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# ISSUES IN PRIVATELY OWNED AFFORDABLE HOUSING: SECTION 8 HAP CONTRACTS OVERFUNDING AND THE DISPOSITION OF EXCESS RESERVE FUNDS

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## SECTION 8 HAP CONTRACTS OVERFUNDING
## AND
## THE DISPOSITION OF EXCESS RESERVE FUNDS©

BY

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**Context**

This research project will examine the manner in which the the federal government's Section 8 program subsidizes private developers to achieve the policy objective of developing and managing affordable housing in Rhode Island. After reviewing the history of the program with particular attention given to the issue of overfunding of reserve funds, specific recommendations will be made for future management of the program. Review of federal and state policy, legislation, statutory law and case law will be required to explain the continued existence of overfunding and the resulting dispute over ownership of overfunded project reserves.

A major part of the Nixon administration's Housing and Community Development Act of 1974, the program was repealed in 1983 after substantially augmenting the nation's affordable housing stock. Although Section 8 is no longer used to develop new housing, it does administer the housing it constructed between 1974 and 1983.

The manner in which the Section 8 program is administered has resulted in controversy. Originally devised in the inflationary period of the late 1970s, the mechanisms established to regulate the amounts of subsidy developers receive have overfunded the reserve accounts of these projects. That these projects were, indeed, allowed to become overfunded did not occur without a legal dispute. Resolution of this dispute, although not completely definitive, has allowed this overfunding to continue and has led to a second closely related problem; disposition of these excess reserve funds.

**Problem Statement**

In examining the progression of events outlined above a number of issues will be considered. The examination of these issues will serve to assess the rationality of this system for providing affordable housing.

What were and are the expectations of the investors in this segment of the real estate market? How has tax reform affected the affordable housing segment of the real estate market? What are the legal issues involved in adjusting Housing Assistance Payment (HAP) contract payments? For tax and other purposes, who owns these "excess" reserves estimated to be $35 million in Rhode Island alone?[1] (In the three lower New England states the total may be $150 million)[2] And what controls do the vying parties have over these reserve? How are state finance agencies responding to this situation? A reasonable legal resolution of the overfunding issue could have precluded the second, disposition of excess reserves, problem from occurring. Unfortunately, this has not been the case.

**Significance of the Problem/Policy Issue**

Although the particular problems of overfunding and the disposition of excess reserves may be perceived as a technical problem within one housing program, it can also be seen as a vehicle for examining larger policy issues. Specifically, what types of assumptions about the relative roles of government, investors, and occupants of affordable housing are contained in the program? How successfully does the program, or can the program,

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[1] RIHMFC.
[2] William Hathaway, The Hartford Courant, November 1992.

reconcile the competing interests of these parties with what are, or should be its own priorities?

## Methods of Analysis

### *Sources of Information*

This research project will examine a variety of sources of information to formulate recommendations for future Section 8 policy. These will include state housing authority materials and regulations, real estate tax journals, federal regulations, court decisions, and interviews with developers and administrators involved in the Section 8 program. As a policy document, this research project will involve little manipulation of primary data. Data collected from secondary sources will, however, be displayed in the final document for illustrative purposes.

### *Methods*

The analysis of the various applicable laws as well as the agreements entered into by the developers and HFAs and HUD will be examined to evaluate the claims made by developers and HFA's to Section 8 project reserves. The primary method of analysis will be to review relevant legal documents (court cases, federal regulations, IRS codes, partnership agreements, etc.) using the same legal criteria that would be used by an attorney or judge. Specifically, the rulings of higher courts take precedence over those of lower courts, and individual contracts will be balanced against the intent of their broader enabling legislation. This is not an exact science, and challenge of the exercise will be to balance the interpretation of technical, legal documents against low-income housing policy considerations.

**Introduction**

This Chapter will provide a brief history of the Section 8 program; describe the mechanics of the limited partnership form of owning real estate; and provide some basic definitions of the terms and mechanics of the Section 8 program.

**Program History**

Although they may differ slightly in their details most federal housing programs designed to encourage the creation of privately owned low-income housing do so by combining

> private development with financial assistance to make the production of low-income housing attractive to private investors. In exchange or financial assistance, in the form of decreased interest rates on mortgage loans and rental assistance payments, the developers were willing to consent to certain restrictions on their property which ensured the availability of the property to low-income tenants for a specified period of time. These restrictions, of course were not perpetual and were set for a term which *balanced the benefits of the assistance with the burden of the continued use of the property as low-income housing.*[1]

20 years was the most common term of these restrictions, because it was short enough a period of time to be attractive to developers and long enough a period of time to be considered a federal housing that would be fair to the needs of low-income tenants.[2] Now that restrictions are elapsing on these properties 20 year old intentions of the Section 8 program are being re-examined in the context of the continued need for affordable housing.

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[1]Simons & Smith, p. 1., *emphasis added.*
[2]Ibid., p. 1.

Approximately 645,000 units of the estimated inventory of two million units of privately owned low-income housing were created by the private for-profit developers under several programs which existed between 1961 and 1973.[3]

*Financial Assistance*

A variety of programs provided interest rate subsidies for the mortgages of these properties. These programs included:

- Section 221(d)(3) of the National Housing Act which provided below-market interest rate (BMIR) and market rate (MR) mortgages fully insured by the Federal Housing Administration (FHA). The latter were often coupled with rental assistance. 221(d)(3) was responsible for the production of approximately 160,000 units of affordable housing; and

- Section 236, of the National Housing Act developed 400,000 units through the use of a one percent interest rate loans to developers.[4]

*Restrictions*

In exchange for these subsidized mortgages and rent supplements, the owner of these properties were obliged to:

- rent to only those tenants defined as income eligible by the respective programs, as defined as percentage of median income;
- limit the amount of rent they charged tenants; and

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[3] Ibid., p. 1.
[4] Ibid., p. 2.

- pay surpluses to the federal government.[5]

These restrictions were in effect for the same period as the term of the mortgage. That is, 40 years for non-profit owners, and 20 years for for-profit owners.[6]

Interest rate reductions, however, was not the sole tool used to foster the development of privately owned affordable housing. The Rent Supplement Program was also necessary. This program was eventually replaced by the Section 8 Existing Loan Management Set Aside Program (Section 8 LMSA) colloquially known as Section 8. This program paid owners the difference between:

(1) 25% (and later 30%) of a tenant's income; and
(2) the actual, or market rent needed to carry the expenses of the project.[7]

Initially 40 year contracts under the Rent Supplement Program, under Section 8 LMSA contracts usually were coterminous with the mortgage (20 or 40 years) and renewed in five year increments. Until 1980 there were no prepayment restrictions on these mortgages.[8]

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[5] Ibid., p. 2.
[6] Ibid., p. 2.
[7] Ibid., p. 2.
[8] Ibid., p. 3.

The Section 8 Program was one of several major affordable housing production and support program of the federal government between 1974 and 1983. One of the main objectives of the program was to minimize the role of government by providing financial incentives to non-governmental bodies to develop affordable housing.[9] Essentially government would guarantee the income stream for properties financed under this program through Housing Assistance Payment (HAP) contracts. Tenants of the projects were required to pay 30 percent of their income for rent. HUD paid the difference between the tenant's contribution and what a fair market rent was for that type of apartment. This guaranteed income stream provided the security necessary for private lenders to provide mortgage financing to these affordable housing projects.

*Key points about the Section 8 Program*

1. Although available to non-profits and local housing authorities, the program was primarily utilized by private, for-profit developers.[10] This is an important distinction because the first two types of ownership are organizations with a specific mission and assets, such as real estate, owned by these organizations are to be used for that purpose or a closely related purpose. In contrast, the property of private developers financed under this program is supposedly that -- private property. Although contractually bound to provide affordable housing for an initial 20 year term, after this initial term

[9]Howell, Joseph T., Real Estate Syndication, p. 90.
[10]Ibid., p. 91.

the developer could use the properties for any purpose that they saw fit.

2. For a program that professed limited government involvement as one of its objectives it was, from the beginning, highly regulated. HUD:
   - determined what rents for the projects would be (more about this later);
   - oversaw the development process requiring compliance with Davis Bacon prevailing wages, review of development budgets for reasonableness, and certification of the development budgets at the end of construction; and
   - required that property management be in accordance with HUD policies including the use of affirmative fair marketing plans.[11]

3. Tax treatment favorable to the owners and investors was also a part of this program. Construction period interest and financing fees could be deducted during the construction period rather than over the life of the loan. Similarly, depreciation(define) of the property could be accelerated into the first five years of the property.[12]

Due to the security of their guaranteed income stream, low cash flow, and tax advantages Section 8 and other projects financed with the

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[11] Ibid., p. 92.

[12] Ibid., p. 92. For tax purposes the value of real estate (buildings, not land) may be depreciated for the decrease in value it experiences as the result of wear and tear. The entire cost of a property may be recovered, or depreciated over a 20 year period, with one twentieth of the value of the property being deducted from the ownership entity's taxes per year. When the cost is recovered in a shorter period of time this is referred to as accelerated cost recovery or depreciation.

promise of an income stream guaranteed by the federal government made attractive tax shelters.[13]

*Prepayment*

Between 1991 and 1995 approximately 334,000 of the 645,000 units of affordable housing assisted with 236 and 221(d)(3) BMIR and MRs became eligible for prepayment. Coupled with changes in the availability of Section 8 rental assistance it has been estimated that 243,000 of these units may be removed from the pool of affordable housing.[14]

In 1987 Congress passed the Housing and Community Development Act of 1987. This act imposed a short term moratorium on prepayment and established a series of procedures that must be followed in order for prepayment to occur. Owner interested in prepaying must first file a 'notice of intent' and then a 'plan of action' with the their state housing finance agency. The plan of action had to outline the owner's plans for the project and how they would effect low-income affordability restrictions, and the supply of affordable housing in the area.[15] This provisions of this Act will be explored in Chapter V.

**The Limited Partnership as Ownership and Investment Mechanism**

The limited partnership is a way of organizing the ownership of a particular individual piece of real estate. That is, a limited partnership is specific to an individual piece of real estate. As the name states, a

[13]Ibid., p. 92.
[14]Simons & Smith, p. 3.
[15]Ibid., p. 4.

limited partnership is a partnership, sometimes also referred to as a syndicate.

A "syndicate is a body of persons who combine to carry through some financial transaction, or undertake some common venture. Syndicates are often, though not exclusively, formed to acquire real estate for income..."[16] Essentially syndication allows a developer to produce equity or cash by selling shares of an income producing property to investors.[17]

Syndication, or group ownership, was a commonly used device hundreds of years ago. In England, groups of individuals with capital to invest shared ownership of ships, stocked them with merchandise, and then sent them all over the world to trade for items which were in demand at home, such as spices, silks, jewelry and works of art. Profits were divided among investors, and then the process was repeated, possibly with new partners. [18]

*Syndication*

Every limited partnership must have one general partner and one limited partner.[19] Typically the general partner establishes the partnership and then the general partner or a representative of the general partner, such as a brokerage house, sells the limited partnership share. A limited partnership can also be created much less

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[16]Hussander, p. 23.
[17]Howell, p. 2.
[18]Hussander, p. 24.
[19]Howell, p. 1.

formally between friends or associates. The cash that limited partners pay for their share of ownership in the partnership is referred to as capital contributions.[20] In return for their efforts the syndication firm receives a percentage of the capital contributions. There can be a great deal of corporate intimacy between the syndicator and the general partner. They may either be part of the same firm or they may be involved in some form of joint venture or the syndicator may buy the developer's ownership share out as part of the syndication in what is referred to as an equity purchase.[21]

The syndication must conform to the regulations of the Securities and Exchange Commission (SEC).[22] The most significant of which is full disclosure. That is all the material facts of the project must be revealed either through a written offering memorandum or a prospectus with the SEC.[23]

The offering memorandum is required to state the various risks associated with the project. They include:

- real estate risk, or the risks associated with any income producing property.
- tax risk, or the possibility that the tax rules which assumptions for the project are based upon, may change.

