

Eligibility of Long-term Leases

REVERSED 8/9/93

February 25, 1993

MEMORANDUM FOR: John E. Wilson, Deputy Regional Administrator - Regional Housing Commissioner, 9S

FROM: Don I. Patch, Acting Deputy Assistant Secretary for Grant Programs, CG

**SUBJECT: Eligibility of Long-Term Leases
City and County of Honolulu, Hawaii**

This is in response to your September 10, 1992, memorandum requesting guidance on a request for an eligibility determination from the City and County of Honolulu (referred to below as "the City"). According to the incoming memorandum and discussions my staff has held with Regional and Field Office staff, the facts of the case are as follows:

- a. with non-Federal resources, the City is newly constructing multi-family rental housing on property it owns;
- b. the City had not previously intended this project to be assisted with CDBG funds;
- c. the City wishes to provide a 55-year lease to a nonprofit organization that will in turn lease a certain number of the units to low- and moderate-income households on a monthly basis;
- d. the City wants to provide several million dollars in CDBG funds in a grant to the nonprofit so that the nonprofit may pay the City a one-time up-front lease payment for the entire lease;
- e. the City plans to allow the nonprofit to use rental payments from the tenants to cover operating costs, only requiring that any residual amounts be returned to the City; and the City apparently plans for this project to be a model for subsequent developments.

Your memorandum raised a number of issues regarding this proposed activity. They will be discussed in turn below.

1. Do we agree with the City that this use of CDBG funds constitutes an eligible §570.201(a) acquisition activity? (Your office does not agree.)

No, we do not agree with the City. As a general rule, if construction of the units to be acquired is complete and the units will otherwise be available for rental or sale on the open market, to the extent that a grantee, prior to completing the construction, had not planned to use CDBG to assist

the activity (in this case by, in effect, "taking out" the construction financing) it is possible to use CDBG funds to assist acquisition of housing units under §570.201(a). In a July 1, 1992, memorandum regarding Brownsville, Texas, and in a January 11, 1993, memorandum regarding the City of Baltimore, Maryland, this policy was described and elaborated for single-family housing and acquisition under §570.201(n), direct homeownership assistance.

To determine when acquisition assistance to the purchaser of a newly constructed residential property is eligible under §570.201(a), acquisition of real property, it is necessary to distinguish:

1. whether the assistance will be provided to purchase a residential property that is to be constructed or has been constructed;
2. if the residential property is to be constructed, whether the assistance or the new construction is eligible under
3. §570.204;
4. whether the assistance has been set aside for a particular development or is available without regard to the new construction status of the property to be purchased; and
5. if construction has been completed, whether construction was completed without knowledge of the availability of CDBG funds.

If CDBG funds are set aside specifically to assist with the purchase of a newly constructed residential property in a particular development upon construction completion and the new construction was not eligible under §570.204, the assistance would not be eligible. Funds set aside for a particular development would be the same as using CDBG funds to finance the new construction, since the developer could be completing the construction based on the availability of CDBG funds.

In the instant case, the City decided to use CDBG funds to assist with acquisition of units in this development while the City was still constructing the residential structure. Further, in a case in which the grantee is the developer of the property in question, the Department believes that it is a rebuttable presumption that the grantee is aware of the availability of CDBG funds. Therefore, unless the project is eligible under §570.204, it would not be eligible to use CDBG funds to purchase units that the grantee has itself developed. Additional §570.204 issues are discussed under question 2, below.

Related to your inquiry is the question of whether a grantee can ever give a subrecipient CDBG funds to acquire an interest in grantee-owned property through a very long-term lease. This could be considered "acquisition" because title to the property effectively changes from the grantee to the subrecipient for the duration of the lease. It should be noted, however, because this is grantee-owned property, it would seem to the Department to be much more cost-effective for the grantee to contract with the nonprofit to carry out whatever purpose the grantee intended. The grantee could, for instance, contract with the nonprofit to manage the property (a contract for which no CDBG funds would be necessary if the rents were used to cover the nonprofit's costs). Because this appears to be a much more cost-effective method of providing affordable housing

than any lease arrangement proposed, the grantee should consider whether such lease costs could be shown to be necessary and reasonable.

