



June 14, 2019

**Rural Development**

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**TO:** State Directors  
Rural Development

**ATTN:** Program Directors  
Multi-Family Housing

**FROM:** Bruce W. Lammers /s/ *Bruce W. Lammers*  
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**SUBJECT:** Extension of March 1, 2017, Pilot Program Promoting Non-Profit  
Participation in Section 515 Preservation

**PURPOSE**

This Unnumbered Letter (UL) announces the extension of our limited research pilot program under the authority in Section 506(b) of the Housing Act of 1949, as amended (42 U.S.C. §1476(b)). The purpose is to test whether offering a prescribed set of incentives to eligible non-profits will increase the number of Section 515 projects being transferred and preserved. If the incentives are effective, 7 CFR 3560 §3560 will be changed to make them permanent. Section 515 transfer applications with project mortgage maturities or final payments due on or before December 31, 2035, and submitted to Rural Development on or after March 1, 2017, which have not yet closed are eligible to participate in this pilot. Rural Development (RD) will review the results two years from the effective date of this UL, to determine if the incentives outlined herein should be revised, be discontinued, or made permanent through rulemaking. Applications for transfer with non-profit incentives must be received by the State Office no later than April 30, 2021.

**BACKGROUND**

Preserving the Section 515 portfolio requires collaboration with current owners as well as the public and private sectors to find innovative methods to preserve affordable rental housing opportunities in rural America. In rural markets, non-profit organizations play a vital role in RD's preservation efforts. RD is considering regulatory changes that may help preserve the projects and encourage greater participation by non-profit organizations to meet the current and future affordable housing needs of the communities they serve. To support this effort, RD has awarded four grants to non-profit organizations to provide Technical Assistance (TA), including financial and legal services, to support the acquisition of projects by non-profit housing organizations and public housing authorities.

**EXPIRATION DATE:**  
June 30, 2020

**FILING INSTRUCTIONS:**  
Housing Programs

## **IMPLEMENTATION**

An eligible non-profit organization may be a corporation, a partnership including a limited partnership (LP), or a limited liability company (LLC), legally organized under State and local laws. If the applicant is a LP, the general partner must be a non-profit entity as defined in 7 CFR 3560 §3560.11. For an LLC, there must be a non-profit entity as the managing member. For a corporation, in addition to the conditions outlined in 7 CFR §3560.55, the corporation must be designated a Section 501(c)(3) or (c)(4) organization under the Internal Revenue Code. The following are the areas where RD will examine the effect of targeted guidance changes to incentivize transfers to eligible nonprofit entities:

### Return On Investment (ROI) for Non-Profit Entities

RD regulations do not require non-profit entities to make an initial equity contribution, therefore they have not been eligible to earn an ROI under 7 CFR §3560.68, as a return is based on an investment. Today, transfers of projects often require layering of multiple funding sources. Non-profit purchasers may invest their own entity's resources, in addition to third-party funds, without the ability to receive a ROI.

*In this pilot, RD wants to increase non-profit participation in the program by allowing non-profits to potentially earn a ROI. Pursuant to 7 CFR §3560.68(d), non-profit organizations are currently eligible to receive reimbursement for Asset Management Expenses (AME), up to \$7,500 per project as an exception to any proration specified in HB-2-3560, Chapter 4, paragraph 4.19. Under this UL, non-profits eligible to earn a ROI will have the option of choosing either the allowable ROI based on their initial investment or the AME, but not both.*

In the event of a portfolio transaction involving the transfer of multiple projects to a non-profit organization for preservation, all projects that are part of the portfolio will be considered eligible for ROI if at least one of the projects meets the pilot's eligibility.

### Developer Loan

Frequently non-profit organizations receive a grant and relend the funds to a new eligible non-profit purchasing entity. This is commonly referred to as a developer loan. This practice is often required in the grant agreement, which requires funds be used for capital improvements.

*A developer loan may be included to calculate a ROI if all the following conditions are met:*

- The developer loan must be from a non-profit organization. This may include a loan from the non-profit purchaser.
- The developer loan must be non-amortizing with the principal and interest fully deferred for the term of the longest RD loan being transferred and assumed by the non-profit transferee including any extension of the original loan's final maturity date. These terms must be stipulated within the developer loan documents.
- Only the portion of the developer loan used for eligible Section 515 rehabilitation costs will be included in the eligible basis for ROI (HB-1-3560, Chapter 12, paragraph 12.6 A).

- The developer loan may be payable upon sale (after maturity of the Section 515 loans) if proceeds are available, otherwise the loan must be forgiven.
- Unless otherwise noted in this UL, all other RD underwriting standards will apply.

#### Hard Cost Contingency

A hard cost contingency is used to meet unforeseen hard costs during construction such as additional labor and materials and is required by most third-party funders and investors. RD's guidance does not deem a contingency as an eligible Section 515 loan purpose.

RD recognizes the need for a hard cost contingency when rehabilitation is being performed and will allow this as an eligible Section 515 loan purpose for transfer and rehabilitation of projects. As an eligible loan cost, the budgeted hard cost contingency may be included in the ROI calculation.

The budgeted amount is generally calculated as a percentage of the construction costs and limited to the amount required by any third-party funder. Prior RD approval will be required on all change orders which document the contingency funds are used solely for hard costs. If any contingency funds remain at the completion of rehabilitation, the funds may be used for additional improvements to the property, as approved by RD, or deposited to the project reserve account. RD will require a self-certification that the contingency was used for additional improvements to the property within 30 calendar days following the completion of the planned rehabilitation and final acceptance by RD as evidenced by approval on Form RD 1924-12, "*Inspection Report*". RD reserves the right to revisit the use of the budgeted contingency and adjust the ROI if funds were used for items other than eligible hard costs.