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[20]Ibid., p. 2.
[21]Ibid., p. 4.
[22]There are, however, several exemptions from compliance with SEC regulations. Under certain conditions those exemptions include: private placement; intrastate offerings; offerings of limited dollar amounts. Hom, p. 4.
[23]Howell, p. 19.

- illiquidity risk, the common risk with many real estate investments (excepting REITs) that an investor cannot get out of the deal unless certain conditions, some of which are typically beyond the investor's control, such as the availability of replacement investors, are met.
- partnership risk, or the possibility that the general partner will not perform up to expectations.
- financial risk, or the results that an economic down turn may have on a project.[24]

Unlike most common forms of partnership, however, the limited partnership, or syndicate, establishes a hierarchy of responsibility and authority among the owners. The general partner is typically responsible for the conducting the business of the partnership. The limited partner is by law required to be a silent partner.[25] Parallel to this is a hierarchy of liability. In limited partnerships the liability of the limited partners is strictly limited to the amount of their investment, or basis. The limited partner can lose no more than they have invested in a particular project. The limited partner may, however, stand to receive tax benefits in excess of their investment. This is referred to as excess basis. It results, for example, when limited partners are able to deduct their share of the interest on the non-recourse loan -- something for which they have no liability.

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[24] Ibid., p. 20.
[25] Ibid., p. 22.

The liability to the general partners, however, is potentially more extensive. General partners may benefit from excess losses.[26] That is, they also have the potential to make more relative to the amount of their investment. (This is one of the many real estate uses of the term leverage.) The first type of financial exposure that a general partner can suffer can occur if the project never makes it past the predevelopment stage. During the predevelopment phase when financing is being negotiated, site reviews being sought, and the design finalized there is always some risk to the general partner(s) that the project may not come to fruition and the general partner will not be able to recoup these costs.

In fact, a rather basic guarantee in a limited partnership is for the general partner to guarantee to cover any construction cost overruns and initial operating deficits.[27] During the operation of the project, (when the project is through the construction phase and hopefully occupied by tenants) there are also economic risks to the general partner. Typically general partner or affiliated companies of the general partner may serve as property manager. They may also serve as the syndicator and receive a promotional fee for this service.[28] Similarly if the general partner or syndicator has a staff of brokers fee income may also be generated through for the general partner of syndicator through brokerage commissions. Profits of the property manager are tied to the performance of the property either implicitly or explicitly. If the assumptions that structured the deal failed to

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[26] Ibid., p. 14.
[27] Ibid., p. 6
[28] Hussander, p. 29.

recognize factors effecting the long term viability of the project the general partner can be effected through their interest in the property management company. Furthermore, the limited partnership documents which govern the operation of the partnership and the property may include guarantees that the general partners will be responsible for absorbing financial shortfalls before the limited partners.

If the partnership is financed with Low Income Housing Tax Credits (LIHTCs) the partnership must operate in compliance with the regulations of the LIHTC program. Failure to do so could endanger the tax credit benefits that the limited partners receive. And since the same group of general partners are seldom involved with only one project their professional credibility and the potential for the general partner to fund other projects in a similar manner will be seriously compromised.

The general partner may also have the opportunity to lease back the syndicate owned real estate. Since land cannot be depreciated there is no motivation for the general partnership to own it. Instead, the land is owned by the non-profit sponsor and partnership has a ground lease for the building which they own during the tax credit compliance period. After all the tax credits have been received the non-profit sponsor commonly becomes the owner of the building as well as the land as per the volumes of legal documents that structure a deal of this type.

The limited partnership is a form of real estate ownership which closely approximates corporate ownership. Instead of shareholders and corporate officers, however, the limited partnership has general partners and limited partners. Furthermore, ownership in a limited partnership is much less liquid than a corporation. Although the limited liability of corporate ownership can be found in a limited partnership, it is not automatic. Corporate ownership, however, does not confer the same tax benefits as a limited partnership, which allows depreciation to be passed on to the limited partners.[29] Corporate earnings are also taxed twice: once at the corporate level; and then at the shareholder, or investor, level.[30]

Typically acting as the developer, the general partner drives the development process. The general partner(s), is usually a development company of some type. Some nonprofit development corporations may act as general partners. The general partner drives the development process including massing the equity necessary to leverage financing. The currently favored form of equity, in affordable housing, comes from tax credits which are the end result of a series of steps involving many intermediaries who channel equity funds to a project. These funds may only be available to a project after a brokerage house has offered them to the security buying public. In the interim the developer may have to take their commitment letter for tax credits to a bank for a bridge loan. In simpler forms of limited partnership,

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[29]If limited partnerships, which invest in one particular property at a time, approximate corporate ownership, then REITs (Real Estate Investment Trusts) which provide investors with an opportunity to invest in a pool of properties at once are roughly analogous to mutual funds.

[30]Hom, p. 4.

equity may also include direct contributions from interested investors.[31]

As the responsible party for the form of ownership, the general partner can be held personally responsible for the debts and other obligations of the partnership.[32] If the financing for the project is non-recourse, or the collateral for the project's financing is only the real estate of the particular project, their liability may be limited to the funds they have invested in that particular project. Typically unless a project is financed with non-recourse loans tax losses are not available to limited partners.[33] Still, once architectural and engineering and legal fees are considered this can be quite substantial. If the loan is not non-recourse other property in which the general partner has a financial interest may be required as collateral.

This is in contrast to the limited partner whose liability is limited to the amount of their capital investment. Furthermore, the limited partners have no management responsibilities for the project. Rather the responsibilities of these inactive investors are no more than they would be for a stockholder.[34]

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[31]This form of syndication was particularly popular in the 1980s. A Connecticut firm, Colonial Realty, rose to prominence during this period through their syndicated holdings. The economic down turn of the late 1980s, however, revealed that Colonial Realty's success had not be attributable to savvy real estate investment. Rather, Colonial Realty utilized a Ponzi scheme, paying distributions to old investors with new investor's funds.

[32]Hom, p.4.

[33]Howell, p. 15.

[34]Hussander, p. 45.

At the time that financing for the project in question is closed, or the syndication complete, the developer typically becomes the general partner.[35] That is, ownership of the project changes from whatever form it previously was to limited partnership. In order for this to happen enough limited partners must be brought on board or syndicated. That is, either through a formal offering not unlike the initial offering of a stock, or a less formal mechanism, sufficient funds are brought together to acquire the property, pay for future construction, and reimburse the developer for past expenses and provide the developer with a profit for the time and money the developer has invested and risked in getting the project commenced.

The complicated nature of this type of ownership vehicle with its dependence on a multitude of professionals such as attorneys, accountants, and investment bankers effectively limits this model to projects large enough to have the economy of scale required to pay for a limited partnerships' high transaction costs.[36] The involvement of all these professionals can be substantial because of the complex and changing nature of the rules and laws that apply to partnerships. For instance, a limited partnership must address aspects of a variety of types of law including: partnership; securities; real estate; and federal and state tax codes.

[35]This may be after construction has been completed and a bridge loan secured to finance the project in the interim period between predevelopment and closing of final financing.
[36]Hom, p. 2.

*Investor Expectations*

In evaluating a general partner most limited partners are concerned with two major items. The first is the financial benefit that the project can produce. The second is the capacity of the general partner.[37]

There are a variety of types of financial benefits. One is cash flow or income that the project can produce. Another is the way in which the real estate can appreciate in value. Another is the way in which limited ownership in a project can allow the limited partner to shelter taxable income by participating in the depreciation of the project. Depreciation, or capital recovery, is an accounting principle that for tax purposes portrays the projects as almost losing money because their value is considered to decrease over time. A property may actually be generating income but show a loss for tax purposes. For the purposes of the federal tax code this depreciation or devaluation of the asset is allowed to happen more quickly, or in an accelerated fashion so that the tax benefits of depreciation may be realized more quickly in the life of the project. This is referred to as excess depreciation.[38]

As stated earlier, there are several types of risks that the investor must be aware of, and these should be spelled out in the offering memorandum, or prospectus.

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[37] Howell, p. 22.

[38] It should be emphasized that the concept of depreciation or capital recovery is only an accounting convention that seems a bit contrived when applied to real estate. After all, no invests in real estate because they believe it will actually decline in value.

*Real Estate Risk*

There are many types of events that fall into this category. Some risks, such as construction cost overruns and low initial occupancy rates can be signed solely to the general partner. If these risks or any others become catastrophic in proportion, however, the ultimate bad event in the property's operation can occur - foreclosure. If foreclosure occurs the IRS may consider this to be the same as a sale and recapture all excess depreciation. This is disastrous for the limited partners, who must now retroactively pay taxes from which they thought they had sheltered themselves.

If a project is looking over the precipice of foreclosure the general partner may lend additional funds to the project or convince the limited partners that they should contribute more cash to the project rather than suffer through recapture with the IRS.

In summary there are three broad categories of consideration that the prospective limited partner should use to evaluate a limited partnership by. The first is the financial return that a project has to offer relative to other forms of investment. Second is the set of assumptions behind the statements contained in the offering memorandum or prospectus. Third, the investor should feel comfortable with the capacity of the limited partner to both develop and manage the limited partnership.[39] These are the specific criteria which for the investor should frame the question, how much money

[39]Howell, p. 39.

will I receive, when will it be received and how much risk is involved in the investment.[40]

**Tax Implications**

A great deal of the motivation for investing in real estate stems from its tax consequences, or real estate's ability to provide tax shelter. The basic considerations involved in evaluating a property for syndication include:

- the applicability of a single or double tax on income and profits of the entity;[41]
- methods of passing through deductions, expenses, and losses to partners;
- capital gains treatment;
- the relative liquidity of the investment;
- estate tax treatment of the investment;
- the applicability of property taxes;
- existence of net worth requirements; and
- the availability of deductions for syndication fees, organizational fees.[42]

*Basis*

This is usually defined as the amount of capital invested in the partnership, or equity. IRS regulations state that a partner's basis also includes his share or the partnerships non-recourse debt. The use of

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[40]Ibid., p. 42.
[41]A limited partnership is a pass-through entity. That is, unlike corporations which are taxed at the corporate and stockholder level, limited partnerships are only taxed once, at the partner level.
[42]Hom, p. 3.

non-recourse debt allows the partner's to increase their basis beyond what they have actually invested and claim loss deductions in excess of their original capital contributions without a corresponding increase in risk.[43]

*Depreciation*

Depreciation or cost recovery is also an essential concept to understanding the financial functioning of a limited partnership.

The attractiveness of the Limited Partnership mechanism is that the tax benefits of a piece of property are available to all of the partners, general and limited. That is, the investor can receive a share of the depreciation that is claimed for the property as against their own tax liability. The participating investor in an acreage or vacant land deal can convert high-earned income received in one year into long-term, low taxed income in a subsequent year. Prepayment of interest and charging the expense of carrying the vacant land against the investors high, earned, ordinary income in the year in which the expenses are paid out, produces this tax savings. An investor who participates in an income property syndicate gets his share of the depreciation on the building against personal ordinary income, leaving him "tax shelter." A syndication's tax gain can be stretched out for tax advantages.[44] With the LIHTC Program a more substantial tax shelter is provided because the tax credit is subtracted from the investors/limited partners final tax liability. From the perspective of the federal tax code depreciation is a

[43]Ibid., p. 4.
[44]Hussander, p. 29.

deduction which reduces the investor's adjusted gross income. The investor's adjusted gross income is then taxed at the applicable rate. A tax credit of any kind, however, is subtracted from the amount of taxes actually owed, providing a more direct and significant shelter.