Also note that the Department has been wary of similar acquisition transactions, as they can be used as a means of "laundering" CDBG funds into a grantee's general revenue account. In this case, instead of contracting with the nonprofit to manage units, the City planned to give the nonprofit CDBG funds to lease the property in a manner that essentially would allow the City to recoup a substantial amount of its development costs immediately. The City then intended to use the proceeds (which would not be CDBG program income) to repay bonds issued by the City for this project. Then the City could issue more bonds for new construction of housing and repeat the process. The City appears to be arguing that the primary purpose of the activity is assisting the nonprofit to provide affordable low- and moderate-income housing that might not otherwise exist. However, it appears that another primary purpose is to avoid the CDBG ineligibility of construction of new housing.

2. If eligible as a §570.204 special activity by a certain subrecipient, what are the implications for grantee compliance with Davis-Bacon, environmental, citizen participation, and other such applicable requirements?

Such a program of new construction of housing could be eligible if carried out by a subrecipient qualified under 24 CFR 570.204, and if the otherwise ineligible activities were all or part of a neighborhood revitalization, community economic development or energy conservation project. If the program were designed as described above with the City providing bond funds for construction financing, the CDBG funds used for the lease payment would be considered to be assisting the new construction by providing the long-term take-out financing. In other words, the CDBG assistance would be considered an integral part of the new construction project financing. That being so, the new construction would be subject to all applicable program regulations, including labor and environmental standards. Further, the §570.204 subrecipient involved would have to exercise sufficient control over the new construction project to be said to be carrying it out.

3. How would the low- and moderate-income housing national objective be met for an acquisition of part of a building?

For rental units, the housing units acquired within a single building by a single purchaser could be considered to be a "structure" for the purposes of §570.208(a)(3). At least 51 percent of such units must be occupied, following the acquisition, by low- and moderate-income households.

4. If CDBG funds assisted a non profit's acquisition of housing units that the nonprofit then rented to low- and moderate-income households, would the monthly rents paid by the tenants be program income, or would the nonprofit be able to use part of the rents for operating costs?

Section 570.503(a)(1)(iii) defines program income to include:

"Gross income from the use or rental of real or personal property acquired by the recipient or by a subrecipient with CDBG funds, less costs incidental to generation of the income;"

Therefore, the rental payments received from the tenants would be program income to the extent that the payments exceeded any operating costs incidental to generation of the payments.

5. What is the appropriate method for establishing the value of a 55-year lease for purposes of determining a one-time up-front lease payment?

The greatest possible lease payment would be based on the appraised value of the property. That appraised value would be based on the present value of the expected tenant payments and any other applicable standard appraisal methods. To make the units affordable to low- and moderate-income tenants, a grantee could choose to exact a lesser payment.

Under the HOME program, new construction is an eligible activity. The recently enacted housing authorization act (the Housing and Community Development Act of 1992) will remove most of the restrictions on new construction investments of unexpended 1992 HOME funds as well as on the Fiscal Year 1993 appropriations. Further, the Act allows a percentage of bond proceeds to be counted toward the match for new construction. The Office of Affordable Housing Programs (OAHP) will contact you with additional information on these changes as the policies are implemented. It is possible that with some restructuring of the City's proposed program it could conform with HOME requirements. Technical assistance on making necessary changes can be obtained from OAHP.

Also, under the HCD Act of 1992, a new eligible activity added to section 105(a)(21) of the HCD Act of 1974 allows CDBG grantees to pay activity delivery costs for any HOME project that meets a national objective. Such CDBG costs are subject to the 20 percent limitation on administration and planning costs unless the HOME-eligible activities are also otherwise CDBG-eligible. The Department anticipates more changes to this section of the law, so grantees should be advised to contact HUD if they choose to take advantage of this provision.

Please contact the Entitlement Communities Division if you or the City have any further questions about CDBG issues.

cc: Robert P. Allen, SC