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Affordable Housing

by Ginger McGuire

Prepare early to Combine USDA funding with tax credits

The U.S. Department of Agriculture’s Rural Development Office of Multi-Family Housing estimates that 4,250 Section 515 affordable rural housing properties “will physically deteriorate to the point of being unsafe or unsanitary within the next few years.” They further estimate the injection of capital required to preserve these 85,000 units at as much as \$3.2 billion for portfolio-wide rehabilitation; accommodating merely the most distressed would still cost \$850 million.

As expensive as preservation is, it is more cost-effective than further deterioration, or building new. For the past decade, the USDA Section 538 loan guarantee program has been available to rural properties as a response to this financing need, as well as for new construction. It is only recently, however, that the number of loans closed annually through this program has been on the rise. The program is increasingly being combined with low-income housing tax credits, providing new financing options in many rural locations where the cost challenges associated with low area median incomes once seemed difficult to accommodate.

A 538 guarantee puts the full strength of the government behind the borrower, allowing the property to access lower interest rates through an interest rate buy-down on the first \$1.5 million of a loan. This portion of the loan can receive a subsidy to reduce the borrowing rate to the Applicable Federal Rate.

When compared to conventional fi-

ancing, the 538 Program can provide more loan proceeds for construction or rehabilitation at a similar monthly debt service. These additional funds can make the difference between merely repairing deferred maintenance and updating amenities and designs for the next 20 years. The program offers a long 40-year amortization in addition to the lower interest rate.

Early preparation can benefit properties applying for both the USDA Sec. 538 program and competitive tax credits: Some states give preference to tax credit applicants that have secured 538 funding. Properties that anticipate renovations, acquisitions or new construction within the next year should coordinate these two options and start familiarizing themselves with the 538 program and their state’s Qualified Allocation Plan (QAP).

Combining Tax Credits and the 538 Program

In 2006, 70 percent of the Section 538 loan guarantees were paired as debt with tax credits. Tax credits provide a dollar-for-dollar reduction of federal income tax liability over a 10-year period in exchange for renting housing units to low-income individuals or families. Private investors are sought to buy the credits and thus provide equity for development costs in exchange for the opportunity to receive the tax benefits.

Two types of low-income housing tax credits are available: 9 percent and 4 percent credits with bonds. States allocate credits based on federal thresh-

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old requirements and criteria outlined in their QAPs, usually a scoring system evaluating such factors as the units' affordability, developer/applicant experience, local government support, property design features and location in "difficult to develop" areas or "qualified census tracts." Several states offer competitive advantages to properties that have already secured an obligation of 538 loan funds.

It is very important to understand the time line for using the 538 and tax credits together. This information can often be found in the tax credit QAP and in the Section 538 Notice of Funds Availability. The steps are interrelated, and in some states certain steps must be completed with documentation prior to making the next move. Some of these items may occur simultaneously, and it is important to monitor progress and ensure requirements are met on time.

Using the 538 Program

As the 538 Program is used more frequently, lenders, developers and USDA Rural Development are finding more efficient ways to make it work.

USDA is allowing rent increases with property improvements in many locations, so long as the final rents are comparable to rents of similar units in the area. Lancaster Pollard has seen average per-unit rent increases ranging from \$10 to \$182 per unit. The property improvements, reserves and the comparable area rents will dictate the rent increase possibilities.

Section 538 can be used in combination with 4 percent tax credits as a bond enhancement on tax-exempt bonds, providing an excellent tool for portfolio transfers and rehabilitation. In a recent financing, the 538 loan provided an additional \$889,042 in loan sources for the transfer and rehabilitation of 219 units of Section 515 housing. Developer Chris Hodges of Emerald Housing Partners is using one 538-enhanced tax-exempt bond and four 538 loans to maximize the economic benefits to the project. When compared with an alternative Fannie Mae bond/debt option on the same four properties, the 538 structure realizes a lower overall interest rate (5.2 percent vs. 6.0 percent) and a longer term of 40 years vs. 30 years.