Likewise, the general partner or syndicator can get a share of the depreciation to charge against his ordinary income. This is in addition to the share of capital gain the general partner or syndicator can receive when the property is resold, (if the model does not involve the property ultimately going to its non-profit sponsor) with little or no investment of their own money.[45] Although applications of this term vary, this is one manner in which the term "leverage" is used. That is, with minimal investment the general partner or syndicator is able to control the property.[46]

**Housing Assistance Payments (HAP) Contract**

The primary subsidy mechanism for Section 8 and other federally assisted housing projects in the Housing Assistance Payment (HAP) Contract. The purpose of the HAP contract is to guarantee a stable income stream to these projects for a period of twenty years at a time. This is done through the contract rent.

The contract rent is essentially determined by what are comparable fair market rents (FMC) in the area. This is determined regularly by HUD surveying rent of apartments with comparable amenities by geographic

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[45] Ibid., p. 29.
[46] Ibid., p. 29.

area. The owner of a project uses the contract rents in the development stage to plan how much debt the project can bear throughout its lifetime. These rents are then periodically updated to stay coincide with current market conditions. Usually the rents increase, or decrease slightly. In any event project owners can count on rents as high or higher than when the project was initiated because they are guaranteed contract rents no lower than when the project was initiated. Without this assurance it would be impossible for the owner to plan for the operations of the project.

The mechanism for updating these contract rents is a multiplier called the Annual Adjustment Factor (AAF). This multiplier is supposed to adjust the contract rents for the effects of inflation on the project. At least once every year AAFs are published specific to the Standard Metropolitan Statistical Area where the project is located. The AAFs as sole determinant of new contract rents has been subject to controversy and is addressed in Chapter III of this document. In short, it two other factors (comparability studies and overall limitations) also influence the determination of new contract rents.

The important thing to remember about contract rents is that they represent a combined payment. That is, the tenant will pay a portion of the contract rent. The tenant's portion is based upon 30 percent of their income. The difference between 30 percent of the tenant's income and the contract rent is provided by HUD through HAP payments.

**Introduction**

This Chapter will examine the mechanisms which determine the amount of subsidy Section 8 projects receive. The primary mechanism governing the amount of project based subsidy Section 8 projects receive is the Housing Assistance Payment (HAP) contract. Court review of these contracts has resulted in what is now termed the excess accumulation of project reserves. Although the decisions reached by the reviewing courts of these cases have not unanimously ruled in favor of letting excess reserves accumulate, a consensus of decisions has, in effect, established this policy.

This Chapter shall first review the cases which, through their interpretation of HAP contracts, have allowed excess reserves to accumulate. A review of the cases which have determined that sections of the HAP contract, and §801 of the HUD Reform Act of 1988, provide HUD with the authority to adjust Annual Adjustment Factors (AAFs) and resulting contract rents downwards shall follow.

In reviewing both sets of cases it is important to consider that the consensus in favor of allowing the "excess reserves" to accumulate has not resulted in the resolution of the conflict between HFAs, HUD and the project owners. Instead, this policy has merely shifted the dispute to a different issue -- determining who owns these excess reserve funds and how they should be disposed of accordingly. This issue shall be examined in Chapter IV.

**Contract Rents**

The owner receives the contract rent in two parts. The contract rent is the sum of construction costs, financing, and maintenance and operating budgets.[1] These maintenance and operating budgets are also commonly referred to as replacement and operating reserves, respectively. The tenant pays an amount equal to 30% of their income. The difference between this and the contract rent is paid to the owner by the federal government under the HAP contract. The contract rent is supposed to be comparable to fair market rent (FMR) for the area. HUD annually establishes what it considers to be FMRs for regions throughout the country.[2]

A substantial portion of the contract rent is virtually guaranteed to owners of Section 8 housing. If a unit is vacant HUD will pay 80% of rent for 60 days. Thereafter HUD pays the equivalent of the debt service for up to twelve months.

**Adjustment of Contract Rent Subsidies**

There are three mechanisms for adjusting the amount of subsidies projects can receive; AAFs, comparability studies, and overall limitations. As assumptions about the economic climate that these projects were constructed in changed, state housing agencies and developers have arrived at conflicting interpretations regarding which mechanism, if any, has precedence over the others for determining contract rent levels. Since the inception of Section 8 the procedure for using AAFs to adjust the amount of subsidy has been

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[1]This actually produces a range, the upper limits of which are usually formalized as Contract Rent in the HAP contract. CFR §1437f(c)(3)

[2]Daye, Charles E., et. al. Housing and Community Development: Cases and Materials, Carolina Academic Press (Durham, North Carolina: 1989) p. 145.

explicitly discussed in the statutes and reiterated almost verbatim in the various HAP contracts. The overall limitations mechanism has been also been is explicitly provided for in statute, and is also a typical HAP contract feature. The third mechanism, comparability studies, was redefined by the HUD Reform Act of 1988 to clarify the relationship between the first two mechanisms. It is important to note that, although the rate of increase in contract rent subsidies may diminish, they will never decline beyond their initial level. The following language, taken from an actual HAP contract, is typical HAP contract language.

> Contract Rents may be adjusted upwards or downward, as may be appropriate; however, in no case shall the adjusted Contract Rents be less than the Contract Rents on the effective date of the Contract.[3]

In 1989, Section 8 was amended to change this floor on Contract Rent levels. Recognizing that inflation factors built into the AAFs were never needed Congress attempted to recapture the payments that had resulted in the accumulation of excess reserves. §1437f mandated a new formula for HAP contract payments since 1980. The AAF was to be multiplied by the amount of the contract rent minus the amount of debt service for a project. Essentially the AAF would not apply to the more predictable part of the contract rent, debt service, which can be determined with a high degree of certainty from the very beginning of a project. The assumption operating here was that AAFs will only increase to compensate project owners for factors beyond their control. This will be important to remember when examining Clay Tower Apartments v. Kemp.

[3] Rainier View Associates v. United States, 848 F.2d 988 (1988).

**Fair Market Rents**

Each year HUD establishes Fair Market Rents (FMRs) for 344 geographical regions throughout the nation. As the term implies, FMRs represent an estimate of what prospective tenants in the unassisted housing market would need to pay for various size apartments. The estimate is arrived at by surveying at least 12 recently constructed projects with similar amenities in the market area. FMRs are generated by holding the 75th percentile of the rent levels and trending it for the last two years. Once FMRs are determined they are used to establish the original contract rent for the projects. HUD may establish the original contract rents lower than the FMR if rents of comparable units are lower than the FMR figure. This would be possible in rental values had suddenly declined.

**AAFs**

The contract rents can be adjusted by the use of automatic annual adjustment factors (AAFs). The need to adjust contract rent levels upwards for inflation is the rationale for AAFs. The AAF is a multiplier consisting of a variety of cost of living factors which is applied to the previous contract rent. These factors are specific to the Standard Metropolitan Statistical Area where the project is located. The process of calculating AAFs must be done at least annually, and can be done more frequently if market conditions warrant. In 1989, Congress attempted to retroactively limit AAFs on certain projects. These were projects which had benefited from inflationary expectations in circa late 1970s AAFs during the recession of the early 1980s.[4]

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[4]HAP contracts of the early 1980s attempted to limit these inflationary assumptions.

**Comparability Studies**

Comparability studies, or market surveys, although allowed from the inception of Section 8, were not used until 1981.

> If the Secretary of appropriate state agency does not complete and submit to the project owner a comparability study not later that 60 days before the anniversary date of the assistance contract under this section, the automatic annual adjustment factor shall be applied.[5]

What the exact relationship of comparability studies to AAFs was, and continues to be, is uncertain. It is a source of controversy in the interpretation of these contracts. Are the two mutually exclusive? Or are they to be used together in sequence?

To slavishly adhere to the AAFs without considering comparability methods has created the disputed excess reserves. In 1989, Congress attempted to rectify this by enacting legislation which explicitly stated that comparability studies were mandated in situations where the application of AAFs would result in material differences.

**Overall Limitations**

Supported in statute by §1437f(c)(2)(C), this concept recognizes that the use of AAFs shall not result in "material differences" in the rents charged to assisted and unassisted rental units in the same market. As a result of the lack of clarity regarding exactly how "overall" the term overall should be construed to be, comparability studies were explicitly provided for in 1989 amendments to Section 8.

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[5]CFR §1437f(c)(2)(c)

**Overfunding**

AAF were originally designed to provide a high degree of subsidy to the owners of Section 8 projects. "...HUD provided enough subsidy money per unit so that *even if every resident paid zero dollars in rent* that there would be enough to pay for operating, vacancy, debt service and a return on investment."[6] The difference between zero and the amount tenants actually paid in rent would be deposited in separate accounts for each project to fund future annual adjustments. This is referred to as the self funding of annual adjustment increases.[7] These increases have, however, exceeded the amount actually needed to sustain maintenance to the projects and have resulted in the accumulation of excess reserves.

**Government Efforts to Limit Funding**

Rainier View Associates V. United States

The first case to address the issue of limiting the funding of Section 8 reserves was Rainier View Associates V. United States 848 F.2d 988. (1988) This Ninth Circuit Court of Appeals decision was reached in June of 1988 and is considered the definitive decision on this matter.

This case gave the first interpretation of the relationship between the three mechanisms for adjusting contract rents; AAFs, market surveys, and overall limitations. The plaintiff, Rainier View Associates, was appealing a United States District Court decision from the Western District of Washington. The plaintiffs sought declaratory relief from the method that HUD used to adjust their contract rent payments. In reversing the lower court decision in favor

[6]The Kerry Company and Achtenberg, p. 12. (*emphasis* added, )

[7]Ibid.

of the defendant, HUD, the Ninth Circuit Court of Appeals reviewed the applicable statutes and as well as the provisions of the HAP between Bremerton, Washington (the local finance agency) and the Rainier View Associates.

In the third year of a 30 year HAP contract, which became effective in 1980, Bremerton changed the method by which Rainier View received contract rent adjustments. Until this time Bremerton had issued Rainier View contract rent adjustments solely in accordance with the AAFs published in the Federal Register. In 1983, however, Bremerton insisted that Rainier View conduct a market study in the area of the project to justify any increases in contract rents. Rainier View sought declaratory relief. The district court held that "...the HAP contract unambiguously permits HUD...to withhold the annual rent adjustment...when such an adjustment would violate the overall limitations provisions..."[8]

The Ninth District Circuit Court of Appeals heard the case de novo and reversed the lower court's decision.[9] The Appeals Court held to Rainier View's contention that the following statute, §1437f(c)(2)(A), listed two mutually exclusive means of adjustment.

> The assistance contract shall provide for adjustment annually or more frequently in the maximum monthly rents for units covered by the contract to reflect changes in the fair market rental established in the housing area for similar types and sizes of

[8] Rainier View Associates v. United States 848 F.2d 988. (1988)

[9] Typically an appeals court review only the manner in which the law was applied to a set of facts by a lower court. When a court considers a case de novo it has the facts presented to it as well and essentially hears the case new, from scratch.

