

Sec. 236 IRP decoupling: A preservation resource whose time is now

By Jennifer Lavorel

Affordable housing preservationists have no time to lose in taking advantage of subsidy available through the Sec. 236 decoupling process. This is a finite resource, limited to the amount that was budgeted when the original mortgage subsidy for a project was approved decades ago under this now-defunct program. In another decade, the last of it will be gone.

From 1968 to 1975, all Sec. 236 contracts that the Department of Housing and Urban Development (HUD) entered into with an owner were dependent upon appropriations being made for the full contract term, generally 40 years. (See sidebar for more program details and terminology.) Legislative changes effective in 2000 allow Sec. 236 interest reduction payment (IRP) decoupling to be used as a preservation technique, applying this previously budgeted project-based subsidy to the current rehabilitation of assisted housing.

In July 2004, Federal Housing Administration (FHA) Commissioner John Weicher told the House Subcommittee on Housing and Community Opportunity that "350 projects with approximately 32,000 units [have been] processed under the Sec. 236 decoupling program." Tens of thousands of additional units could benefit from this preservation technique.

A finite resource

Although the existing contracts for IRP subsidy have been funded in full, the amount of subsidy available is fixed. Because the subsidy depends upon the original mortgage terms, its net present

value declines over time.

Further, when Sec. 236 mortgages are prepaid without an IRP decoupling, the unused subsidy is ultimately returned to the Department of the Treasury,

amounting to a loss of critically needed rehabilitation dollars. In addition, several factors that complicate decoupling transactions – adding time and costs – must be addressed if this important resource is to

Basic decoupling terminology

Sec. 236 program. Active from 1968 through 1975, this program enabled private developers of rent-restricted multifamily housing to obtain Federal Housing Administration (FHA) mortgage insurance and a mortgage interest-rate subsidy. The subsidy took the form of an interest reduction payment (IRP), which the Department of Housing and Urban Development (HUD) paid directly to the lender, reducing the owner's interest rate to 1%. Project sponsors were required to rent to low- and moderate-income households and to abide by Sec. 236 regulations, which included budget-based rent calculations and limits on distributions, for the duration of the mortgage. Most of the units financed under the program took on 40-year mortgages that were eligible for prepayment after 20 years.

Interest reduction payment (IRP) decoupling. In the HUD Appropriations Act of 2000, Congress authorized the continuation of the IRP subsidy when Sec. 236 mortgages were refinanced through a process known as IRP decoupling, or Sec. 236 decoupling. A sponsor that elects to use the decoupled subsidy can acquire cash for rehabilitation by refinancing the old mortgage at today's lower rates and obtaining new debt supported by both the decoupled subsidy stream and the new, higher net operating income. The sponsor must continue to adhere to Sec. 236 regulations for five years after the receipt of the final IRP subsidy or the term of the original insured mortgage, whichever is later.

Enhanced vouchers. Enhanced vouchers protect tenants in assisted properties that have been converted to market-rate properties when owners have either gone through prepayment or opted out of a project-based Sec. 8 contract. HUD is also required to provide enhanced vouchers to eligible tenants in properties that have gone through certain preservation transactions (such as a Mark-to-Market restructuring). Enhanced vouchers are like regular housing choice vouchers (HCVs) except that rents may exceed those allowable under the HCV program, and enhanced vouchers give tenants the right to remain in their units.

Equity takeout. Refinancing an existing mortgage at a higher level of debt, with an upfront cash takeout.

Mark-to-Market. The Mark-to-Market program was created to address above-market Sec. 8 rents in FHA-insured properties. The program provides for a reduction of both rents and debt service through a restructuring of the project mortgage.

Mark-Up-to-Market/Mark-Up-to-Budget. The Mark-Up-to-Market program provides economic incentives to for-profit owners of Sec. 8 properties with below-market rents (typically located in strong markets). In exchange for keeping a property in the affordable inventory, an owner can raise rents to market level. Nonprofit owners of older Sec. 8 properties may be permitted at contract renewal to raise rents to cover needed capital improvements under the Mark-Up-to-Budget program.

achieve its full potential as a preservation tool.

Impediments to using Sec. 236 decoupling

Three factors undermine the preservation potential of Sec. 236 decoupling. First, the Internal Revenue Service (IRS) has failed to provide clear guidance regarding how the decoupled subsidy should be treated in transactions that use 9% low-income housing tax credits (LIHTCs). Second, HUD policy regarding equity takeouts (see sidebar) negates the entire value of the resource in some circumstances. Finally, regulations do not allow nonprofit organizations to obtain enhanced vouchers (see sidebar) upon prepayment of Sec. 236 mortgages, which further undermines the value of this otherwise promising preservation tool.

The basis question. Not all Sec. 236 decoupling deals employ LIHTCs. This is partly because the IRS has not been clear about whether the decoupled subsidy is to be considered a federal grant or loan (and therefore excluded from eligible basis). Although a HUD representative stated that the agency does not track such things, the convention in Sec. 236 decoupling transactions is to combine the subsidy with 4% credits and tax-exempt bond financing. Some IRP decoupling deals have involved 9% credits, in which case the subsidy is typically excluded from basis. As one industry expert observes, this results in "resources being left on the table."

In a few 9% LIHTC transactions, the subsidy has been included in basis, and the parties structuring the deal have been careful to ensure that the blended interest rate of the refinanced loan and the new debt either meets or exceeds the applicable federal rate (AFR), the guideline for determining whether a mortgage is subsidized. Some parties have actually excluded the subsidy from basis and met or exceeded the AFR.

