

# Policy Alert - Use of Operating Subsidies for Mixed-Finance Project Reserves

## Use of Operating Subsidies for Mixed-Finance Project Reserves

*Revised April 21, 2004*

HUD is issuing this policy alert to clarify policies regarding the use of public housing operating subsidies for mixed-finance project reserves. This alert does not reflect a change in policy or the implementation of a new one; rather, its intent is to clarify existing policies for all mixed-finance transactions.

### Types of Project Reserves

Real estate developers typically include reserves as part of a project's structure to protect against unforeseen expenses or loss of income and to ensure the long-term sustainability of the project. In mixed-finance projects, the following types of reserves are common:

- **Initial Operating Period Reserve:** Operating subsidy for public housing units begins after the development reaches the end of the initial operating period (EIOP), as defined at 24 CFR 941.404(a). For mixed finance projects where public housing units may come on line for occupancy over a long period of time, there will be a period where some units are **occupied** but not yet eligible to receive operating subsidy. Mixed-finance projects may capitalize an Initial Operating Period Reserve (also called a Lease-Up Reserve) from development funds as part of the development budget to fund initial operating deficits related to the public housing units prior to receipt of operating subsidy. This reserve must be used for public housing purposes.
- **Operating Deficit Reserve:** An operating deficit reserve is often created for projects to guard against insufficient income. The reserve is used when a project's income cannot cover its operating expenses, either because rents are lower, or expenses are higher, than expected. Often, this kind of reserve is capitalized from equity (non-PIH capital sources) at the beginning of operations and is part of the development budget. An Owner Entity may establish one reserve to cover both public housing and non-public housing units, or may establish separate reserves for public housing and non-public housing units. If one reserve is established, it must be proportionally replenished from public housing and nonpublic housing sources. If operating subsidy or tenant rents are used to replenish an Operating Deficit reserve, these funds must be used for eligible operating subsidy purposes; specifically, the portion of the reserve replenished with public housing sources must either stay with the project to support public housing operating expenses or must be returned to the PHA to support other public housing operating expenses. This reserve is not meant to fund income shortfalls due to delays in the start of operating subsidy. Those shortfalls are funded by the Initial Operating Period Reserve.

- **Operating Subsidy Reserve<sup>1</sup>:** This type of reserve is unique to projects that include public housing units. Because funding levels for operating subsidy can be unpredictable, mixed-finance projects carry the risk of a subsidy shortfall. As a result, many developers and other investors in mixed-finance transactions have required an Operating Subsidy Reserve to support the PHA's annual operating subsidy obligation to the project. The project would use funds from the Operating Subsidy Reserve if there were a shortfall in the amount of operating subsidy pledged to the development. This reserve covers only the public housing units. At the end of the compliance period, or upon sale of the project, the portion of this reserve replenished with operating subsidy or tenant rents must be used for eligible operating subsidy purposes; specifically, the portion of the reserve replenished with public housing sources must either stay with the project to support public housing operating expenses or must be returned to the PHA to support other public housing operating expenses.
- **Replacement Reserve:** The replacement reserve is created to fund the replacement of long-lived capital items such as heating or roofing systems. After the construction of a project is complete, a per unit amount is contributed annually to build the reserve. An Owner Entity may establish one reserve to cover both public housing and non-public housing units, or may establish separate reserves for public housing and non-public housing units. If one reserve is established, it must be proportionally replenished from public housing and nonpublic housing sources. If public housing funds are used to replenish a Replacement reserve, these public housing funds must be used for public housing purposes; specifically, the portion of this reserve replenished with operating subsidy or tenant rents must either stay with the project to support public housing capital expenses or must be returned to the PHA to support other public housing expenses.
- **Exit Tax Reserve:** Mixed-finance projects that involve tax credit financing may include a reserve to pay for the investor limited partner's exit taxes at the end of the compliance period. Public housing funds (including public housing tenant rents) may not be used to capitalize, or to make incremental contributions to, the Exit Tax Reserve as this expense is not an eligible use of operating subsidy. The mixed-finance public housing units must be public housing replacement units.

### **Use of Operating Subsidy for Reserves**

In a mixed-finance project, some portion of the PHA's operating subsidy is allocated to the project's public housing units. (Chapter Five of the Mixed-Finance Guidebook discusses a number of approaches to allocating operating subsidy.) The amount of subsidy and the manner in which it is allocated must be negotiated between the PHA and the developer, documented in the Regulatory and Operating Agreement and approved by HUD. Operating subsidy may only be used for "allowable" public housing operating expenses. HUD has made the following determinations with regard to the use of operating subsidy for reserves:

1. Initial funding of operating reserves is not an allowable use of public housing operating subsidy. Public housing capital funds may be used only to establish an Initial Operating Period Reserve. Otherwise, all operating reserves must be

funded initially from tax credit syndication or other nonpublic housing development proceeds.

*EXAMPLE: As a condition of making their initial contribution, a project's tax credit investors require the establishment of an operating subsidy reserve equal to three years of the projected ACC needs for the development. The Owner Entity may not capitalize this reserve from public housing operating or capital funds but may use tax credit equity or other nonpublic housing financing.*

2. Operating subsidy and public housing tenant rent contributions may be used to fund a proportionate share of the annual contributions to a replacement reserve, depending upon the number of public housing units versus nonpublic housing units in the development. In the case of Replacement Reserves, HUD allows operating subsidy to be contributed to the reserve over time. In other words, an owner entity may provide operating subsidy and public housing tenant rents, in addition to market rate rents, incrementally over time to the reserve account.