> dwelling units or, if the Secretary determines, on the basis of a reasonable formula.[10]

The Appeals Court held that when HUD committed itself to the method in the first clause of the above paragraph, this was an exclusive election, and HUD could not switch to a different method. The HAP contract between Bremerton and Rainier View listed only the "reasonable formula", or AAF method. It did, however, also contain an Overall Limitations section, designed to ensure that the price of subsidized units would be comparable to the price of market units. The overall limitations section from the Rainier View HAP contract follows:

> d. *Overall Limitation.* Notwithstanding any other provisions of this Contract, adjustments as provided in this Section shall not result in material differences between the rents charged for assisted and comparable unassisted units, as determined by the Government; provided that this limitation shall not be construed to prohibit differences in rents between assisted and unassisted units to the extent that such differences may have existed with respect to the initial Contract Rents.[11]

In other words, the only time a disparity between assisted and unassisted units would be permissible is when the disparity was established from the beginning of the contract. Presumably this would be a disparity which would favor the assisted units, and serve as further incentive to the developer. The court held to Rainier View's view that the overall limitation applied only to the chosen method, AAFs. The Overall Limitation section did not provide HUD with the latitude to switch methods or even use more than one

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[10]CFR §1437F(c)(2)(A).

[11]Rainier View Associates v. United States 848 F.2d 988. (1988)

method. In other words, "...the clause may *not* be construed as providing HUD with an independent basis for refusing to apply the published AAFs."[12]

The court held that "...HUD could choose either a market survey method described in the first clause of Section 8(c)(2)(A) *or* a formula method (described in the second clause of Section 8(c)(2)(A)."[13] The court found that neither the statute nor the contract permit HUD to abandon the AAF method entirely in favor of market surveys, although if HUD were to adjust the AAFs in light of market conditions this would be acceptable. In the words of the Court:

> HUD misconstrues the role of the overall limitation. The overall limitation provision in section 1.9d, consistent with it statutory analog, Section 8(c)(2)(C), is clearly a limitation on the calculation of the formula used to adjust rents, not an independent basis for making annual rent adjustments. Under the statute, HUD could either choose a market survey method described in the first clause of Section 8(c)(2)(A) *or* a formula method (described in the second clause of Section 8(c)(2)A)). n the contract HUD elected the formula method. Having made its choice, HUD cannot now change its mind. The overall limitation provision of the statute and the contract permit HUD to adjust the formula factors in light of market conditions, but it does not permit HUD to abandon entirely the formula method it chose and to adjust rents solely on the basis of a market survey. HUD's interpretation of the overall limitation provision would render the formula method authorized by the statute and elected in the contract a nullity. It would make all rent adjustments depend on the market survey method.[14]

The court pointed to the following section as evidence that HUD possess the mechanism to satisfactorily adjust AAFs rather than discontinuing their use altogether.

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[12] Ibid.
[13] Ibid.
[14] Ibid.

> if the application of AAFs results in rents that are substantially lower than rents charged for comparable units not receiving assistance..., in the area for which the factor was published or a portion thereof, and it is shown to HUD that the costs of operating comparable rental housing have increased at a substantially greater rate than the Adjustment Factors, the HUD Field Office will consider establishing separate or revised Automatic Annual Adjustment Factors for that particular area."[15]

The above paragraph, however, only concerns upward adjustments. One wonders how the court would have reacted to HUD basing a reduction in contract rents upon the above section. It is difficult enough to believe that the court considers the above paragraph a limitation upon Overall Limitation wording.

In summary, the court held that the overall limitations provision of the contract only limits the results of methods and does not allow HUD to switch from one method to another or use more than one method. Furthermore, the court found that HUD had elected to use the AAF method to the exclusion of market surveys.[16]

### *Alpine Ridge Group V. Kemp*

In response to the possibility that HUD would not be able to limit excessive payments to owners of Section 8 housing Congress enacted, as part of the HUD Reform Act of 1989, new mechanisms for determining both past rent adjustments and future rent adjustments. Alpine Ridge Group v. Kemp challenged that legislation in the Ninth Circuit Court of Appeals. This case was actually consolidated from two cases for the purposes of review by the

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[15] 24 CFR §888.204 1987

[16] Rainier View Associates v. United States 848 F.2d 988. 1988

Court. The plaintiffs (owners) argued that their rights to due process were violated by the retroactive provisions of the HUD Reform Act which compromised their vested contractual rights.

In its decision the Court reaffirmed the basic principles behind the Rainier View decision. Despite the fact that the disputed issues have been generated by both contract and statute, the court held that the matter is a contractual one. The Court stated that to do otherwise would require the Court to relinquish jurisdiction.[17] HUD argued that the Constitution provides that the government does not have "to adhere to a contract that surrenders an essential attribute of its sovereignty."[18] The Court found that this did not apply to Alpine Ridge because although the contracts were effected by legislation, they were also effected by "independent consideration" and therefore should be considered vested.[19] This reasoning seems suspect. It ignores the fact that the Section 8 program, like most government programs, was fairly standardized, and that in all likelihood only the details of HAP contract were bargained over. Nevertheless, the Court found that the rights gained by the developers were not gratuitous, they were bargained for, and thus could not be lost through curative legislation.[20]

*Was Due Process Violated by the HUD Reform Act?*

The Court answers this question in the affirmative. "Congress does not have the power to repudiate its own debts ... simply in order to save money." "Through Section 801 (HUD Reform Act) Congress has attempted to change

[17] Alpine Ridge Group v. Kemp, 955 F.2d 1382 (1992)
[18] Ibid.
[19] Ibid.
[20] Ibid.

Section 8's meaning retroactively, 14 years after its enactment."[21] The Court wonders how Congress has the authority to legislate a compromise involving vested property rights, ignoring the fact Congressional legislation directly created the Section 8 program and indirectly created the HAP contracts.

**Cases Ruling in Favor of Limiting Funding**

Sheridan Square Partnership v. United States

In examining the procedure for Section 8 rental adjustments Sheridan Square Partnership v. United States, 761 F.SUPP 738 (1991) departed from the interpretations offered by Rainier View Associates v. HUD and Alpine Ridge v. Kemp. During the first four years of Sheridan's project life rent adjustments were based on AAFs. In 1984, Sheridan applied for a rent increase. Instead of using published AAFs to adjust the contract rent, HUD conducted a market survey of comparable unassisted units.[22] The information yielded by this survey resulted in a downward adjustment of the contract rents Sheridan received. Consequently, Sheridan brought suit seeking the following six forms of relief:

- Declaratory judgment that HUD may not abandon the AAF factors.[23]
- Injunctive relief to prevent HUD from withholding rent due Sheridan under the AAF formula.[24]
- Mandamus relief ordering HUD to reinstate rent calculated under the formula.[25]

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[21] Ibid.

[22] This is in contrast to the facts of Rainier View. In that case the finance agency authority required the project owner to conduct the comparability study.

[23] Declaratory judgment: When a party asks a court to declare a law unenforceable.

[24] Injunctive relief: When a party asks a court to get another party to stop doing something.

[25] Mandamus relief: When a party asks a court to force another party to do something, the converse of injunctive relief.

- Sheridan claims HUD violated the Freedom of Information Act.
- Sheridan argues that HUD violated the Administrative Procedures Act. because of defects in HUD's notice and rule making procedure.
- Finally, Sheridan claims its Fifth Amendment right to due process was violated and that the HUD Reform Act is unconstitutional.[26]

Because Sheridan only briefed the first and sixth claims these were the only ones considered by the Court. The Court found that two issues were presented for it to review: does Sheridan have a right to AAF formula rent adjustments. and does the 1989 HUD Reform Act interfere with Sheridan's rights as a Section 8 landlord?[27]

In issuing its ruling the Court openly acknowledged that it was departing from the Ninth Circuit of Appeals Rainier View. The Court identified the ongoing conflict between AAFs (the Sheridan perspective) and comparability studies (the HD perspective). The Court found that both methods could be used -- that they were independent.[28] Why should rents in assisted housing increase if those in the surrounding market were not? This had been the effect of exclusively using AAFs. This Court reviewed the same statues reviewed in the cases discussed earlier and came to quite a different conclusion -- that there was no right to have contract rents based solely upon AAFs.[29]

The Court then reviewed the HAP contract to determine if HUD, through the HAP, had conceded rights in addition to the ones provided by statute. This

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[26]Sheridan Square Partnership v. United States, 761 F.SUPP 740 (1991)
[27]Ibid.
[28]Ibid.
[29]Ibid.

Court decided that this had not happened. The Court reviewed the same sections of the Sheridan HAP contract which are identical to the Rainier View HAP and came to a different conclusion regarding AAFs and Overall Limitations. Contrary to the Rainier Court, this Court found that the Overall Limitations paragraph is indeed "...meant to trump conflicting provisions..." The Court further found that the comparability limitation section of the contract "...belies the contention that HUD made an exclusive election to follow the AAF regardless of the results."[30] Furthermore the Court found that the AAF is to be considered a first step in the contract rent calculation process.

In addition, employing a refreshing variety of judicial criteria, the Court rejected the argument of Sheridan because it found that it made little practical sense. The Court maintained that without endless refinement of the AAFs they could never be completely accurate. Consequently, comparability studies are a necessary check "...to insure that Section 8 rents do not exceed rents in comparable, unassisted units."[31] Although it has been obscured by previous decisions this is after all the heart of the issue which the courts should consider. Furthermore, the Court suggested that it may be a matter of semantics whether one chooses to adjust AAFs by market data, or whether HUD modifies an existing formula to reflect accurately the value of an individual project."[32]

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[30] Ibid.
[31] Ibid.
[32] Ibid.

With regard to the question of due process, the Court held that it cannot be established that Sheridan has a property right to be violated. What is their property right asks the Court, "above-market rent"?[33]

In view of the HUD Reform Act Amendment, the Court held that there is no longer any doubt about the intention of the Section 8 statutes. The court holds that:

> Subsequent legislation which declares the intent of an earlier law is not, of course, conclusive in determining what the previous Congress meant. But the later law is entitled to weight when it comes to the problem of construction.[34]

After determining that HUD had not elected to solely use AAFs in determining contract rents and that the due process rights of the owners had not been violated, the court continued its decision to give a general policy assessment of the HUD Reform Act. The Court admits that the HUD Reform Act is an attempt to resolve a controversy between HUD and landlords.[35] The Court professes its disagreement with the Alpine Ridge v. Kemp decision which stated that Congress has no place legislating agreements of this type. As a taxpayer, it may difficult to disagree. Legislating a resolution is clearly the most cost effective way of reaching a solution. And in all probability, the legislation was probably only proposed after consultation and negotiation with representative of all the parties involved. The Court felt that the HUD Reform Act has provided a fair, if not generous, method of providing owners with rent adjustments. The Court reviews the "exclusive method" established by the HUD Reform Act for determining rent disputes and finds that it is fair as well as more generous than the effects of a comparability

[33] Ibid.
[34] Ibid.
[35] Ibid.

Before the HAP contract was signed, or construction of Clay Towers completed, the issue of what would happen to the contract rent levels at Clay Towers when the tax abatement expired was raised with HUD. In 1978, HUD responded to OHA's inquiries with the following statement:

> Your staff expressed concern to HUD regarding what will happen to the rents when (Clay Towers) is placed on the tax rolls after the 10 year tax abatement period runs out.
>
> All we have at this time are the instructions in the Federal Register dated April 15, 1975, which is Appendix 5 of the Section 8 Housing Assistance Payments Program Housing Finance and Development Agencies Processing Handbook, 7420.4. See paragraph number 883.207, Rent Adjustment, (c) and (d). They are as follows:
>
> (c) Special Additional Adjustments. Special additional adjustments may be granted, when approved by HUD, to reflect increases in the actual and necessary expenses of owning and maintaining the Contract units which have resulted from substantial general increases in real property taxes ... but only if and to the extent that the owner or the HFA clearly demonstrates that such general increases have caused increases in the Owner's operating costs which are not adequately compensated for by automatic annual adjustment factors. The Owner or the HFA shall submit to HUD financial statements which clearly support the increase.
>
> (d) Overall Limitation. Notwithstanding any other provisions of this Part, adjustments as provided in this section shall not result in material differences between the rents charged for assisted and comparable unassisted units, as determined by the HFA (and approved by HUD, in the case of adjustments under paragraph (c) of this section).
>
> We trust that this is sufficient to answer your concerns.[38]

The letter is interesting because HUD refrains from explicitly answering yes or no to the possible increase. Instead, HUD points to sections which are less

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[38] Clay Towers Apartments V. Kemp, 757 F.Supp 1145. (1991)

than unambiguous. It seems to be more of a safe bureaucratic answer than something which can be counted on.

