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Rental Senior Housing – 142(d) Housing Bonds

The need for affordable rental senior housing has never been greater than it is today. Safe residential options that can provide needed assistance with actives of daily living at an affordable cost are increasingly difficult to find. According to the LeadingAge Center for Applied Research, more than 33 percent of all seniors had annual incomes below 200 percent of the national poverty level – approximately $20,000 – in 2010. According to the same source, approximately half of the poorest seniors spend nearly 50 percent of their income on housing which makes necessities like food and healthcare difficult to afford.

What are 142(d) Housing Bonds?

In order to address the need for affordable senior housing 142(d) housing bonds ("142(d) Housing Bonds") have been utilized to provide a non-recourse financing source for new senior housing projects. Accordingly, 142(d) Housing Bonds are tax-exempt bonds ("Tax-exempt Bonds") that are subject to the rules and regulations set forth under Internal Revenue Code Section 142(d) and related Treasury Regulations ("the Guidelines"). While 142(d) Housing Bonds are a federal tax code, the 142(d) Housing Bonds program is administered by state housing finance agencies in each state. To qualify under the Guidelines, among other things, projects must provide residential rental housing (i.e., have separate facilities for living, sleeping, eating, cooking and sanitation within the unit or single-room occupancy units with shared facilities for eating, cooking, and sanitation) without continual or frequent nursing, medical, or psychiatric services. The project must meet at all times one of two requirements, elected by ownership at the time of issuance, as outlined below:

(A) 20/50 Test: The facility meets the requirements of this test if 20 percent or more of the units are occupied by individuals whose income is 50 percent or less than the area median gross income (the "20/50 Test").
(B) 40/60 Test: The facility meets the requirements of this test if 40 percent or more of the units are occupied by individuals whose income is 50 percent or less than the area median gross income (the "40/60 Test").

For example, based on a 20/50 election by the borrower (the "Borrower") of the qualified rental project (the "Project"), at least 20 percent of the residential units must be occupied by individuals whose aggregate household annual income is less than or equal to 50 percent of the area median gross income for the county of the Project as adjusted for household size as determined by the Department of Housing and Urban Development ("HUD"). The current HUD income limits for each county can be assessed at https://www.huduser.gov/portal/datasets/il.html. The following table is an example of a typical county income limit summary from HUD:

FY 2018 Income Limit Area	Median Income	FY 2018 Income limit Category	Persons in Family			
			1	2	3	4
Fulton County (Georgia)	$74,800	Very Low (50%) income limit	**$26,200** [1]	$29,950	$33,700	**$37,400**
		Extremely Low Income Limits	$15,750	$18,000	$20,780	**$25,100**
		Low (80%) Income Limits	$41,900	$47,900	$53,900	**$59,850**

(1) Residents are assumed to qualify as a single occupant under "1" Persons in Family.

Regulatory Agreement and Declaration of Restrictive Covenants

In order to obtain 142(d) Housing Bonds, the Borrower will enter into a Land Use Restriction Agreement, (the "Regulatory Agreement"), by and among the Borrower, the governmental issuer (the "Issuer") and the bond trustee ("the Trustee"). In our example, the Regulatory Agreement requires that at least 20 percent of the residential units are occupied or made available for tenants whose incomes do not exceed 50 percent of the applicable area median income, as adjusted from time to time and as determined in accordance with applicable Treasury regulations by HUD. The affordability restrictions in the Regulatory Agreement are typically enforced for a period of at least 15 years.

The following terms are typically defined in a Regulatory Agreement:

- "**Adjusted Income**" means the adjusted income of a person (together with the adjusted income of all persons who intend to reside with such person in one residential unit) calculated pursuant to Section 8 of the Housing Act as required by Section 142(d) of the tax code.
- "**Qualified-Income Resident**" means a resident whose gross income, together with the gross income of all persons who intend to reside with such person in one residential unit, does not exceed fifty percent (50%) of the median gross income for the area, as determined from time to time by HUD for the area in which the project is located.
- "**Qualified-Income Units**" means the residential units in the project required to be rented to, or held available for occupancy by, Qualified-Income Residents pursuant to Section 4(a).
- "**Median Gross Income for the Area**" means, with respect to the project, the median income (adjusted for family size) for the households in the area which includes the standard metropolitan statistical area in which such project is to be located.
- "**Qualified Project Period**" means the period beginning on the first day on which 10 percent of the residential units are occupied and ending on the latest of (a) the date that is fifteen (15) years after the date on which 50 percent of the residential units are occupied, (b) the first date on which no Tax-Exempt private activity bond issued with respect to the project is outstanding, or (c) the date on which any assistance provided with respect to the project under Section 8 of the Housing Act terminates.
- "**Income Certification**" means a certification as to income and other matters executed by the household members of each resident in the project substantially in the form attached or such other form as may be prescribed in accordance with the Regulatory Agreement.

