the commitment of all parties involved and takes into account the federal income tax consequences and risk profile of the workout to the investor. Consulting with the investor early in the process will help ensure that tax issues are identified early on so that the project has the best chance to get back on the road to success.

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## Prevailing Wage Update

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caution against such reliance. If prevailing wages ultimately are found to apply to projects financed with California state LIHTCs, such projects may be required to provide back pay to workers at prevailing wage rates.

There remains similar uncertainty regarding *Greystone*'s impact beyond SB 975. The *Oxnard* determination letter was non-precedential, and the DIR states that it has no immediate plans to publish any related determination. However, until the DIR position is formally challenged in court, developers in California should expect prevailing wage requirements to apply to any project involving construction that receives California state or local subsidies and that does not otherwise qualify for an exception.

Pillsbury will continue to stay abreast of prevailing wage developments. We invite you to contact us if you would like more information.

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## Phase I Environmental Site Assessments

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ESA that was conducted within one year before the date of property acquisition. An entirely new Phase I ESA must now be conducted if the last full Phase I ESA is over a year old on the date the ownership entity acquires the property.

Finally, for any property acquired on or after November 1, 2006, the original Phase I ESA must have been completed in conformance with the AAI rule or ASTM E1527-05. In other words, even if an earlier Phase I ESA's shelf life has not expired and it remains less than a year old, a Phase I Update will not satisfy the new requirements if the earlier Phase I ESA conformed only with prior ASTM E1527 standards, such as ASTM E1527-97 or ASTM E1527-00. An entirely new Phase I ESA is now required if, on the date of property acquisition by the ownership entity, the last full Phase I ESA was not in conformance with the new AAI rule or ASTM E1527-05, regardless of whether that earlier Phase I ESA is less than a year old.

### Conclusion

Phase I ESAs must now satisfy the new timing and update requirements outlined above. These are crucial, because a Phase I ESA that otherwise conforms with all AAI rule and ASTM E1527-05 requirements cannot be used toward qualifying for CERCLA landowner liability protections if the Phase I ESA is conducted at the wrong time or if the new Phase I Update requirements are not satisfied.

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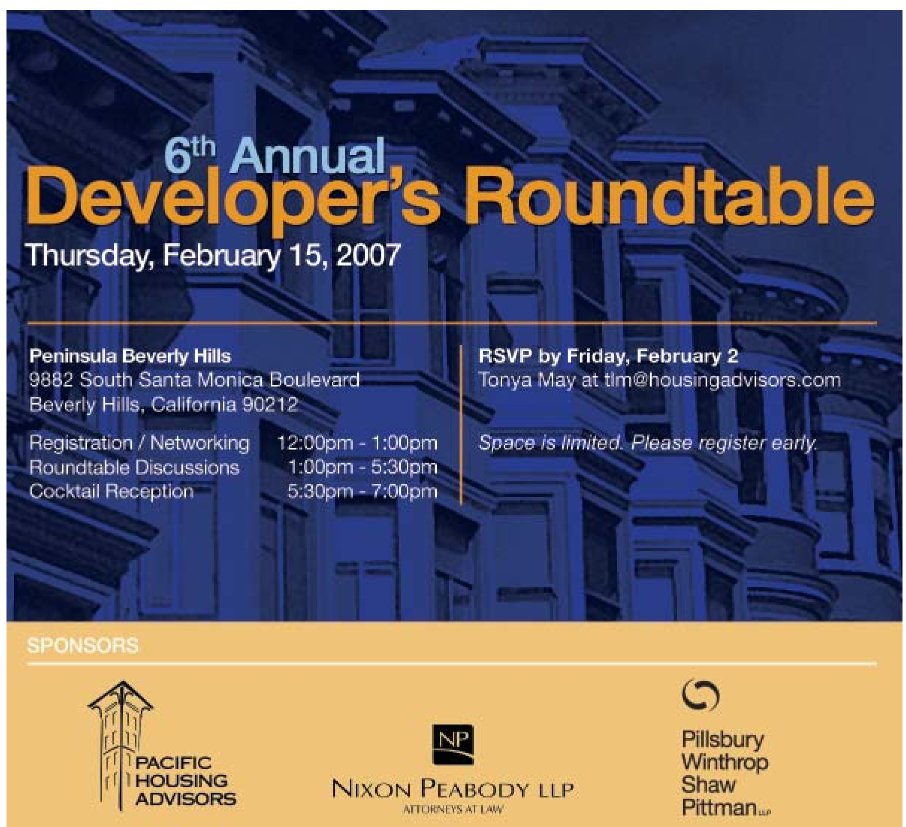

Project Spotlight

# Northstar-at-Tahoe

Polar Star Development is developing a rental housing project at the Northstar-at-Tahoe ski resort, with the Town of Truckee as sponsor. Many of the units created will provide housing to largely seasonal employees working in operations or on the long-term redevelopment and expansion of the resorts known as the Village at Northstar and the Northstar Highlands. Pillsbury is representing the nonprofit 6320 corporation as bond counsel and Northstar Community Housing Corporation as developer's counsel. The 6320 corporation was formed on behalf of the Town of Truckee to issue tax-exempt bonds and own and provide affordable rental housing for employees from the surrounding Martis Valley.

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