Nevertheless, in 1990, when the Clay Towers property tax exemption expired the owner sought a contract rent adjustment to reflect the additional property taxes. The property value had a resultant increase from $600,000 to $9,343,800, and Clay Towers had an additional $313,062.15 in property taxes to add to its yearly budget. Consequently, Clay Towers sought a contract increase from HUD.

As with Rainier View v. HUD there was a means for adjustment listed in the HAP contract. The language of §1437f(c)(2)(A) was repeated virtually verbatim in the HAP contract. (This language is listed on page 7 above.) The justification that Clay Towers relied on, however, was similar to the wording of 24 CFR 883.207 (c) 1987 listed above in the letter from HUD to the OHA. The contract language read as follows:

> The contract shall further provide for the Secretary to make additional adjustments in the maximum monthly rent for units under contract to the extent he determines such adjustments are necessary to reflect increases in the actual and necessary expenses of owning and maintaining the units which have resulted from substantial general increases in real property taxes ... which are not adequately compensated for by the adjustment in the maximum monthly rent authorized by subparagraph(A).[39]

When this request was presented to HUD by OHA on behalf of Clay Towers, HUD responded rather unsympathetically. HUD responded that they did not consider the expiration of the property tax abatement to be a "general increase

[39]Ibid.

in real property taxes." It appears that in this context HUD understands "general" to be regular. HUD also tells OHA that the OHA should have made the decision without consulting HUD, and that it is in fact their responsibility under the Annual Contributions Contract. The best advice HUD offers is to check and see if the abatement is built into the financing of the project so that when the abatement expired debt service would be scaled back to prevent ballooning payments for Clay Towers' budget.

In its decision the court held that imprudent planning on the part of Clay Towers does compel HUD to award a rent increase. The court said "...Clay Towers made no provision for an entirely foreseeable day..."[40] Indeed, the court held that Clay Towers had a history of receiving truly general rent increases and that their excess annual adjustment reserves should have been earmarked for the expiration of the tax abatement.

The problem with this case is the letter from HUD to OHA from 1978. It seems to be the strongest support for Clay Towers argument that they are entitled to a rent increase. This the court dismisses as sympathetic but not a binding commitment.[41]

**National Leased Housing Association v. United States**

Historically the second case to address the issue of overfunding Section 8 projects through excessive AAFs was National Leased Housing Association v. United States 22 Cl. Ct. 649 (1991). This case differs from other cases in this Chapter because it was reviewed in a different forum; the Claims Court. Traditionally the forum for resolving the claims of creditors against the

[40] Ibid.
[41] Ibid.

federal government, the Claims Court is an administrative court which usually renders more prosaic decisions than the one contained in the above referenced case.

In National Leased Housing Association, the plaintiffs, a group of 230 present and former owners and 58 developers, challenged the authority of HUD to revise their contract rents downward. The plaintiffs contended that HUD had violated their right is a number of ways including contractual violation of HAP contracts, violations of the Housing Act, and that by instituting comparability studies HUD had violated their rights to due process, the Administrative Procedures Act, and the Freedom of Information Act. On what they contended was a lack of jurisdiction, HUD sought a motion to dismiss. This was denied by the court.

The holding of National Leased Housing Association is important for two reasons. First, the court held that the HUD Reform Act of 1988 did not implicitly relieve the court of its jurisdiction in such matters. Secondly, this court was able to recognize the primacy of the Overall Limitations provision of the HAP contract.

**Jurisdiction**

HUD attempted to avoid Claims Court review of its policy of contract rent adjustment by raising the question of jurisdiction. HUD maintained that §801 of the HUD Reform Act of 1988 eliminated the Claims Court's Tucker Act jurisdiction over the matter.[42] The court disagreed, stating that "Congress did

[42]The Tucker Act provides that the Claims Court hear contract claims against the United States.

exhibit the type of 'unambiguous intention to withdraw the Tucker Act remedy'[43] that is necessary to preclude a Tucker Claim. Moreover, the Court stated that §801 of the HUD Reform Act of 1988 demonstrates ". . . no plain intent to preclude a Tucker Act breach of contract suit here."[44] The Court maintained that §801 ". . . merely establishes an arithmetic formula for calculating rent adjustments that certain property owners with HAP contracts should receive."[45] The Court went on to state that the intent of Congress was to limit the amount of damages by imposing a ceiling on the amount of damages which could be awarded under a Tucker Act claim. Whether or not a party qualified for damage amounts, and in what amount (as long as it was under the ceiling) was for the Claims Court to decide. Or as the Court stated, "Congress intended to affect the remedy available. But there is no plain indication in §801 that Congress also intended to effect the forum in which that remedy could be sought."[46]

**Contract Rent Adjustment**

Although HUD lost on the issue of jurisdiction, once the Court ruled that it had jurisdiction to review the case, the Court proceeded to rule in HUD's favor on the issue of contract rent adjustment.

The plaintiffs maintained that HUD transgressed their rights when it implemented comparability studies and used the results of these studies to revise the contract rent levels project owners received. The plaintiffs maintained that the problem with this process was that it bypassed the

[43] Ruckelshaus v. Monsanto Co. 467 U.S. 986, 1019 104 S. Ct. 2862, 2881, 81 L.Ed. 2d 815 (1984)
[44] National Leased Housing Association v. United States, 22 Cl. Ct. 655 (1991)
[45] Ibid.
[46] Ibid.

adjustment of AAFs. The plaintiffs maintained that when HUD instituted the comparability studies it should have used whatever information it gained to first revise the AAFs and then adjust contract rent levels. By failing to take this intermediate step, and leaving the published AAFs unadjusted from comparability study information, HUD had abridged the rights of the developers and owners involved.

Apparently and understandably confident in its ability to interpret a contract the Claims Court acknowledged and then departed from the decision of Rainier View. The Court outlined the process which HUD uses to adjust contract rents by reviewing what it termed the "three relevant procedures," Fair Market Rents, AAFs, and comparability studies.[47] In outlining the relationship between these terms and the Contract referred to the Overall Limitations section of the HAP contract. It read as follows:

> d. *Overall Limitation*. Notwithstanding any other provisions of this Contract, adjustments as provided in this Section shall not result in material differences between the rents charged for assisted and comparable unassisted units, as determined by the Government; provided that this limitation shall not be construed to prohibit differences in rents between assisted and unassisted units to the extent that such differences may have existed with respect to the initial Contract Rents.[48]

The Court placed special emphasis on the primacy of this section in coordinating the "three relevant procedures."

> The title "Overall Limitation" and the phrase "not withstanding any other provisions of this Contract"

[47] Ibid. For a brief discussion of these concepts, please refer to the beginning of this Chapter.
[48] Ibid.

> indicate very precisely that the limitation in paragraph 1.9d is paramount; that it overrides any other provision of the contract, including the paragraphs 1.9b and 1.9c, that otherwise would result in a rent adjustment that would produce a material difference from rents charged for comparable unassisted units. Hence, the "Overall Limitation" would appear to preclude HUD's use of the most recently published AAFs in setting the rent adjustments when the amount of such adjustments of would result in such material differences.[49]

The Court held several other things in relation to the HAP contracts including the following:

- That the Overall Limitation section of the contract implicitly stated that HUD would have to conduct some type of market study to ensure that a material difference did not exist between unassisted and assisted units.

- That nothing in the HAP contract language limited HUD to a particular methodology in adjusting contract rent levels.

- And that ". . . nothing in the contract obliged HUD to translate the results of a comparability study into modified AAFs and then to set the amount of rent increases based on such AAFs."[50]

The Claims Court critiqued the Rainier View decision by pointing out that the Rainier View Court did not find any ambiguity in paragraph 1.9d, but instead relied on the wording of Section 8(c)(2) of the Housing Act (42 U.S.C. § 1437(c)(2). This does not seem to make a great deal of sense: presumably the

[49] Ibid.
[50] Ibid.

developer's lawyers would have detected any significant differences (certainly ones of the magnitude detected by the Rainier View decision) between statute and contract. Also, in general, the notion of moving from the specific to the general seems to be an illogical method of analysis, legal or otherwise, but especially legal. Check this against the logic of the Alpine Ridge decision with regard to Congress' power to legislate contract resolution.

The National Leased Housing also took a dim view of the Rainier Court's attempts to regulate the methodologies HUD employed to run itself as an agency. As the National Leased Housing court stated, "Absent clearer indications of congressional intent, this court will not impute to Congress the intent to restrict HUD's options so as to oblige HUD to take a less efficient route to reach essentially the same end result."[51] Furthermore, the Claims Court took umbrage with what it perceived as the issue of interfering with an agency's discretionary role in respectfully implementing a statute.

**Conclusion**

The Sheridan decision seems to be the only one which is informed by and considers the policy implications of its decision.[52] The Rainier and Alpine decisions are virtually silent on what the Section 8 program is trying accomplish. But as the Sheridan decision stated, "Section 8 was designed to provide a vital product to residents and a reasonable return to the developers."[53] As to the idea that the Court's action may deter the private development of affordable housing, the Court states that, "If Section 8

[51] Ibid.
[52] The Clay Towers decision also seems reasonable. But this is in large part due to the unreasonable expectations of the owner.
[53] Sheridan Square Partnership v. United States, 761 F.SUPP 738 (1991)

landlords entered into HAP contracts with the government to secure above market rent and insulation from market forces, my decision would deter these landlords."[54] This Court feels that given the guaranteed income stream, low interest financing, and various tax advantages, that these projects receive, it is insulting for them to try to manipulate HAP contract language into a demand for above market rents. By affirming the strength of the Overall Limitations provision of Sheridan's HAP contract, the Court disallows the exclusive use of AAFs and the material differences they would produce between assisted and unassisted units.

Unfortunately, not all the Courts to review HAP contract disputes have displayed the respect for the policy issues that these types of cases raise. More importantly, a higher court (Ninth Circuit Court of Appeals) has twice reached decisions contrary to the one reached in Sheridan, one before and one after Sheridan. This has had an unfortunate effect. It has shifted the debate of the issues raised in these cases to a new arena. Instead of debating how much money should go into project reserves via contract rents, the debate has become one of who owns the excess reserves produced by exclusive use of AAFs. This has spawned a new series of litigation including, which is still in its formative stage. Already State Finance Agencies are echoing the actions of HUD on the earlier round -- they are attempting to negotiate and legislate compromise solutions. These efforts are, however, destined to be challenged in a new round of court cases. Hopefully next time the courts will respond in a more affirmative fashion to the policy issues involved.

[54] Ibid.

**Introduction**

In Chapter III the litigation which determined the proper amount of Section 8 subsidy in HAP Contracts was reviewed. In Alpine Ridge it was determined that once HUD had based payments upon the use of AAFs it could not change to a method based upon comparability studies. The larger payments that resulted from such a decision helped create larger than normal reserve funds in Section 8 projects and brought the issue of prepayment to prominence.