*EXAMPLE: An owner entity agrees to allocate \$250 per unit per year for all units to fund the development's Replacement Reserve. If there are 100 public housing units and 50 nonpublic housing units, \$25,000 of public housing income (which may be a combination of operating subsidy and public housing tenant rents), and \$12,500 of nonpublic housing rents would be deposited into the reserve account each year.*

3. Operating subsidy and public housing tenant rents may be used to replenish reserves under certain conditions. In the case of Operating Deficit Reserves and Operating Subsidy Reserves, HUD has determined that operating subsidy may only be used to replenish the reserve, meaning that operating subsidy can replace funds that have been disbursed for allowable public housing expenses. A PHA may not agree to make incremental contributions of operating subsidy to the reserve account; it may only agree to replace funds which have been disbursed for allowable public housing expenses for the project. Furthermore, operating subsidy can not be used to increase the initial funding level of the reserve account except for funding increases that are consistent with the Consumer Price Index.

*EXAMPLE: A project's Operating Deficit Reserve is initially funded with \$300,000 of tax credit equity. In Year 4, there is a \$10,000 operating subsidy shortfall and funds must be drawn from the reserve account. At this point, the PHA can provide \$10,000 in operating subsidy to replenish the Operating Deficit Reserve. However, the contribution of operating subsidy cannot exceed the amount disbursed, meaning that the subsidy cannot be used to increase the value of the reserve to more than \$300,000.*

4. No operating subsidy, public housing tenant rental contributions, or other public housing funds may be used to fund or replenish an Exit Tax Reserve.

*EXAMPLE: A project's exit tax liability is estimated at \$500,000. An exit tax reserve of up to \$500,000 may be capitalized from tax credit equity as part of the development budget.*

## **Long Term Ownership and Use of Reserve Funds**

HUD requires that the portion of the reserves capitalized or replenished with public housing funds, other than the Exit Tax Reserve, be used for public housing purposes and may not be used for items such as deferred developer fee or debt repayment.

The portion of any reserve that is funded with operating subsidy or tenant rents may be used only to pay for an expense that is an eligible use of operating subsidy or public housing funds. Ineligible uses such as partnership exit taxes or deferred developer fee must be funded from nonpublic housing sources. If public housing funds are used to replenish reserve accounts, projects will need to track which funds are contributed from HUD sources (including operating subsidy, public housing tenant rents, and program income) and which are from other sources such that other sources pay for any ineligible uses.

## **Establishing Reserves with Excess Operating Subsidy**

Although operating subsidy is provided to cover only reasonable and necessary project expenses and is therefore not consistent with the notion of a surplus, short-term surpluses can result from income and expense projections which are inaccurate. In the event that operating income exceeds expenses with respect to public housing units, excess public housing operating subsidy and/or tenant rents may be (1) remitted to the Public Housing Authority to be used for eligible operating subsidy expenses; (2) retained by the owner entity to reduce operating subsidy the following year; or (3) PHA may establish may establish a reserve under the following conditions:

- the Housing Authority must control the funds and have ownership of the account;
- the Housing Authority should deposit excess operating subsidy and/or tenant rents into a separate funding account;
- the reserve must be established for a specific project;
- the funds in the reserve must be used for eligible operating subsidy uses and must be expended in accordance with applicable public housing requirements; and,
- the Regulatory & Operating Agreement (or another document) should provide the conditions whereby the reserve funds may be expended.

Upon completion of the compliance period, a Housing Authority may use the reserve funds for other eligible operating subsidy uses. If the mixed-finance development generates a short-term operating surplus, the PHA will generally be eligible for a lower level of operating subsidy in the following year, on an aggregate basis for all projects under the same ACC. However, the impact of the reduction on the PHA's subsidy payment obligation to the owner depends on the terms of the Regulatory & Operating Agreement. If the mixed-finance project has its own ACC, any decrease in subsidy received by the PHA should be passed through to the project and the should be outlined as such in the Regulatory & Operating Agreement.

## Summary

The following chart summarizes the types of reserves and the availability of operating subsidy and/or tenant rents to funds those reserves:

<b>Type of Reserve</b>	<b>Eligible Use of Operating Subsidy/ Public Housing Tenant Rent</b>	<b>Long Term Use of Reserve</b>
Initial Operating Period Reserve	Initial Funding: Public Housing Development Funds  Subsequent Funding: N/A	The reserve must be used for public housing purposes and may not be used to pay nonpublic housing eligible expenses.
Operating Deficit Reserve and Operating Subsidy Reserve	Initial Funding: NO Subsequent Funding: YES, but only to replenish funds disbursed for allowable public housing costs.	The portion of the reserve funded with operating subsidy or tenant rents must be used for eligible operating subsidy purposes, or returned to the PHA for eligible operating subsidy purposes.
Replacement Reserve	Initial Funding: N/A Subsequent Funding: YES, incremental contributions are allowed.	The portion of the reserve funded by operating subsidy or tenant rents, must be used for eligible operating subsidy purposes, or returned to the PHA for eligible operating subsidy purposes.
Exit Tax Reserve	No use of HUD funds (including public housing tenant rents) is allowed.	The reserve is owned by the Ownership entity.

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<sup>1</sup> Operating Subsidy Reserve is also called "ACC Reserve," "PHA Reserve" or "Affordability Reserve."