Tax-exempt bond origination costs can be cost-prohibitive on smaller transactions and may cancel out some of the benefits that can be realized by issuing them. A Section 538 guarantee on a taxable loan may accomplish the same goal as a tax-exempt bond issuance on a transfer of fewer than five properties. In many instances, Rural Development permits sharing of rental assistance on property combinations where

one 538 loan is used as debt in a bond-like transaction. A 538 guarantee, without bonds, may be more efficient than a tax-exempt bond structure on a smaller number of combined projects because of the lower origination and legal costs, although if 4 percent tax credits are used, tax-exempt bonds must be utilized.

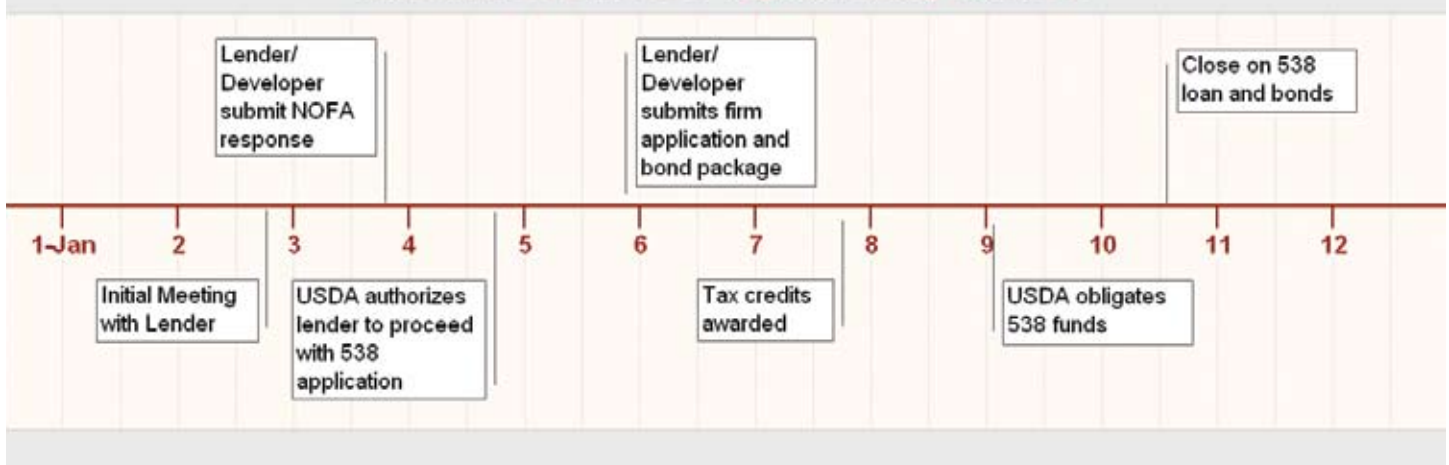
The 538 is being used in many states to combine properties. Three existing 515 properties in New Mexico that were destroyed by a breached levy will relocate to a new site in the same area by using one 538 loan for all three properties, combined with emergency tax credits that New Mexico reserves for such disasters and other emergencies. All three properties have 100 percent rental assistance and will retain their 515 loan to keep the rental assistance and increase the rents.

Preparing for Preservation: Start Now

- Research your state's tax credit allocation timeline and the elements of its Qualified Allocation Plan. Each state's scoring process is different; knowing the requirements and point system will help improve your application's chances of receiving a tax credit allocation.
- Plan to contact a lender about the financial portion of your 538 structure several months ahead of the due date for tax credits. The federal government will issue guarantees for only a finite amount of funds each year (approximately \$100 million in 2007), and only those who are prepared to act will be able to take advantage of the opportunity. Some states require that a 538 guarantee be approved prior to tax credit allocation. Plus, tax credits will be allocated based on how much debt a property can take on, which will be affected by the debt product being used.
- Put your development and financing team together early in the process to maximize your efficiency, and your application's chances of receiving the necessary resources. This team will help you determine your eligibility for various structures, understand your options, and help complete each step in the process.

The Capital Issue: Using Sec. 538 and Tax Credits

Timeline: USDA 538 Program using LIHTC's



Low-income Housing Tax Credit Flowchart