Once it was determined that HAP contracts were committed to the higher AAF driven payments the question for the Section 8 projects became, "who owns or controls these funds?" Regulatory agreements between the state housing finance agencies and the limited partnerships controlled the amount of profits to which the partnerships were entitled while active. Upon dissolution there was a possibility that limited partnerships may be able to disburse these reserve funds to their partners. While active the partnerships are responsible for paying taxes on these reserve funds because the Internal Revenue Service (IRS) considers them to be income. This is despite the fact the limited partners do not have access to them. Thus the funds are referred as "phantom income."

The cases to be examined in this chapter chronicle the second front of legal wrangling related to the AAF controversy. Briefly, once the projects in question were going to be funded through the use of AAFs or, as some might contend, overfunded, who would have control over these funds during the operation of the project and afterwards?

**Wisconsin Housing and Economic Development Authority v. Bayshore**

This case is actually two cases consolidated into one by the State of Wisconsin Dodge County Circuit Court.[1] The documentation referred to here is a transcript of the proceedings. In this case the Wisconsin Housing and Economic Development Authority (WHEDA) brought suit against two Wisconsin limited partnerships: Bayshore Apartments; and Flagship over the disposition of excess reserve funds in their respective projects. Note that these excess reserve funds would not existed to such a large degree if not for the continued reliance on AAFs for determining the amount of subsidy that Section 8 projects were to receive.

In the oral opinion for this case, which ended in summary judgment for the plaintiff, WHEDA, the court examined the various legal instruments governing the operation of the project and first described the hierarchy of documents governing the operation of the project.[2] The hierarchy, listed in descending order, was described as follows:

- statute
- mortgage and note
- regulatory agreement
- partnership agreement

At dispute in this case was the ownership or, more generally, the control of the respective project's reserve funds. Reserve funds are basically a rainy day account for the operations of projects. If unanticipated events such as a decline in the rental market, capital

[1] Both partnerships had the same general partner.

[2] A court may grant summary judgment of a case when the facts of the case are not in dispute. The court merely decides the effect of law upon an accepted set of facts.

repairs, or other unforeseen circumstances threaten the financial viability of the project the reserves funds would provide monies to address these problems without the partnership immediately returning to the lender for additional funds, or seeking additional capital contributions from the partners.

The decision in Wisconsin Housing and Economic Development Authority v. Bayshore begins by referring to the Wisconsin statute which requires and regulates the operating of reserve funds in the projects. The court begins its analysis of the statute by stating that it could be one of two things. One, as the defendants contended, it could be a security mechanism required by the lender to ensure that the project will remain financial viable over a long term period. Or as the Wisconsin Housing and Economic Development Authority (WHEDA) maintained, it could be a mechanism for limiting profit. The court referred to the title of the statute itself "Limited-profit entity; distributions," in trying to infer the intent of the legislation when it created the statue.

The court characterized the case as primarily turning on one sentence in the statute. "Upon the dissolution of the limited-profit entity any surplus in excess of distributions allowed by this section shall be paid to the authority."[3] In other words, after the limited partners receive their share of the excess reserves, as defied by the statute, the remainder of the reserves would go to the WHEDA. At the heart of this one sentence is the word dissolution. The two sides in the case offered

[3]Wisconsin Chapter 234.07.

competing versions of what this word actually means in the context of the sentence. The court interprets this word to mean dissolution of the limited-profit entity. This interpretation ties dissolution to the limited partnership itself. This is in contrast to the defendant's contention that dissolution can refer to an element of the financing, specifically the WHEDA held mortgage, which comprises a part of the limited partnership.

Indeed, since the reserves funds could only be accessed through dissolution, the partnerships were exploring the limits of the term dissolution to find out exactly what they had to do to obtain the reserves funds. One method of obtaining these funds is prepayment, or paying the mortgage off to free the developers from their contractual obligations to manage the property as affordable housing. Given the rather dramatic decline in interest rates since most of these properties were originally financed in the middle and late 1980s, refinancing of the properties could provide the funds to prepay the mortgages and distribute the reserve fund to the limited partners, providing, however, it was an allowable interpretation of the word dissolution.

The court characterized the argument of the defendants as "hyper-technical."[4] That is, that the defendants were attempting to place undue emphasis on a phrase in a document (the contract, or regulatory agreement) which was relatively low on the hierarchy of documents governing the operation of the project. In making this characterization the court referred to the statute which stated that, the partnership was

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[4] Wisconsin Housing and Economic Development Authority v. Bayshore, (1992), p.49.

limited to a six percent return on equity on a cumulative basis over the life of the contract. The court suggested that the defendants were ignoring this by asserting that they were entitled to reserves in excess of six percent at the completion of the project. The court cited the Flagship regulatory agreement which said, "Upon satisfaction of the Mortgage Note and Mortgage, the Replacement Reserve shall be disbursed, first to the mortgagor to bring its cumulative return on equity to the maximum permitted by the Act and second to WHEDA."[5]

Perhaps, most importantly, in its decision, the court acknowledged that these projects are a different type of project, ones that would not exist without federal and state financial assistance. Consequently, it somewhat inappropriate to view them as a normal commercial, or market, transaction between a private bank and a partnership.

> The court agrees with the plaintiff that the specific type of funding set up by this chapter, and implemented through the cooperation of the state and federal government is not a typical commercial transaction, does not operate under the usual assumptions, but operates under very specific conditions determined by the legislature and by the federal government; and that it doesn't help the court to suggest what would normally happen in some other so-called every-day commercial real estate transaction between a bank and a partnership developing some property, using market interest rates and market forces, in terms of determining and receiving rent and other things. Here, there's a specified relatively low interest rate provided to the developers, also government-funded rent subsidies... And in fact in these cases, about two-thirds of the rent payments the defendants have received have been paid by the government. Well the government has a right to set the conditions on that program. And it appears that the defendants voluntarily entered those relationships under those terms.[6]

[5]Ibid., (1992), p.53.
[6]Ibid., (1992), p.53.

The court basically stated that the partnership knowingly agreed to limit their profit in exchange for a government stabilized income stream and below market financing (which equates to lower risk for the partnership).

The court went on to say that the fact that economic conditions had changed in the interim does not change the intention of the legislature when they created the statute.[7] Or, as the court said, "I can't change the rules because some unforeseen things happened after the game was commenced."[8] What the court referred to is the treatment of these funds by the IRS. On that issue, which the court felt was unrelated to its decision, the court recommends that the partnership review Maryland Jockey Club, as this Chapter will, for a strategy for dealing with the IRS on this issue.

In reaching its decision the court reiterated the two questions that it saw before it and the one which it would actually rule upon.

> One was: Who was the owner of the replacement reserve funds now? And it was also stated as: Who is entitled to the reserve funds? What is the disposition of those funds properly in the determination of this relationship between the plaintiff and the defendants?... At the end of the time that the money has been handled consistent with all of these documents, then where does the money go? I think that's the real question.[9]

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[7] Legislative intent can be examined by reviewing transcripts of debate on proposed legislation. The concept is that this information is to supplant omissions in or areas of the legislation which may lack clarity.
[8] Wisconsin Housing and Economic Development Authority v. Bayshore, (1992), p.55.
[9] Ibid., (1992) p. 60.

The court refused to rule upon who owned the reserve funds and that it was irrelevant who presently did because there were a multitude of legal documents defining the management, if not the ownership, of the reserve funds in question. The court maintained that based upon the regulatory agreement, mortgage and other documents, the reserve funds in question would be paid to the partnerships at the rate specified in their regulatory agreements, six percent. The amount remaining afterwards would go to WHEDA.

In summary, the court did not accept the partnerships' contention that the funds should be available to them after the end of the partnership. "...the attempt to by the legislature to create limited-profit entities and to establish these conditions showed an interest by the legislature to place a ceiling on profits and not simply defer them to a later date."[10]

**Maryland Jockey Club of Baltimore v. U. S.**

*Background*

This is the case that the judge in Wisconsin Housing and Economic Development Authority v. Bayshore recommended to the partnerships in that case because it might provide an argument against the IRS's contention that the partnerships pay income taxes on the reserve funds. Maryland Jockey Club had a long history in the court system. Two episodes in this history will be referred to here.

The Maryland Jockey Club of Baltimore, referred to as taxpayer, owned and operated the Pimlico Race Course in Baltimore Maryland. As part

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[10]Ibid., (1992) p. 57.

of an agreement with the State of Maryland the owners of this race course and others within the state paid one half of one percent of pari-mutuel proceeds into the state administered Racing Fund. These funds were to be made available to the race track operators when they had entered into binding commitments, or contracts, to spend the funds on capital improvements to their race tracks. In essence the Racing Fund was a reserve fund. Funds were reserved on behalf of the race track in order to ensure its long term operational viability. The regulatory body (the state gaming commission) had an interest in guaranteeing that the race track was operated in a manner that ensured its long term viability. This is because if the race track failed the state would lose the benefits (tax revenue) it derived for its investment (semi-exclusive license to race track, financial assistance) and would probably have to, in some manner, subsidize a new race track owner to start a new race track, or re-open the existing one. This is fairly analogous to state housing finance agencies requiring a reserve fund so that the public benefit of affordable housing would continue to be derived from the investment of below market financing and a guaranteed income stream.

The Racing Fund was established so that any funds not expended by a race track owner within three years would revert back to the State and become part of the general fund.[11] During the late 1940s, however, events occurred which complicated the operation of the reserve fund. At this time federal government Korean war time restrictions on construction prevented the Maryland Jockey Club from entering into

[11] Maryland Jockey Club of Baltimore City v. United States, 226 F.Supp. 608 (1964), p. 2.

commitments to spend their Racing Fund monies on improvements to the track. In recognition of this extenuating circumstance the state officials administering the Racing Fund agreed with track owners that the funds would not revert to the general fund. Instead, several years worth of funds, in an amounts larger than those typical for a disbursement from the Racing Fund to the Maryland Jockey Club, were issued to the race track owners in 1950 and 1953.[12] The race track owners posted a surety bond to use the funds for improvements to the track within one year of repeal of the federal regulations prohibiting construction otherwise they would be obligated to return the unspent funds to the Racing Fund.

These larger than typical disbursements, however, were characterized by the IRS as income that should be taxed in accordance with the World War II Excess Profits Tax Act. In brief this act defined types of income which would be taxed at higher rates than normal, and defined categories of income which would be excepted from these higher rates. The rationale being that during war time the federal government would be more aggressive in its tax collection particularly with respect to those taxpayers who could afford it most - those enjoying large or excessive profits.

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[12]The disbursement in question were made over a three year period, from 1950 to 1953. A litigated resolution was not reached until 1964.

Maryland Jockey Club of Baltimore City v. United States of America, 226 F. SUPP 608 (1964)

In the above referenced case, the race track owners sought to exempt their racing fund proceeds from higher tax rates by arguing that the reserve funds did not fall into the category subject to higher rates abnormal income. The owners argued that the income had been deferred and was "...income arising out of a claim, award, judgment or decree or interest on any of the foregoing."[13] In its decision the court reasoned that the income did not truly arise out of a claim as used within the context of "claim, award, judgment or decree" because although claim alone might have a broad variety of meanings, when grouped in the phrase with the other words mentioned, claim "requires that there be a bona fide dispute on an asserted demand."[14] That is, the court believed something less resembling an existing right and more resembling a disputed or litigated claim was necessary for an exemption to be granted under the statute for the disbursement from the Racing Fund to be classified as abnormal income and not be subject to the provisions of the World War II Excess Profits Act.[15] Since there was no dispute between the race track owners and the state officials, rather there had been a negotiated agreement which was later ratified by statute, the court held that there was no basis for an abnormal income tax claim by the race track owners and denied excess profits tax relief. The Maryland Jockey Club paid excess profits tax on the fund in question and appealed in the following case.

