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Understanding Prepayment Options
Section 515 Rural Rental Housing Loan Program

USDA Rural Development's Section 515 Rural Rental Housing borrowers may seek to pay their USDA account in full *ahead of schedule* and thus remove their project from USDA rules. This is referred to as "**prepayment**". Prepayment is not a simple process because it carries a number of ramifications. The owner must consider:

1. Financial feasibility – Prepayment will terminate USDA's Rental Assistance. Given the nature of the project and local market, will the project be economically viable as conventional rental housing?

2. Tax consequences – If a sale of the property is planned, this could have very serious tax ramifications. Many years of deferred taxes may become due. Be sure to review these consequences with a tax professional.

3. Problems with the property – Many prepayment incentives are contingent on deferred maintenance first being addressed and delinquent reserve accounts being fully funded. If the property has problems, correct them first.

4. Tenant & public reaction – The prepayment and resulting loss of affordable housing is controversial because of its impact on low income tenants. It involves public notices and often attracts public scrutiny and comment.

5. California State law – Even though Section 515 projects are federally financed, California State law imposes several restrictions on owners of Section 515 rental housing wishing to prepay their loans.

6. USDA prepayment regulations – USDA regulations limit owner options on prepayment

Alternatives to prepayment

Owners wishing to relinquish their 515 rental housing responsibilities and be released of liability need not always prepay to accomplish this. There are some simple alternatives:

1. Partial membership change – Any <100%-owner may transfer his/her ownership interest to another or to an heir. This must be approved by USDA, but it requires little paperwork and is generally easily accomplished.
2. Gradual membership transition – All <100%-owners may transfer their ownership interests to others or to heirs, provided no more than 100% ownership change occurs within 12 months time. This must be approved by USDA, but it requires little paperwork and is generally easily accomplished.
3. Limited partner changes – Limited partners can transfer their ownership interests to others, including heirs, without prior USDA consent.

Alternatives requiring some USDA processing and approval, but faster & less complex than prepayment:

4. 100% membership change – Transfer 100% ownership interests to others within a 12-month period
5. Assumption without transfer – Have another entity assume your USDA loan, with title and collateral remaining unchanged
6. Transfer and assumption – Transfer your property to another entity who assumes your USDA loan.

California State Law

State law governing prepayment is contained in Government Code Sections 65863.10, 65863.11, & 65863.13. You can find a summary of the State's requirements on the State of California's web site at:

http://www.hcd.ca.gov/hpd/hrc/tech/presrv/

Generally, there are two requirements in State law:

1. Notice. 12 months and 6 months prior to prepayment, the owner must notify all tenants, the local government, and the State of the proposed prepayment.
2. Offer to Sell. 12 months prior to prepayment, the owner must offer the property for sale to everyone on a state-maintained list of prospective purchasers who are willing to assure the long-term affordability of the housing. For 180 days, these prospective purchasers have an exclusive right to make an offer. For an additional 180 days thereafter, any of these prospective buyers that made an offer but was rejected still maintains a right of first refusal.

Owners may wish to seek legal advice on State laws affecting prepayment.

Because of the 12-month notice and offer requirements, owners will need to have begun to comply with State law before applying for prepayment with USDA.

USDA prepayment regulations – RD Instruction 1965-E

USDA's rules governing prepayment come from the Emergency Low Income Housing Preservation Act of 1987 (ELIHPA) and are contained in RD Instruction 1965-E. For a complete copy:

http://www.rurdev.usda.gov/regs/regs/pdf/1965e.pdf

RD Instruction 1965-E requires the owner go through several steps before being allowed to prepay. In these steps, USDA seeks to avert the loss of the affordable housing by developing alternatives to prepayment.

If an acceptable alternative is found, the owners are asked to consider alternatives from USDA in return for a new 20-year restrictive use period

Eligibility to prepay

Not all Section 515 borrowers can prepay. Prepayment rules vary depending on when USDA made its original loan to build the property and what additional loans or servicing actions have occurred since.

There are four categories of Section 515 projects:

"Unrestricted"	"Restricted"	"Extended"	"Prohibited"
Initial loans approved before 12/21/1979 with **no** subsequent loans or servicing actions	Initial loans approved from 12/21/1979 to 12/14/1989 with **no** subsequent loans or servicing actions	"Unrestricted" and "Restricted" loans which received subsequent loans or servicing action	Initial loans approved after 12/14/1989
No restrictive use period	20-year restrictive use period	20-year restrictive use period from the date of last subsequent loan or servicing action	No prepayment for life of loan, i.e.: ➢ 50 years for loans 12/15/1989 to 11/17/1997 ➢ 30 years for loans after 11/17/1997
May prepay at any time subject to the 1965-E process*	Must honor 20-year restrictive use period, though may prepay at any time subject to the 1965-E process*	Must honor latest 20-year restrictive use period, though may prepay at any time subject to the 1965-E process*	**These loans may NOT be prepaid.** (The 1965-E process does not apply to them.)

***The "1965-E" process**

The owner must submit a written request to prepay their loan, including evidence of their financial ability to do so. The owner must also submit other information so that USDA can evaluate the request. (USDA-California has developed a streamlined "Request for Prepayment of MFH Account" format that may be used for this purpose.)

Step 1. Inducements to avert prepayment.

Initially, USDA seeks agreement with the borrower to continue with the property as affordable housing.

a. Voluntary reconsideration (*only for Restricted/Extended projects whose restrictions have NOT yet expired*).

(Such requests are unusual, since there is generally no benefit in prepaying while restrictions are still in force.)

USDA formally asks the owner to (a) re-enroll the property as affordable housing for an additional 20-year restrictive use period or (b) agree to sell the property a non-profit or public body.

