U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
WASHINGTON, D.C. 20410–8000

ASSISTANT SECRETARY FOR HOUSING —
FEDERAL HOUSING COMMISSIONER

Special Attention of: All Multifamily Regional Center Directors All Multifamily Satellite Office Directors All Multifamily Asset Management Division Directors All Contract Administrators All Multifamily Project Owners	Notice H–2023–## Issued: ##/##/2023 Expires: This Notice remains in effect until amended, superseded, or rescinded Cross references: Notice H 2016–16

SUBJECT: Processing Budget-Based Rent Increases that Include Debt Service for Projects Subject to the Low Income Housing Preservation and Resident Homeownership Act of 1990

I. Background

Congress enacted the Low Income Housing Preservation and Resident Homeownership Act (LIHPRHA)[1] in 1990 to prevent the loss of FHA-insured and HUD-assisted affordable housing units. HUD offered a variety of incentives under LIHPRHA, including Section 241(f) equity take-out loans, additional Section 8 subsidy, Section 8 rent increases, and capital grants. In exchange, owners could agree to either (1) extend low-income affordability restrictions for the remaining useful life of the property (for no less than 50 years) or (2) transfer their properties to nonprofit organizations, tenant associations, or community-based organizations who agreed to maintain the property as affordable for its remaining useful life.

HUD oversees a portfolio of approximately 640 projects and more than 75,000 units subject to LIHPRHA provisions. Statutory use restrictions and rent-setting mechanisms for these properties appear in the LIHPRHA Use Agreement, as well as in a project-specific Plan of Action.

LIHPRHA[2] requires that rent adjustments for LIHPRHA projects be made by applying an annual factor to be determined by the Secretary to the portion of project rent attributable to operating expenses for the project. The Secretary has determined to use the Operating Cost Adjustment Factor (OCAF) as the annual factor. Accordingly, the Plan of Action for a LIHPHRA project generally requires that rents are adjusted by an OCAF. Further, section 524(e)(1) of MAHRA requires that HAP contracts for LIHPHRA projects are renewed with the same terms as those provided under the Plan of Action. If an owner believes that the contract rents approved by the Secretary pursuant to the OCAF are inadequate, and if their LIHPRHA Use Agreement or Plan of Action authorizes it, an owner may request that its contract rent increase be calculated using the budget-based method pursuant to Section 222(a)(2)(G)(ii) of LIHPRHA. Pursuant to this statutory

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[1] 12 U.S. Code § 4112

[2] See, in particular, section 222(a)(2)(G)(i) of LIHPRHA (12 U.S.C. 4112(a)(2)(G)(i)) and 24 C.F.R. § 248.145(a)(9).

authority, HUD may approve a rent increase in excess of that needed to cover project operating expenses only if HUD determines such an increase is necessary to reflect extraordinary and necessary expenses of owning and maintaining the project. LIHPRHA Use Agreements incorporate these rent-setting mechanisms as follows:

> *Project rent adjustments shall be calculated based on an annual adjustment factor established by HUD and applied to the portion of rent attributable to project operating expenses. The Owner may apply for a rent adjustment on an annual basis on the anniversary date of approval of a LIHPRHA Plan of Action. If the Owner believes that the rent adjustment approved by HUD is not adequate, the Owner may appeal HUD's determination within 30 days of receiving notice of HUD's decision. HUD may approve a rent increase in excess of that needed to cover project operating expenses only if HUD determines such an increase is necessary to reflect extraordinary and necessary expenses of owning and maintaining the Project.*

LIHPRHA Use Agreements also limit any such budget-based increase only to the year approved; in other words, the increase does not carry forward into subsequent years. Other LIHPRHA Use Agreements restricted project owners from refinancing or realizing any proceeds from a refinance of the project.