In one recent 9% deal involving a property that had been through the Mark-to-Market program (see sidebar), the existing first mortgage was too small for the blended rate to meet AFR. Though the

subsidy was excluded from basis, parties to the deal recognize that an adverse ruling from the IRS regarding the simple presence of the subsidy could taint the deal. Another Sec. 236 decoupling that included the subsidy in basis and met the AFR threshold was structured to ensure that if the subsidy later needed to be subtracted from basis, the deal would still work with 4% credits. In that case, the

nonprofit sponsor would forego its development fee and look to other sources for gap financing.

HUD's equity-takeout position. HUD will permit budget-based rent increases in conjunction with Sec. 236 decouplings on a case-by-case basis. As a

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Sec. 236 decoupling

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general rule, the rents on units with Sec. 8 assistance can be increased to market rates if the units are eligible under either Mark-Up-to-Market or Mark-Up-to-Budget programs (see sidebar), while the rents on unassisted units can be increased by up to 10%. HUD policy requires, however, that project rents be reduced by the amount of IRP subsidy, directly negating the allowed boost.

For properties in weak markets and those needing significant repairs, HUD will consider waiving this requirement. A waiver will never be granted, however, for a transaction involving an equity takeout without a transfer in ownership. For existing owners that might want to retain their properties and keep them affordable, this policy actually encourages prepayment over preservation. According to one industry expert, some owners "would agree to extend the existing affordable reg-

ulatory regime for five years or more if HUD changed this policy to permit an equity takeout," provided that their property's needs were met through the decoupling transaction.

Nonprofits at a disadvantage. During the 1969 to 1976 moratorium on new construction for the elderly under the Sec. 202 program, many nonprofit sponsors of seniors housing used the Sec. 236 program. A lot of Sec. 236 family housing also has nonprofit sponsors. Nonetheless, Congress has not yet authorized access to enhanced vouchers for nonprofit owners when they prepay Sec. 236 mortgages. This deprives the nonprofits of resources that they could combine with decoupled IRP subsidy to preserve affordability for aging properties.

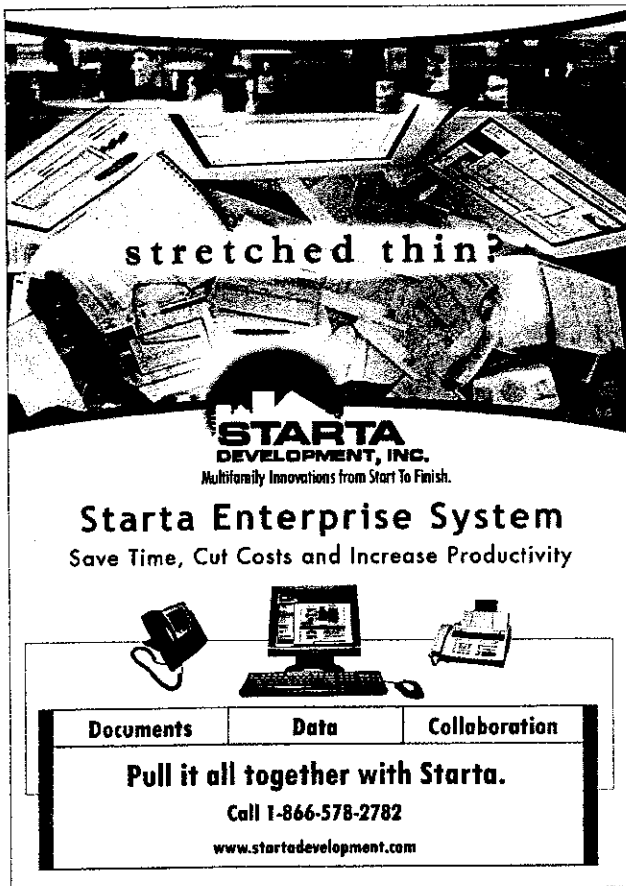
Use it or lose it

In the late 1990s, Congress directed that the IRP subsidy that was freed up when Sec. 236 mortgages were prepaid or

foreclosed should be recaptured and used to rehabilitate eligible multifamily properties. However, HUD never issued a notice making this pool of funds available, and ultimately \$300 million was rescinded and used instead for an "emergency supplemental" appropriation.

Using Sec. 236 decoupling assures that funds appropriated for housing are used for housing. But for this process to fulfill its potential, the IRS, HUD and Congress must provide clarity, policy support and statutory authority. Continued inaction to correct the disincentives discussed in this article will further erode the value of this critical and finite resource. ■

Jennifer Lavorel is policy director of Stewards of Affordable Housing for the Future (SAHF), a membership organization composed of eight national nonprofit organizations engaged in housing preservation. For more information about SAHF, visit the organization's Web site at www.sahfnet.org.



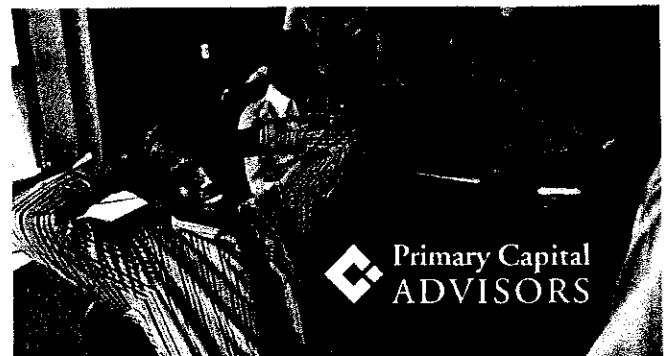
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