Calculating Qualified-Income Resident Income

The determination of resident income related to the 20/50 Test or 40/60 Test is to be made at least annually for each unit on the basis of current income of the residents. The Borrower is responsible for defining specific strategies to market the community to potential residents that meet the low-income criteria ("Qualified-Income Residents") while having sufficient assets to pay the full monthly fee via a spend down of assets, which is a common use of assets by seniors needing affordable housing and care services. Section 142(d) does not limit the rent that may be charged to residents; it only requires that the residents meet the applicable income requirements. The Borrower can charge market-rate rents to individuals whose incomes put them in the qualified-income category.

In addition to evaluating income sources, the Borrower should assess total assets of prospective residents including home values, investments, and other assets prior to their admission. The expectation is that a portion of the potential residents would have sufficient assets to cover any short fall between the resident's annual income and the annual cost of residing in a unit. The level of assets has no bearing on whether or not a potential resident meets the Qualified-Income Resident criteria. Additionally, prospective residents might qualify for additional "Payment Options", as noted below.

Compliance Strategies

During a project planning and design phases, appropriate unit configuration and unit mix should be studied to ensure that the mix and design complement the Borrower's election. Both independent living and assisted living 142(d) projects benefit from a unit mix which includes a variety of unit types and sizes, including a number of smaller unit types, such as studios which are less expensive.

As noted earlier, the determination of resident income related to the 20/50 Test or the 40/60 Test is to be made at least annually for each residential unit on the basis of current income of the residents. The Borrower will be required to submit to the Internal Revenue Service ("IRS") an annual certification on Form 8703 as to whether the Project continues to meet the requirement of subsection 142(d).

Proportionate Lease-up (new construction projects)

New construction projects are subject to the requirements of the 20/50 Test or 40/60 Test beginning from the date 10 percent of units are first occupied through the end of the Qualified Project Period. Though submission of annual Project certification occurs on December 31st of each year, new construction properties are strongly encouraged to lease market-rate and income-qualified units proportionately throughout fill up. For example, if a 100-unit, 20/50 Project reached 50 percent occupancy in July, then 10 of the 50 occupied units should house Income-Qualified Residents, with the remaining 40 units rented at the market rate.

Vacancy Factor

If the units were previously occupied, the vacant units will be counted as Qualified-Income Units only if the previous occupant was a Qualified-Income Resident. The following table provides an example of how vacant units are treated:

<table>
<tr><th></th><th>Situation</th><th>Outcome</th></tr>
<tr><td rowspan="3">VACANT UNITS</td><td>• Unit A is vacant
• The Project is in fill up
• Unit A has never been occupied</td><td>• Unit A may not be counted as a Qualified-Income Unit. Qualified-Income Units must be occupied proportionately throughout fill-up. When assessing the 20/50 or 40/60 Test during fill-up, vacant units reduce the total unit count used as the denominator.</td></tr>
<tr><td>• Unit B is vacant
• The previous occupant of Unit B was a Qualified-Income Resident</td><td>• Unit B is counted as a Qualified-Income Unit, provided the unit is in livable condition and made ready within 120 days of vacancy</td></tr>
<tr><td>• Unit C is vacant
• The previous occupant of Unit C was <u>not</u> a Qualified-Income Resident</td><td>• Unit C is counted as a market-rate unit</td></tr>
</table>

Supplemental Payment Options

While the 50 percent median income limitation in the County typically falls below the income qualifications established for the Project, the Borrower may also consider utilizing funding sources to subsidize rents to help address the compliance requirements of the 142(d) Housing Bonds.

Utilizing various payment options can help strengthen occupancy in the Qualified-Income Units. Generally, the amount of funding that may be required for an independent living or assisted living Project varies based on the Project's unit mix, level of service provided and type of facilities, with more emphasis being applied to independent living units (choice-based product offering to seniors) versus assisted living/memory care units (needs-based product offering to seniors).