In 2015, Congress amended LIHPRHA in Section 77002 of the Fixing America's Surface Transportation Act (FAST Act) to add the following language that applies in conjunction with refinancings:

> *(c) Future Financing.—Neither this section, nor any plan of action or use agreement implementing this section, shall restrict an owner from obtaining a new loan or refinancing an existing loan secured by the project, or from distributing the proceeds of such a loan; except that, in conjunction with such refinancing—*
>
> *(1) the owner shall provide for adequate rehabilitation pursuant to a capital needs assessment to ensure long-term sustainability of the property satisfactory to the lender or bond issuance agency;*
>
> *(2) any resulting budget-based rent increase shall include debt service on the new financing, commercially reasonable debt service coverage, and replacement reserves as required by the lender; and*
>
> *(3) for tenants of dwelling units not covered by a project- or tenant-based rental subsidy, any rent increases resulting from the refinancing transaction may not exceed 10 percent per year, except that—*
>
> *(A) any tenant occupying a dwelling unit as of time of the refinancing may not be required to pay for rent and utilities, for the duration of such tenancy, an amount that exceeds the greater of—*
>
> *(i) 30 percent of the tenant's income; or*
>
> *(ii) the amount paid by the tenant for rent and utilities immediately before such refinancing; and*

(B) this paragraph shall not apply to any tenant who does not provide the owner with proof of income.

This language clarifies that neither a LIHPRHA Use Agreement nor a Plan of Action prohibits an owner from including new debt service in a budget-based rent increase request made pursuant to the HAP contract. Owners may wish to include this debt service in budget-based rents in order to address capital repairs and other project physical needs to ensure that the project can operate sustainably on a long-term basis.

II. Purpose

The purpose of this notice is three-fold: (1) to provide guidance for owners subject to a LIHPRHA Use Agreement who wish to take on a limited amount of new debt for the purpose of recapitalizing and preserving their property on a long-term basis; (2) to clarify the process for reviewing and approving a budget-based rent increase that includes such new debt service; and (3) to provide guidance for HUD asset management staff who will evaluate such requests.

Chapter 7 of the *Section 8 Renewal Policy Guidebook* provides some guidance regarding LIHPRHA budget-based rent increases that include debt service, and that chapter should be read in conjunction with this guidance.

III. Applicability

This notice applies to all properties with a Section 8 PBRA HAP contract subject to a LIHPRHA Use Agreement or Plan of Action that authorizes a budget-based rent increase in the event an OCAF adjustment is insufficient to address project needs. Once an owner determines that rents in excess of the OCAF are necessary to reflect extraordinary and necessary expenses of owning and maintaining the housing (and if those expenses include new debt service), the owner must follow the procedures established in this Notice when requesting a budget-based rent increase.

IV. Requirements for Submission

All requests for a budget-based rent increase for a property subject to a LIHPRHA Use Agreement must be submitted directly to HUD. If a Contract Administrator receives such a request, it must be forwarded to the HUD field office for processing.

In order to assess whether the proposed rehabilitation meets the requirements specified in the FAST Act, the HUD Account Executive will request the following documentation from an owner requesting a budget-based rent increase that includes new debt service:

A. <u>Narrative of transaction.</u> If an owner is requesting a budget-based rent increase in lieu of an OCAF rent adjustment, that request must be made in writing to the HUD field office. The owner must describe the proposed transaction, including how it will result in the long-term sustainability of the project; its potential effects on tenants (such as temporary relocation during rehabilitation); and whether there are tenants residing in unassisted units who are not covered by tenant-based assistance and, if so, the anticipated percentage increase in their rent due to the budget-based rent increase. The estimated debt service coverage ratio following the transaction must be stated.

B. <u>Term sheet for new financing.</u> The term sheet must include contact information for the mortgagee, the principal balance to be borrowed, the interest rate of the financing, the projected reserve for replacement deposit amount, and the projected monthly debt service payments.

C. Project Capital Needs Assessment (PCNA). A PCNA dated within five years of the submission must be provided to ensure that the proposed repairs will result in the long-term sustainability of the property.

D. Scope of work. A detailed scope of work must be provided and must address the capital repairs described in the PCNA. A timeline for the repairs must be included. If any capital repairs in the PCNA are not included in the scope of work, the owner must provide a narrative explaining how and when those capital repairs will be completed, or if they have already been completed.

E. Sources and uses. A full accounting of all sources and uses of funds in the transaction must be provided.

F. Budget worksheet. A budget worksheet (HUD–92547–A) conforming to HUD requirements[3] must accompany the submission. The budget must reflect the debt service payment projected in the term sheet and reserve for replacement deposits.

