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CHAPTER 19. TAX-EXEMPT FINANCING UNDER SECTION 103(b)(4)(A)

- 19-1. GENERAL. Interest on industrial development bonds issued by State or local government units is generally subject to Federal income taxation. However, Section 103(b)(4)(A) of the Internal Revenue Code and the IRS implementing regulations at 26 CFR, Section 1.103-8(b) exempt such interest when:
- A. Substantially all of the bond proceeds are used to finance a "residential rental project"; and
  - B. At least 20 percent of the project units (15 percent in the case of a "targeted area project") will be occupied by "individuals or families of low or moderate income" for the term of the "qualified project period."
- 19-2. IRS DEFINITIONS
- A. Residential rental project. (See 26 CFR, Section 1.103-8(b)(4).) A building or structure, together with any functionally related and subordinate facilities, containing one or more similarly constructed units which:
    - 1) Are used for non-transient purposes;
    - 2) Are available to members of the general public and
    - 3) Once available for occupancy, are rented or available for rental on a continuous basis during the longer of:
      - a) the remaining term of the obligation, or
      - b) The qualified project period.
  - B. Targeted area project. (See 26 CFR, Section 1.103-8(b)(8)(iii).) A project located in a qualified census tract (as defined in 26 CFR, Section 6a.103A-2(b)(4)) or an area of chronic economic distress (as defined in 26 CFR, Section 6a.103A-2(b)(5)).
  - C. Individuals or families of low or moderate income. (See 26 CFR, Section 1.103-8(b)(8)(v).) Individuals and families whose adjusted incomes do not exceed 80 percent of the median gross income for the area.
  - D. Qualified Project period. (See 26 CFR, Section 1.103-8(b)(7).) For projects financed with obligations issued on or after September 4, 1982, the period starting on the later of the date of issuance or the date on which 10 percent of the project units are first occupied, and ending on the latest of:

- (19-2) 1) The date which is 10 years after the date on which half of the project units are occupied;
- 2) The date which is a "qualified number of days" (i.e., half of the term of the tax-exempt obligations with the longest maturity) after the date on which any of the units in the project is first occupied; and
- 3) The date on which any assistance to the project under Section 8 of the U.S. Housing Act of 1937 terminates.

19-3. COVENANT REVIEWS BY LENDER. Before initial endorsement (the single endorsement for coinsurance on completion), the lender must review proposed Section 103(b)(4)(A) covenants for acceptability pursuant to paragraph 19-5.

19-4. STATE AND LOCAL RESTRICTIONS. Lenders may not, without HUD Headquarters approval, coinsure projects subject to State or local occupancy restrictions more stringent or burdensome than the requirements of Section 103(b)(4)(A), regardless of whether the restrictions are to be recorded as covenants running with the land.

Send requests to the Office of Insured Multifamily Housing Development, and include:

- A. Description of the statutory, regulatory, judicial, or other basis for imposing the restrictions; and
- B. Brief analysis of the likely effect of the restriction on project occupancy, marketability, and overall feasibility.

19-5. COVENANT REQUIREMENTS. Because of their inherent rigidity and lasting effect, Section 103(b)(4)(A) covenants are permitted on coinsured projects only if:

- A. They are expressly subordinate to the coinsured mortgage (i.e., must contain a subordination clause);
- B. The covenant does not conflict with applicable HUD mortgage insurance or Section 8 regulations. The following paragraph must be included:

Notwithstanding anything in this document to the contrary, the provisions hereof are subordinate to all applicable HUD coinsurance (and Section 8, if applicable) regulations and related administrative requirements. In the event of any conflict between the provisions of this document and the provisions of any applicable HUD regulations, related HUD administrative requirements, or HUD/FHA loan documents, the HUD regulations, related administrative requirements or loan documents shall control.

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- (19-5) C. They automatically terminate upon foreclosure or transfer of title by deed in lieu of foreclosure (i.e., must contain automatic termination clause);
- D. Failure to comply with them will not be a basis for default on the coinsured mortgage;
- E. They do not appear in the note, mortgage, coinsurance regulatory agreement, or any other HUD loan document;
- F. The covenant provides that its enforcement will not result in a claim against the project, mortgage proceeds, any reserve or deposit required by HUD in the mortgage transaction, or rents or other income from the property, other than:
- 1) Available surplus cash if the mortgagor is profit-motivated, or
  - 2) Available distributions and residual receipts authorized for release by the lender if the mortgagor is limited-distribution;
- G. The covenant contains a provision making any subsequent amendment contingent on prior lender approval;
- H. Any covenant requirement for owner preservation of tax-exemption of the interest on the notes or bonds (or which prohibits the owner from taking action that might jeopardize the tax-exemption), specifically excepts HUD requirements (or prohibitions) pursuant to:
- National Housing Act
  - Coinsurance regulations
  - HUD/FHA loan documents
  - Section 8 of the U.S. Housing Act of 1937 and its regulations, if applicable;
- and
- I. The covenant instrument is not, without HUD Headquarters approval, more stringent or burdensome than necessary to comply with the minimum requirements of Section 103(b)(4)(A) of the IRS Code and the IRS regulations issued under it.
- 19-6. REQUIRED CONDITION FOR PROJECT APPROVALS/COMMITMENTS. Any SAMA/feasibility letter or equivalent, conditional commitment, or firm commitment for a project involving Section 103(b)(4)(A) financing must be expressly conditioned on lender approval, before initial endorsement, of any special covenants proposed for tax-exemption

(unless approval has already been granted).