The following payment options are available to the Borrower to assist in meeting the affordability requirements:

1) The spend-down of assets usually from the sale of a primary residence;
2) Support from adult children (if in a market with strong adult care giver influence);
3) U.S. Department of Veterans Affairs Aid and Attendance Program for assisted living care;
4) State specific Medicaid Waiver programs for assisted living care; and,
5) A portion of the Project's units that are identified for the Qualified-Income Residents and priced at rent level equal to approximately 80 percent of the County's median income.

It is anticipated that these payment options would be used during fill-up through post stabilization of the Project.

Scholarship Fund

Assuming some residents will need support to pay the monthly fees at some point during their stay, a Scholarship Fund may be established and funded annually to maintain a predetermined minimum level of proceeds. The Scholarship Fund may be funded with initial working capital proceeds and with additional proceeds during fill-up. Scholarship Funds could come from additional cash flow from the Project or development fund raising efforts.

Consistent File Methodology

The Borrower should develop a comprehensive file methodology to support and/or demonstrate the Project's ongoing adherence to the terms of the Regulatory Agreement, particularly Income Certification and re-certification throughout the Qualified Project Period. File systems that consistently track progress toward the 20/50 Test or the 40/60 Test requirements will streamline compliance verification for the Borrower and the Compliance Monitor, if required, beginning with initial certification through the life of the Project.

In order to maximize the benefits of allowable deductions to annual income for residents, the Borrower may design internal documents to isolate distinct, deductible components of the Project's monthly fees, such as level of care fees, which are considered a medical expense, or the cost of food, which may be excluded from income when expressly subsidized by an adult child or other supporter.

Compliance Monitors

Depending on the terms of the Regulatory Agreement, and the practice of the Issuer, it may be required that the Project be monitored and reviewed by a compliance monitor ("Compliance Monitor") to ensure that the requirements of the 20/50 Test or the 40/60 Test are met. In practice, the main function of the Compliance Monitor is to provide education and guidance, which typically includes orienting the Borrower to the operating requirements to maintain compliance and providing training and advising to the Borrower, as needed, to become proficient in the resident certification process, as well as being available to answer questions throughout the Qualified Project Period.

When the Project requires monitoring, the Borrower must select a Compliance Monitor and execute a compliance monitoring agreement ("Compliance Monitoring Agreement"). Typical Compliance Monitoring Agreements stipulate contract terms, including compensation for monitoring services, processes for notification to the Issuer, termination of the agreement, and services and responsibilities of the Compliance Monitor. Though variation exists in the practice of different Compliance Monitors, services generally include training and advice to the Borrower, conducting annual inspections and records review, notifying the Borrower, Issuer and bondholder ("Bondholder") of any breach of the Regulatory Agreement and issuing a written report summarizing the annual inspection. Annual inspections include resident file review in order to assess the following:

Applications and processing – Applications from prospective residents should cover income, rental history and asset information along with a statement that the information is true and correct as well as an authorization allowing the Borrower to verify the information.

Initial certification/recertification – All households must be initially certified prior to counting them toward the 20/50 Test or the 40/60 Test. In order to properly certify a resident, all residents must be properly verified with sufficient verification of income, a completed application and an executed tenant income certification. Qualified-Income Resident households must be recertified on an annual basis.

Verification of income – The Borrower is responsible for gathering income data and calculating gross income for prospective residents to ensure that twenty percent (20%) of the residential units are occupied or made available to tenants whose gross income does not exceed fifty percent (50%) of the applicable area median income (if the 20/50 Test is selected). Verification of income must be received prior to certification, though no earlier than 120 days from the date the Borrower receives it. After 120 days, the verification is no longer valid and a more current one must be obtained.

Income certification and certificate of continued program compliance ("CCPC") – Tenant income certifications should be sent to the Compliance Monitors initially as residents are qualified. Once all have been reviewed, it is only necessary to send tenant income certifications monthly. A CCPC showing the number of units occupied by Qualified-Income Residents should be submitted on a monthly basis. The required twenty percent (20%) qualified-income units must be maintained on a monthly basis.

Assets – Asset amounts are used to calculate the income derived from these assets. When a resident's assets are lower than $5,000, the actual income from those assets is added to the resident's income. If the asset total is greater than $5,000, the total assets must be multiplied by the HUD passbook savings rate which as of January 2017 is .06 percent and is subject to change on an annual basis.

Why is Compliance Important?