G. Copy of notice to tenants. At least 120 days before submission, the owner must provide written notice of the rent increase request to all tenants. The notice must explain the effect of the increase request on the total tenant payment (if any) and must provide instructions to tenants who have no rental assistance for providing proof of income to the management agent for the purposes of a rent increase calculation. See paragraph VI(A)(3) for more information on this requirement. Owners must ensure the notice is accessible for individuals with disabilities, as well as individuals with limited English proficiency.

V. Criteria for Approval

Account Executives will review the submission to ensure that the transaction meets the following criteria:

A. The duration of any tenant displacement necessary for rehabilitation shall not exceed one (1) month. The Regional Center Director may approve a longer construction term so long as tenants will not be permanently displaced, and all relocation costs are borne by the owner.

B. The budget worksheet must include the debt service payments described in the term sheet. The budget must meet all HUD requirements.[4] The projected debt service coverage following the transaction must be at least 1 but must not exceed 1.2. Debt service coverage can be calculated from the budget worksheet using the following formula (the numerals shown are the line numbers on the budget worksheet):

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[3] As of the date of publication of this Notice, these requirements are contained in Chapter 7 of HUD Handbook 4350.1.

[4] As of the date of publication of this Notice, these requirements are contained in Chapter 7 of HUD Handbook 4350.1 and Chapter 11 of HUD Handbook 4350.6.

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C. The PCNA must be dated within 5 years of the submission.

D. The scope of work must address the capital repairs described in the PCNA. Any capital repairs in the PCNA that are not addressed in the scope of work must either already have been completed, or the owner must explain how they will be completed. Asset Management staff will seek the advice of the Production Technical Specialist Branch in assessing whether this requirement has been met.

E. The acquisition cost for the property must be commercially reasonable. Asset Management staff may consult the Production Underwriter Branch for input on whether the listed acquisition or purchase price is reasonable.

F. The developer fee in the transaction must not exceed 10 percent of the total transaction costs (including acquisition, hard, and soft costs).

G. The sources and uses document must show that the loan is not generating an equity takeout.

VI. Processing the Budgeted Rent Increase

If all criteria above have been met, the Account Executive can proceed with processing the budgeted rent increase using the guidance in Chapters 2 and 7 of the *Section 8 Renewal Policy Guidebook*. If the mortgagee requires HUD approval of the rent increase prior to issuing a commitment to provide the financing, HUD may furnish an approval letter establishing the rents following the refinance. The new budget-based rents will be effective the first of the month following closing. Pursuant to paragraph 7–9(B)(3) of the *Section 8 Renewal Policy Guidebook*, the rent increase will not be rolled back in subsequent years, despite language in the Use Agreement (or Plan of Action) indicating that it will be.[5] Future OCAF rent adjustments will be computed using the new budget-based rents as the "Current Section 8 Contract Rents."

In cases where the project contains units that are not assisted under a project-based rental assistance HAP contract, the following additional procedures will be followed:

A. The budgeted rent increase must be applied across all units:

1. If the property includes non-HAP units that are subject to a rent restriction (for instance, if they are capped as a result of a Low Income Housing Tax Credit use restriction), then the budgeted rent increase must be applied to the extent permitted by the rent restriction.

2. The rent increase on non-assisted units occupied by tenants who are not covered by tenant-based assistance may not exceed 10 percent, as described above.

[5] As described in Section I, the rollback language in the Use Agreement (or Plan of Action) pertains to rent increases unrelated to the FAST Act provision on new debt service.

3. A tenant in a dwelling unit not covered by project- or tenant-based rental assistance may provide the project owner or agent with income documentation. If they do, their combined rent and utility payments may not exceed the higher of either:

    a. 30 percent of the tenant's income; or

    b. The amount paid by the tenant for rent and utilities immediately before the refinancing.

B. The remainder of the budgeted rent increase must be applied to the PBRA HAP-assisted units at the property.

C. The budget must include the gross potential non HAP-assisted unit rents (following the rent increase described in 1 above) in the Rent Revenue line item.

VII. Contact

For further information or if there are questions, HUD Regional Center or Satellite Office staff should call their Headquarters Desk Officer in the Office of Asset Management and Portfolio Oversight. Owners should contact the Account Executive in the Regional Center or Satellite Office responsible for their project.

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Julia R. Gordon
FHA Commissioner —
Assistant Secretary for Housing