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[13] Maryland Jockey Club of Baltimore City v. United States, 226 F.Supp. 608 (1964), p. 4.
[14] Ibid., p. 5.
[15] Ibid., p. 5.

Maryland Jockey Club of Baltimore City v. United States of America, 339 F.2D 311 (1964)

Considering this case on appeal from the previously discussed case this court defined the issue which it was considering by granting an appeal as whether or not the income in dispute arose from a claim.[16] This court found that the income in question did constitute abnormal income. Reasons given by the court included that the amount exceeded 115% of the average income for the proceeding four years and was attributable to income from a previous year, both criteria were not mentioned in the previous court's consideration of Maryland Jockey Club.[17] More importantly, the court found that within Maryland statute, disbursements to taxpayers were, by definition, claims.[18] In its opinion the court stated that "...written and express permission of the Commission..." must first be obtained before any funds are disbursed to racing track owners, "...it...(is)...not a perfunctory disbursement"[19] In its decision the lower court placed great emphasis on the fact that no Racing Funds monies had ever been held back from race track owners. Because of this the lower court felt that the race track owners did not have to make a claim to their Racing Fund monies. This was termed irrelevant on appeal. Unlike the previous court's decision which implied that litigation was required to truly constitute a claim, this court found that the term claim "...simply implies a stage or an asserted right, which may or may not later pass into arbitration or litigation."[20]

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[16]Maryland Jockey Club of Baltimore City v. United States, 339 F.2D 311, (1964), p. 2.
[17]Ibid., p. 4.
[18]Ibid., p. 4.
[19]Ibid., p. 4.
[20]Ibid., p. 4.

This court was reluctant to punish the owner for being able to amicably reach an agreement with State Racing Fund officials on its share of the Racing Fund. The court went on to state that if adversity was required for a claim then it was present in the federal regulations prohibiting construction.

**Joseph L. Stendig; Eileen M. Stendig v. U.S.**

As with the first case discussed in this chapter, Wisconsin Housing and Economic Development Authority v. Bayshore, the parties in this case were a state housing finance agency, Virginia Housing Development Authority (VHDA), and a limited partnership, Holiday Village Associates. The Stendigs presumably were general partners for Holiday Village Associates. The Stendigs sought a refund of taxes they had paid on funds held in reserve for a project they owned which was regulated by the VHDA. At issue in this case was the question of whether receipts (funds) placed into two accounts (the replacement and operating reserves) constituted accrued income to the partnership in the years of their deposit.[21]

The Stendigs contended that the reserve funds could not be considered partnership income until the VHDA was divested of control over their disposition. This court cited National Memorial Park, Inc. v. Commissioner, as establishing a test for determining when funds held in reserve, or trust should be considered income.

If...a trust is created, and taxpayer is bound, either by statute or its agreement, to pay certain sums into a trust fund, and if such trust fund

[21]Stendig v. United States, 843 F.2D 163 (1988), p. 2.

is entirely beyond its control, and if the principal and income from such trust can not inure to the benefit of the plaintiff, then the sums paid into the trust are not considered to the benefit of the plaintiff, then the sums paid into the trust are not considered as part of the plaintiff's income.[22]

In a lower court ruling the Stendigs failed to show that the reserve account would not inure to their benefit.[23] Therefore, regardless when they received it they would be responsible for paying taxes on those funds. Or, in the words of the 4th Circuit, "a normal result of the accrual basis of accounting and reporting is that taxes frequently must be paid on accrued funds before receipt of the cash with which to pay them."[24]

In this appeal to the 4th Circuit the Stendigs argued that it was in the power of the VHDA to unilaterally elect to spend the reserve funds. The 4th Circuit characterized this possibility as remote and defined the principal tax question before them as "...whether in the tax years at issue the partnership acquired the "fixed right to receive the [funds deposited in the] reserves."[25] Citing the Supreme Court decision of Commissioner v. Hansen the court used a three part description to determine if the reserve funds should be considered taxable income for this case. The first part was described as "...the right to receive accrual basis income, not its actual receipt, that determines the time of its

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[22]National Memorial Park, Inc. v. Commissioner, 145 F.2D 1008 (1944)
[23]Stendig v. United States, 669 F.Supp 138
[24]Stendig v. United States, 843 F.2D 163 (1988), p. 4.
[25]Ibid., p. 4.

inclusion as gross income." The second part was described as "When the right to receive an amount becomes fixed, the right accrues." The court stated that the Stendigs received a fixed right to receive the funds in the reserve accounts in the years of their deposit. The third part was described as a right to receive income is "fixed if there is a reasonable expectation of receiving it."...the right to receive an amount becomes fixed"[26] In deciding against the Stendigs the court found all three conditions to be satisfied.

The court noted that the Stendigs received: more than $3 million in low interest, long term loans for the construction of their project; operating subsidies for the low-income portion of their tenant population; double depreciation benefits and accelerated deduction of the costs of financing (interest); and deductions for surplus loss that they have used against income from sources other than this partnership. As such the court implied that the Stendig's requests for other benefits, to which they were not entitled, were unreasonable.

The reserves account exists to ensure the rentability of the apartments ,which in turn ensures they will produce income, which in turn ensures that they will have value should the note be defaulted upon. Given that the mortgage is a nonrecourse loan it is important to the VHDA that the reserve function as a loan guarantee or security mechanism because that individual piece of property is the only collateral that the VHDA has with the partnership.

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[26] Commissioner v. Hansen, 446, 464, 79 S.Ct. 1270, 1280, 3 L.Ed.2d 1360 (1959)

Or, as the 4th Circuit Court stated, the VHDA's temporary control over the disposition of the funds is but a consequence of the Stendig's voluntary election to obtain the financial advantages that low income housing investments such as these provide.[27] The operating reserves in question were largely comprised of these and market rate rental payments which the Stendigs always expected to receive. Given that they always expected to and most likely will receive them it is unreasonable to not classify these funds as income despite the fact that the Stendigs have not yet received them.[28]

To summarize, the court did "...not think that the remote possibility of nonbeneficial expenditures constitutes sufficient reason to exclude the entire operating reserve from the partnership's accrued taxable income."[29]

**Conclusion**

If nothing else the cases discussed in this chapter illustrate the complicated nature of resolving a dispute in privately owned affordable housing. Not only must owners deal with HUD and state housing finance agencies, they may also have to become intimately familiar with the Internal Revenue Service and the court systems in order to administer their projects.

The question of who will ultimately own the reserve funds, or the full extent of the owner's reversionary interest, is unclear from the cases

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[27] Stendig v. United States, 843 F.2D 163 (1988), p. 5.
[28] Stendig v. United States, 843 F.2D 163 (1988), p. 5.
[29] Ibid., p. 6.

examined in this chapter. Indeed, it is premature for the courts to be examining this issue, and they cannot rule on it until it is brought before them. For that to happen the dissolution of a partnership, according to any of the definitions listed in Wisconsin Housing and Economic Development Authority v. Bayshore, would first have to occur and not be resolved to the satisfaction of the one of the parties at an administrative level.

What the cases discussed in this chapter do make clear, however, is that until such time as a partnership is dissolved the documents already in place more than adequately govern the operation of the these projects, and the treatment of the reserves. Unfortunately from the partnerships' perspective it will be unclear what is the appropriate amount of taxes until after a partnership as been dissolved and the reserves have been disposed of in some manner.

The cases examined in this Chapter cannot fully address the reversionary interest, or who will receive what share of the reserve funds upon dissolution, or prepayment. Although Wisconsin Housing and Economic Development Authority v. Bayshore is fairly clear on these issues the court in this case does not actually rule on them, preferring to defer on them until if and when they become an issue in the future. Maryland Jockey Club and Stendig present different opinions of the same issue with the fact pattern, or circumstances of the case in Stendig being more analogous to the subject of this research project.

Given the lack of definitive court rulings on the issue of phantom income, as the projects in question reach their later stages when dissolution or prepayment may be available to them (and financial benefits like depreciation have largely been taken) the desire of partnerships to push the issue of prepayment will mandate that State housing finance agencies deal quickly and effectively with these issues.

## Introduction

The previous Chapters have chronicled the events leading to the prepayment controversy. These events have included: the formation of excess reserves through HAP contract overpayment; concerns over the tax liability of these reserves, particularly in relation to limited partners; and preliminary indications of who would gain control of the reserves, and under what circumstances.

This Chapter will review the State of Rhode Island's experience with prepayment. This will be accomplished by reviewing: some early prepayment transactions; regulations promulgated by the Rhode Island Housing and Mortgage Finance Corporation (RIHMFC); and recent legal proceedings between developers and RIHMFC.

The transactions, regulations, and court decision will be evaluated in terms of their importance to the formation of a public policy which is consistent with its original objectives, and able to modify or adjust its practices to achieve these objectives over time.

As a state, the Rhode Island experience with the issue of overfunding and prepayment has not been unique. In Rhode Island 46 federally subsidized affordable housing projects in the state have between $400,000 to $1 million in excess reserves in their accounts. This totals approximately $35 million dollars potentially in dispute between developers and RIHMFC.[1]

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[1] Michelle Hirsch, Providence Business News, June 28, 1993.

*General and Limited Partner Concerns*

As with projects throughout the country the owners of these projects have been motivated to sell because of the phantom income issue for the limited partners and its associated tax liability. Cash poor general partners also have been motivated to transfer or sell projects to receive cash in exchange for their management rights. General partners intent upon accessing the entire amount of the reserves would have to wait until their original mortgage term expired. After subjecting their limited partners to a full mortgage term worth of phantom income it could be possible that the ownership of the reserve funds would have been decided in the favor of RIHMFC and their patience would have been poorly spent.[2] Consequently, it may be better for owners to negotiate a prepayment or transfer now rather than wait for the long-term resolution of an uncertain legal issue.

Buyers, however, may also experience phantom income problems. This may especially be true if the amortization term of the loan is short (less interest is available for deduction) and the reduced basis a project may have if cash has been transferred to the seller at closing. That is, in addition to not yielding reserve cash (which, given the experience of the old owners, few new owners expect to receive) the tax advantages received by the new owners may not be as great as those enjoyed by the original owners. In general the new owners seem resigned to the fact that they will not receive the reserve surpluses and may be

[2]The Kerry Company and Achtenberg, p. 21.

characterizing the reserves as expenses for tax purposes.[3] It remains to be seen what kind of success thus strategy will yield.

*National Background*

As the events that were leading to prepayment developed in the late 1980s Congress provided state housing finance agencies with guidelines for resolving these matters in the form of the National Housing and Community Development Act of 1987. Providing that owners commit to maintaining affordability by limiting rent increases to maintain the same tenant income profile the state housing finance agencies were authorized to: increase the permissible rate of return on owner's investment; increase access to residual receipts or excess replacement reserves; provide additional financing for capital improvements; increase the availability of Section 8 funds; and increase rents or new tenants.[4]

*First Transactions*

RIHMFC took an ad hoc approach to dealing with the first developer's who sought prepayment by selling, or transferring, their projects. From the beginning of 1991 through mid 1992 seven transactions occurred between RIHMFC and developers seeking to gain control of their respective project's excess reserve funds. All seven of these transactions were approved for prepayment before they were eligible to elect prepayment under the terms of the their respective mortgages and

[3]Ibid., p. 21.
[4]Simons & Smith, p. 4.

regulatory agreements. That is, before the window of opportunity that typically occurs between 15 and 20 years into the mortgages.