When a 142(d) Project is found to be out of compliance from the IRS and/or Compliance Monitor, the Borrower will receive a notice of non-compliance, along with a reasonable time period to correct the issue. The time allotted for correction varies depending on the type of compliance issue, although 60 days is typical. Failure to correct non-compliance within the given period may cause the 142(d) Housing Bonds to become taxable from the date of the violation of possibility from their date of issuance. Typically in the event 142(d) Housing Bonds are declared taxable, the 142(d) Housing Bond documents require redemption of the bonds at a premium designed to compensate investors for their loss of tax-exemption. Such a failure may cause additional repercussions for Project owners, such as a forced refinancing, default under the mortgage and possible foreclosure, and lawsuits by Bondholders.

Appendix – Frequently Asked Questions

Q: Should my community select the 20/50 Test or the 40/60 Test? What is the difference between the two tests?

A: The selection of the 20/50 Test or the 40/60 Test should be determined by the unit mix and relative financial position of the 142(d) Project and the expected demographics of residents. 20/50 Test communities are required to have twenty percent (20%) of their units occupied by individuals whose incomes are 50% or less than the area median gross income. 40/60 Test communities are required to have 40% of their units occupied by individuals whose incomes are sixty percent (60%) or less than the area median gross income.

Q: Is there a limit on the amount of rent that can be charged for residential units at 142(d) Projects?

A: Section 142(d) does not limit the rent that may be charged to residents; it only requires that the residents meet the applicable income requirements. In theory, the Borrower could charge market-rate rents to individuals whose incomes put them in the qualified-income category, but who can afford, for whatever reason, to pay market-rate rent.

Q: Are monthly payments from a resident's adult child considered resident income?

A: Yes. Regular contributions from an adult child to a parent are considered income unless the money is for food or healthcare related expenses. Temporary, non-recurring and sporadic income (including gifts) are not counted as income.

Q: Does each 142(d) Project have to have a Compliance Monitor?

A: Not all 142(d) Projects are required to have a Compliance Monitor. Whether a 142(d) Projects has a Compliance Monitor or not, all Projects must maintain compliance and submit Form 8703 - Annual Certification of a Residential Rental Project on an annual basis in order to retain their Tax-Exempt Bonds.

Q: What exactly does a Compliance Monitor do?

A: Though variation exists in the practice of different Compliance Monitors, services generally include providing training and advice to the Borrower, conducting annual inspections and records review, notifying the Borrower, Issuer and Bondholder of any breach of the Regulatory Agreement and issuing a written report summarizing the annual inspection

Q: What happens when a Qualified-Income Resident can no longer afford to pay their rent?

A: 142(d) Projects should consider funding a Scholarship Fund with initial working capital proceeds and with additional proceeds during fill-up, and beyond. The Scholarship Fund could be used to subsidize the rent of residents who can no longer afford to pay.

Q: Does a 142(d) Project have to recertify their residents every year?

A: Yes. Some Regulatory Agreements require full recertifications annually, with income and assets verified by a third party Compliance Monitor. For 142(d) Projects that do not have a Compliance Monitor, the Borrower must recertify the income of its residents annually in order to file Form 8703 - Annual Certification of a Residential Rental Project with the IRS.

About the Authors

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Keith is the partner-in-charge of DHG Healthcare's planning and finance team. He has more than 30 years of experience in the healthcare industry. He leads a practice of business and financial advisory services such as strategic planning, financial forecasting, market demand analysis, third party reimbursement, operational audits and systems review. He has been a key participant in more than 100 continuing care retirement community (CCRC) development projects, including startup communities, existing campus repositioning and obligated group financings.

Keith has conducted financial analyses of merger and acquisition transactions and financing structures to include valuations, due diligence, economic and market feasibility analyses for proposed and existing healthcare and other retirement housing projects.

Prior to joining Dixon Hughes Goodman, Keith worked for a Big Four accounting firm as a consultant in the long-term care industry and as an auditor for a Medicare Intermediary.

Keith is a member of AICPA and LeadingAge. He is an accomplished presenter on topics affecting acute care facilities, skilled nursing providers and home health agencies. Keith holds a B.S. degree in accounting from Ball State University.

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Kenny has more than 17 years of experience in the senior living industry. He primarily performs financial analyses, development advisory, project planning, and strategic planning for senior housing and care communities. His experience includes project administration in the development of senior living communities, financial planning and other financial analyses. His primary focus is providing financial planning services for new developments, expansions, and acquisitions.

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