



## HUD Notice H 00-8 Highlights Interest Reduction Payments (IRP) Decoupling and Section 236 (b) Transactions

In May, 2000, HUD Issued Notice H 00-8, Guidelines for Continuation of Interest Reduction Payments ("IRP") after Refinancing. This preservation initiative has proven successful in providing owners and acquirers with additional resources to support comprehensive recapitalization and preservation of aging Section 236 properties. Given the newness of the program and inherent complexity in such transaction types, owners contemplating retention of the Section 236 IRP should expect intensive review and collaboration by the HUD field office, HUD Headquarters, the new lender, Section 8 Contract Administrator, and other involved state or local governments.

**Applicability.** The Notice covers two types of Section 236 recapitalizations: Section 236 (e)(2) transactions and Section 236 (b) transactions. Any insured, non-insured or HUD-held Section 236 project where the owner or prospective owner is in good standing may participate.

**Section 236 (e)(2).** Otherwise known as a "decoupling transaction", this is where the owner prepays the mortgage but retains IRP subsidy and applies it to a new mortgage.

**Section 236 (b).** In this case, an approved state or local mortgagee purchases the insured Section 236 mortgage, terminates the insurance, keeps the Section 236 mortgage in tact and provides the additional financing for the remainder of the transaction.

**IRP Assistance.** Payments must be made directly to the mortgagee on behalf of the mortgagor. Lump sum IRP payments are prohibited (the IRP Grant program is not covered in the Notice.) Yearly payments cannot exceed the monthly or annual allocation (Contract Authority) that was originally established. The continued IRP assistance may be used for debt service needs. Other potential uses for the IRP are not discussed.

**Use Restrictions.** For both types of transactions, an owner must enter into a Use Agreement that extends the Section 236 use-restriction period at least 5 years beyond the current mortgage maturity. The Use Agreement also requires the owner to accept Section 8 assistance during the term of the Agreement and to operate the project in accordance with all federal affordability restrictions in place at the time of the transaction. Such restrictions include Section 236, Title II



or Title VI Plan of Action use restrictions, Low-Income Housing Tax Credit restrictions, etc.

**Regulatory Oversight and Financing.** A public agency must continue to provide regulatory oversight for the project. In cases where there is an acceptable agency, any mortgagee can be used to finance the transaction. If there isn't an acceptable agency, then the owner must use a HUD-approved mortgagee and finance the transaction with an FHA-insured mortgage. In these cases, HUD will perform the regulatory oversight function.

**Rent Structure.** The same Section 236 rent structure as exists today - Basic and Market Rents - will continue as will the other current Section 236 requirements re: occupancy, income limits, financial reporting, excess income, etc. The mandatory rent payments are the Basic and Market rents. Tenants can pay rents below the Basic rent only if there is an available subsidy on the tenant's behalf, such as Section 8 assistance. In the case of lower rents for tax-credit units, the subsidy can be provided by the owner through a reduction in its return on equity component. Maximum rents are market rents less the IRP subsidy attributable to each unit type. It should be noted that the Section 236 (b) transactions completed prior to issuance of this Notice had maximum rent levels capped only at market comparable unassisted rents.

Owners can obtain rent increases via a budget-based rent increase or a Section 8 Mark Up to Market increase (if eligible). In the case of a budget-based rent increase, "appropriate added debt service" can be included in the budget, subject to rent increase limitations. In addition to the maximum rents being limited to market comparable rents less IRP, the Notice further limits rents to a 10% increase over the current rents. Though not explicitly stated, it appears as if this 10% limit applies only to the non-Section 8 units in a project. In the case of a Mark Up to Market, the Notice clearly states that Section 8 rents will be increased in accordance with 99-36 (which does not limit the percentage increase). Owners should confirm with HUD that the 10% rent increase cap applies to non-Section 8 units only since this distinction is not made in the Notice. HUD will retain regulatory approval over future rent increases (even if it is processed by a public agency.)

**Distributions.** HUD's policy regarding the equity distribution allowance to be used in each transaction type is very unclear since the guidelines outlined in the Notice conflict with required IRP Agreements.

First, the Notice implies that, for either a Section 236 (e)(2) or 236 (b) transaction, limitations on distributions from surplus cash are prescribed by 24 CFR 236.50. This regulation states that dividends are limited to 6% of the

mortgagors initial equity investment unless distributions were increased via a Title II or VI preservation deal. However, the Notice also indicates that the return on equity calculation for transactions where there will be new FHA insurance or a risk sharing loan and equity from tax credit syndication proceeds will be based on a 10% return on 10% percent of the amount of the new mortgage debt after the Section 236 (e)(2) or 236 (b) transaction. And to make matters more confusing, the Notice further indicates that where the transaction will keep the mortgage in tact (a 236 (b) transaction), the original 6% of initial equity is used.

In contrast, the Section 236 (b) IRP Agreement seems to indicate that distributions are governed by the public agency's Regulatory Agreement. These agreements tend to allow for 10% equity distributions, where the equity component is periodically revalued. Alternatively, the Section 236 (e)(2) IRP Agreement indicates that distributions are limited to 6% of the initial equity *except* in the case of transactions with existing Section 236 state-agency, non-insured mortgages. In these cases, distributions would be controlled by state law.

Assuming that the IRP Agreements control the equity distributions (rather than the Notice guidelines), it would seem that for any Section 236 property that either (i.) has an existing non-insured, state-agency mortgage, or (ii.) is acquired by a state or local mortgagee as part of a Section 236 (b) transaction, should have its equity distributions determined by that state or local mortgagee. For existing Section 236 FHA-insured deals that contemplate Section 236 (e)(2) transactions with conventional financing, distributions may be limited to 6% of the initial equity distribution.

*Our experience* has shown that HUD will allow increased dividends when an owner refinances with FHA mortgage insurance, obtains new financing with a state agency, or uses Low-Income Housing Tax Credits. The dividend limit for FHA deals have been 1% of the new mortgage amount, considerably higher when owners have used state agencies for the new financing, and 10% of the syndication proceeds in LIHTC transactions. We have also been successful in obtaining distributions for nonprofits equal to 6% of equity. Given the Notice's ambiguity regarding owner distributions and HUD's discretion in this area, owners should confirm the applicable equity distribution allowances with HUD on a case-by-case basis.

***Tenant Participation and Protections.*** As currently required for all Section 236 mortgagors, both transaction types require owners to comply with the tenant participation provisions outlined in 24 CFR Part 245. These regulations require the owner to post a notice of prepayment and rent increase, make materials available to residents, and provide residents with an opportunity to provide



written comments. These transactions cannot cause involuntary displacement - for example, tax credit deals that require a lower income profile.

**Preservation Projects.** ELIHPA and LIHPRHA projects may also participate but cannot obtain a rent increase as a result of the transaction. As noted previously, these owners must also extend their Plan of Action Use Agreements at least five years beyond the current mortgage maturity.

**Proposal.** Very detailed proposals must be submitted to HUD - all required elements are clearly outlined in the Notice. If the proposal is submitted in accordance with the Notice, it can be approved at the HUB level. If the proposal contains elements outside of the Notice, it must be recommended by the HUB and approved by HUD Headquarters.

**Processing Time-Frame.** This will vary based on the unique elements of each transaction and other factors. However, owners can generally expect HUD processing to be completed within 90-120 days of proposal submission.