As part of their prepayment the projects required new capital. This came from several sources. RIHMFC provided refinancing with tax exempt bonds. Amounts were determined by capitalizing the income streams for the projects, or determining what kind of debt burden the income stream of the projects could support. The financing was coterminous with the HAP contracts or longer. Excess project reserves and equity through tax credits were also used as a source of funds for these prepayment transfers. For these transfer transactions a developer's fee ranging from six to ten percent was allowed by RIHMFC.[5]

In exchange for these financial incentives given to developers RIHMFC retained permanent regulatory control over the properties, including control over property management and operations. RIHMFC also was also guaranteed that the properties would remain affordable for perpetuity.[6]

RIHMFC also stipulated that the projects must maintain an operations reserve as a contingency for when HAP contracts would expire. Projects were also required to contribute to a preservation fund. Three to five percent of each projects gross income was to be put in a preservation fund. If these funds were not needed by the project that

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[5] The Kerry Company and Achtenberg, p. 7.
[6] Ibid., p. 5.

contributed them, they then would be available to other similar projects which required additional funds at some point in their operation.

In the course of transferring ownership in these first seven transactions 75% of the newly created financing sources went to buyers and seller, five percent went to transaction costs, and the remaining 20% stayed with the projects.[7] As a result of these first transactions 70% of the aggregate reserve funds (a subset of the new financing sources) were liquidated and disbursed to sellers and buyers.[8]

In reviewing this first series of transactions that took place between owners and RIHMFC it is important to note that what took place could be referred to as rather contrived refinancing. That is in order to access the reserves, owners were compelled, by RIHMFC's initial policies, to sell the projects. The transaction costs associated with such sales did not benefit the owners, RIHMFC, or the projects. Furthermore, the buyers in these cases were only necessary as a means to access the reserves. The new owners, or developers, risked virtually nothing and had very little development work to perform. Consider,

- the Section 8 subsidy was in place;
- The equity comes from the project reserves and mortgage payoff - not from the buyer;
- RIHMFC provides the permanent financing

[7] Ibid., p. 10.
[8] Ibid., p. 10.

- the amount of rehabilitation is minimal, so there is little construction risk.[9]

In addition to being somewhat contrived transactions, the transactions were very generous in the amount of benefits they bestowed upon the project owners. It is not clear that all the benefits were necessary in order to achieve the pubic purpose goals of RIHMFC. Especially when it is considered that the benefits were derived from government build-up of project reserves. These reserves were in turn capitalized to determine a new principal amount for refinancing of the projects. RIHMFC's regulations would not allow the reserves to simply be disbursed from the projects they could be accessed through prepayment.[10] This technical inconsistency provides the motivation for and the controversy surrounding prepayment. The interests of the owners, projects, and RIHMFC would be better served if RIHMFC allowed a less extreme method than transfer of ownership for the owners to access some of the reserves. Undoubtedly there are capable and competent owners whose continued presence as owners would well serve the projects. RIHMFC should provide a less convoluted way for these owners to meet their phantom income tax liabilities and remain owners of the projects.[11]

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[9] Ibid., p. 12.
[10] Ibid., p. 11.
[11] Ibid., p. 20.

*New Regulations*

On July 6, 1993 RIHMFC promulgated regulations regarding prepayment entitled Rhode Island Housing and Mortgage Finance Corporation Regulations Governing Proposed Prepayments or Transfers. These regulations set out a specific process and set of criteria that RIHMFC would employ in evaluating an owner's request for prepayment. These regulations governed all transfers or prepayments except those that had been expressly disclosed in the original mortgage application.

The three main criteria outlined in the regulations are physical condition, financial condition, and management capacity. In regards to physical condition RIHMFC insists that the project be in adequate physical condition in order for a transfer or prepayment to take place. As such RIHMFC requires a capital needs assessment for a prospective prepayment project and that a capital improvement plan to correct any physical deficiencies be incorporated into the transfer or prepayment process.

In regards to the financial condition of the property, RIHMFC requires that all mortgage arrearages, operating deficits, or reserve delinquencies be brought up to date, and that a transfer or prepayment will not result in a "...material escalation of rents..."[12] This is perhaps the most important condition and if it is met the transfer or prepayment will be eligible for financial incentives in the form of cash from the excess reserves.

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[12]Rhode Island §92-020-011.

In regards to management capacity RIHMFC requires that the owner and/or management agent be suitably experienced with the management of multi-family housing. In addition, standard language prohibiting principals who have been suspended, disbarred, or otherwise restricted by federal or state government from participating in the projects is included in the regulations, as is less usual language prohibiting those convicted of a felony from participating in the project.

As if to prevent a shell and nut game from taking place, the regulations require that RIHMFC be notified and a new application be filed if the transferee's principals or form of legal entity change.

The application for transfer of prepayment is defined as a three stage process in the regulations. Phase I consists of a pre-applications stage in which concept of the transfer is explained in summary form to RIHMFC. During Phase II a full application is submitted by the transferee and reviewed by RIHMFC.

Phase III is the period during which preliminary approval is granted and the tasks needed to close the deal are scheduled and performed. This is the period when the specifics of project operation are established between the transferee, transferer and RIHMFC. A new regulatory agreement codifying these terms is negotiated and drafted during this period. Major points to be addressed by this document include the provisions guaranteeing that rents will not materially escalate, and that RIHMFC will continue to oversee the operations, and approve disbursements of the project. The entire process, as outlined in the regulations can take at least three to four months. A non-refundable processing fee and a transfer fee based upon a percentage of the appraised value of the project are also required of the applicant.

Parkway & Diakonia v. Godfrey (RIHMFC)

In August 1995 Parkway & Diakonia v. Godfrey was decided by Providence Superior Court. Originally two separate cases with two separate plaintiffs, Parkway Towers Associates and Diakonia Associates Limited Partnership, they were consolidated into one case for the purpose of this decision.

The plaintiffs brought suit after being informed by RIHMFC that RIHMFC's permission, in accordance with the terms of the new regulations, was first required in order to prepay their mortgages. The plaintiffs sought a judgment that the regulations were "...beyond the scope of RIHMFC's legislative authority," in particular RIHMFC's requirement that the plaintiffs sign a prepayment Regulatory Agreement as a condition of prepayment.[13]

In its decision the court referred to RIHMFC's enabling legislation. The court stated that the General Assembly vested RIHMFC with

> all powers, authority, rights, privileges, and titles to enable it to accomplish the encourage[ment] of private investment in the construction, operation, and maintenance of residential housing

[13] Parkway & Diakonia v. Godfrey, 1995.

> affordable to persons and families of low and moderate income through public financing.[14]

The court found that this was a "plain, clear, and unambiguous"[15] indication of the legislature's intent in drafting the enabling legislation. The plaintiffs argued that the legislature had only given RIHMFC the power to determine whether or not a material escalation of rents would occur if prepayment occurred.

The court cited Lower Main Street Assoc. v. New Jersey Housing and Mortgage Finance Agency 553 A.2d 798 (N.J. 1989) in its ruling as an example of a housing finance agency appropriately exercising its statutory authority. In the New Jersey case, however, the New Jersey Housing and Mortgage Finance Agency had not properly established procedures and criteria for the application process. The Providence Superior Court found that RIHMFC had adequately established procedures and criteria in its regulations.

The court also found that the plaintiffs had received numerous benefits from RIHMFC including a mortgage that covered 90% of their total development costs, and low (6.8%) financing. "In return for these benefits, (the Court found) that Plaintiffs agreed to be bound by the rules and regulations imposed by RIHMFC, which include the Prepayment Regulatory Agreement."[16]

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[14]RIGL §42-55-6(d).

[15]Parkway & Diakonia v. Godfrey, 1995.

[16]Ibid., 1995. This type of argument has been made before in Wisconsin Housing and Economic Development Authority v. Bayshore and Stendig v. United States.

The court did not agree with the plaintiff's contention that the 1988 Act grants financial incentive to developers in order to bind them affordability restrictions. Rather, the court found that the 1988 Act only provides financial incentives to developers who elect to keep affordability restrictions in place 20 years after "(a) the date it could prepay its mortgage or elect not to renew a Section assistance contract or (b) the maturity date of the mortgage note."[17]

The plaintiffs also argued that the HAP contracts would prevent the material escalation of rent. The court, however, agreed with RIHMFC that the HAP contracts did not provide adequate guarantees that rents would not materially escalate upon prepayment because the HAP contracts and their affordability restrictions could be terminated upon prepayment.[18]

Finally the court in Parkway & Diakonia v. Godfrey found that the "plaintiffs have a right to prepay their mortgage loans upon a finding by RIHMFC that prepayment will not result in the material escalation of rent."[19]

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[17]Parkway & Diakonia v. Godfrey, 1995.
[18]This type of argument by the plaintiffs in similar to that made by the developers in Wisconsin Housing and Economic Development Authority v. Bayshore who the court accused of attempting to bolster their case by inverting the order of the various documents that governed the operations of the project.
[19]Parkway & Diakonia v. Godfrey, 1995.

**Conclusion**

Parkway & Diakonia v. Godfrey is currently being appealed to the Rhode Island State Appeals Court. Without speculating on the outcome of the appeal or whether it will even be considered for appeal it is safe to state that for this case to be decided for the plaintiffs would have severely weakened RIHMFC's authority not only with regards to the issue of prepayment but quite possibly on a wider range of issues as well. This case, after all, challenged the fundamental concept of whether or not RIHMFC has the right to exist.

The challenge posed by Parkway & Diakonia v. Godfrey aside, RIHMFC prepayment regulations demonstrate a pragmatic reaction to a difficult situation. A court battle over the ownership of the reserve funds could drag on for years and leave owners, projects and RIHMFC activities shrouded in uncertainty. RIHMFC's regulations and policy of splitting reserves with owners is an important compromise which balances the desires of owners with the public policy objective of providing maintaining a supply of affordable housing which has already been paid for by the government.

by this project: how these funds are treated for tax purposes. The fact that these funds are considered income because they will eventually innure to the benefit of the limited partners in these projects (although the taxes are due before disbursements from these funds are available to limited partners) has given rise to the term phantom income. Phantom income provided motivation to limited partners to gain access to these reserve funds so they may pay the taxes on them. Issues have been raised regarding who owns the funds, both during the term of the original project mortgage as well as at completion of the mortgage payments. Resolution of these issues has largely been deferred: by the courts who do not consider it appropriate to rule on it yet; and by the prepayment programs which have for the most part reached agreements with owners.

As far as gaining some predictive value of who would own the funds at the completion of mortgage payments the courts can be of little help until a mortgage expires and the ownership issue can be litigated. Consequently, the parties involved in these negotiations, namely owners and state housing finance agencies had an incentive to reach mutual understandings on the disposition of reserve funds without letting the issues slip into the time abyss of the court system. Furthermore, the court cases examined in this research project suggest that the ownership issue would not be settled as conclusively in favor of the owners as the owners might think. Some owners, however, do not appreciate this as evidenced recent by recent litigation brought on rather fundamental issues such as RIHMFC's right to issue regulations on prepayment.

These events aside, the policies that have emerged from RIHMFC seem to be satisfactory to most of the owners or transferers and prepayers involved. Considering that excess payments will be split fifty fifty between: (1) transfers, transferees, and prepayers; and (2) RIHMFC's preservation program fund, RIHMFC and the owners have also successfully met the public policy objective of maintaining the stock of affordable housing that the government had already created that based on the cases examined here, seems relatively immune from being invalidated by future litigation.