#### Grants

Currently, RD does not recognize grant dollars as the applicant's own resources and does not include them in the ROI calculation. This reflects a time when non-profit organizations relied on debt for their low-income housing financing and RD lent 100 percent of costs. Today, project transfers to non-profit organizations are more complex and require multiple funders of both equity and debt.

For transfers of projects potentially exiting the program to eligible non-profit entities, *RD will consider any grant dollars awarded to the non-profit applicant as the applicant's own resources and will include the amount in the ROI calculation as long as the grant is provided by a Federal, State or local Government, or other source as approved by RD, and the grant funds are used for payment of hard costs of construction.* The non-profit applicant must submit a written commitment of the grant that includes the grant amount and conditions. Deferred or soft loans other than those addressed in this UL are not eligible for inclusion in ROI.

#### Loan-to-Value (Security Value)

Security Value (SV) is defined in 7 CFR §3560.63(a). RD is responsible for determining the SV and uses it to determine the maximum loan that may be placed on a property. In determining the SV, the appraiser values the real estate as well as intangible assets in financing the property, such

as interest credit subsidy for the Section 515 loan, low interest loans from non-RD sources, tax credits and grants.

For the purposes of this pilot, *RD will allow the value of Federal direct or Federal intermediary loans in the SV as well as including the value of State or local loans provided at favorable rates in the calculation of intangible assets so long as an Agency accepted appraisal documents the value.*

### Two-Step Transfer Process

Transfer of any RD project requires RD's prior approval. RD may approve a project transfer [7 CFR §3560.406 (b)] if that project continues to further the objectives of the program, if the transaction is in the best interest of Government and the tenants, and if RD's security is protected. Although, Chapter 7 of HB-3-3560 elaborates Agency policies and thresholds for processing transfers, RD recognizes that the preservation and rehabilitation of a project may require resources which are not immediately available to a local non-profit organization. Under this UL, RD will consider the two-step process described below to preserve and rehabilitate a project:

**Step 1** – 7 CFR 3560.406(d)(5) states “All immediate and long-term repair and rehabilitation needs must be identified by a Capital Needs Assessment. The reserve requirements for the housing project will be reviewed by the Agency and adjusted; if necessary, to adequately cover the cost of addressing the property's capital needs.” *For projects participating in this pilot, RD may allow transfers of ownership to eligible non-profit applicants prior to the reserve requirements adjustment.*

RD will require verification of funding to address all health, safety, and Section 504 compliance accessibility needs immediately following the transfer. However, under this pilot, RD will allow the new non-profit owner to address the rehabilitation needs it is not able to fund immediately after the transfer over a period not to exceed two years after the closing of the transfer. RD will consider authorizing the transfer once it approves the 24-month [or less] rehabilitation plan (plan) proposed by the new non-profit owner.

All approved transfers will be under new rates and terms.

**Step 2** – The new non-profit owner implements, and RD monitors the implementation of the approved plan. The new non-profit owner may propose changes to the approved plan; however, RD must authorize in writing any changes before they are implemented.

The two-step process will require a conceptual meeting with the RD loan servicer, seller, and purchaser as early in the process as possible to evaluate the potential suitability of the proposed transfer and formulate a mutually acceptable rehabilitation schedule.

Deviations from the reserve requirement guidance in 7 CFR §3560 and the handbooks will be identified in the State Director's transfer approval request to the Director, Multi-Family Housing Preservation and Direct Loan Division (PDLN).

If there are any conflicts between guidance in this UL and any other underwriting guidance issued prior to the date of this UL, the guidance in this UL will take precedence.

Attachment A provides a chart summarizing the policy updates for qualified non-profits in this UL.

The point of contact for this UL is the PDL Review Underwriter assigned to your State Office and field office.

Attachment

## **PROPOSED REGULATORY CHANGES ELIGIBLE NON-PROFITS**

This Unnumbered Letter proposes to test limited regulatory changes to increase non-profit participation in the Section 515 program. The changes include allowing an eligible non-profit to earn a Return on Investment (ROI), the inclusion of value for certain loans provided at favorable rates in the Security Value (SV) determination and allowing a transfer subject to future rehabilitation.

### 1. ROI:

- a. Eligible non-profits to earn a return based on the investment of their own resources following the ROI methodology.
- b. Grant funds used for hard costs of construction may be included in the ROI methodology.
- c. Developer loans made by sponsoring non-profits to a non-profit purchasing entity may be included in the ROI calculation.
- d. Allows hard cost contingency as an eligible Section 515 loan purpose to be included in the ROI calculation.

### 2. Security Value:

- a. The Agency to include the value of Federal direct or Federal intermediary loans.
- b. State or local loans provided at favorable rates, in the SV determination as intangible assets when adequately documented.

### 3. Two-Step Process:

- a. For projects participating in this pilot, Rural Development (RD) may allow transfers of ownership to eligible non-profit applicants prior to the completion of all repairs identified in the Capital Needs Assessment and the reserve requirements adjustment.
- b. Approval is subject to RD acceptance of any feasibility plan which may be proposed to defer repairs/rehabilitations until funds become available from alternative sources to implement a sustainable plan of operation including Multifamily Preservation and Revitalization, Low Income Housing Tax Credits, State and local resources, rental subsidies, etc.