Owners are not required to agree to this request, but they are required to consider it and respond in writing.

b. Incentives (*only for Unrestricted projects and Restricted/Extended projects whose restrictions have expired*).

USDA offers the owner financial incentives to re-enroll the property as affordable housing for an additional 20-year restrictive use period.

Incentive offers by USDA are discretionary and therefore not subject to any appeal. Owners are not required to accept the incentives, but they are required to consider them.

Owners who are seriously willing to consider incentives to avert prepayment will be made a detailed offer after a full analysis by USDA – i.e., Specific Incentives

Owners who are firmly committed to prepayment and unwilling to accept incentives regardless of their content may be quickly provided a generic offer – i.e., General Incentives

Incentives may consist of one or a combination of the following:

NOTE: Comparable rent sets a cap on the extent of the incentives that can be offered. Incentives can only be offered if the resulting basic rent needed to pay for them does not exceed the comparable market rent.

i. Increased return on investment (RTO)

Typically, RTO on USDA projects is relatively small. This incentive offers the owner the chance to increase their annual RTO from the project.

The increased RTO is typically 8% of the owner's recalculated equity position based on 100% of the project's current appraised value as unsubsidized, conventional rental housing.

The advantage to this approach is that there is no waiting for loan funds and can be quickly approved.

The disadvantage to this approach is that the owner gets no immediate cash.

Example:

Current project value	$1,500,000	based on appraisal + reserves balance
USDA debt	-$ 900,000	
Recalculated equity	$ 600,000	
Rate of return	x 8%	
Increased annual RTO	$ 48,000	

ii. Equity incentive loan

This incentive gives the owner cash from a new equity loan.

The amount of the incentive loan is typically the difference between the USDA debt and 90% of the project's current appraised value as unsubsidized, conventional rental housing.

The advantage to this approach is that the owner gets cash.

The disadvantage to this approach is that USDA's equity incentive loan funds are very limited.

In FY04, $5 MM was available. Depending on demand for funds, owners may have to wait to get this incentive.

Owners may elect to receive an equity incentive loan from a third-party source. This money is readily available, but, because such funds are more expensive than USDA's, the size of the incentive loan is typically reduced.

Note that receiving an equity loan will reduce equity and thus reduce any increased RTO incentive.

Example:

Current project value	$1,500,000	based on appraisal + reserves balance
	x 90%	
Discounted FMV	$1,350,000	
USDA debt	-$ 900,000	
Equity incentive loan	$ 450,000	

iii. Withdraw excess reserve funds

If the project has capital reserve funds in excess of that required by the loan agreement, the borrower may be allowed to withdraw this excess cash.

iv. Transfer incentives

If the owner has a buyer interested in the property, it can be arranged to transfer the property along with equity incentives to the new owner.

The property's existing USDA debt may be assumed by the buyer. USDA can also finance some or all of the equity in the property, either through a subsequent USDA loan or 3rd party financing (with a subordination or junior lien).

USDA can finance:

95% of the fair market value – for-profit buyers of tax credit projects – with a 20-year affordability contract
97% of the fair market value – for-profit buyers of non-tax credit projects – with a 20-year affordability contract
100% of the fair market value – for-profit buyer – with a 30-year affordability contract
100% of the fair market value – nonprofit or public buyers – with a "remaining useful life" affordability contract

In FY04, $1.0 MM was available to finance sales to nonprofit or public buyers, and $4.0 MM was available on a competitive basis for "innovative approaches" transfers.

v. Other incentive features

USDA may provide interest rate reduction, reamortization, and additional Rental Assistance to pay for these.

If incentives result in rent overburden, USDA is required to provide Rental Assistance with its incentive offers.

Step 2. Final evaluation of preservation alternatives after failure of incentives
If owner rejects USDA's incentive offer, prepayment becomes an imminent possibility. At this point, 1965-E requires that USDA evaluate the likely affect of the loss of the project on affordable housing needs:

a. *If housing opportunities for minorities will be materially affected*, USDA will require the owner to seek a nonprofit or public body buyer for 180 days, as outlined below.
(The owner has the right to appeal USDA's determination on this issue.)

Attempt sale to nonprofit or public body
The sales price offered must be the project's current appraised value as unsubsidized, conventional rental housing. (If USDA's appraisal is disputed by the borrower, additional appraisals may be obtained to establish a fair price.)
The owner must contact interested nonprofits & public bodies and advertise the property for 180 days.

If a *bona fide* buyer materializes, USDA will help finance the sale through a transfer & assumption and possibly an equity loan (or USDA may agree to a subordination for third party equity loan)
USDA may provide interest rate reductions & more Rental Assistance to pay for equity loan
USDA may make a $10,000 grant to the nonprofit/public buyer for its due diligence & packaging costs
In FY04, $1.0 MM was available from USDA for equity loans in connection with such sales. (This is the same pool of funds mentioned under "Transfer incentives" above.)

If no *bona fide* buyer surfaces, the owner may prepay without further restrictions
Displaced tenants receive a Letter of Priority Entitlement to move into other USDA projects.

b. *If housing opportunities for minorities will **not** be materially affected*, USDA must determine if there is adequate affordable housing in the market area for the existing tenants

i. *If there is not an adequate affordable housing in the market area for the existing tenants*, the borrower may prepay but the existing tenants must be protected for the duration of their tenancy (i.e., they must be assured affordable rent).
(The owner has the right to appeal USDA's determination on this issue.)

ii. *If there is an adequate affordable housing in the market area for the existing tenants*, the borrower may prepay without further restrictions.
Displaced tenants may receive a Letter of Priority Entitlement to move into other USDA projects.

Prepayment sequence and timeline

Owner evaluates prepayment decision, decides to seek prepayment

Owner mails & posts 12-month notice to tenants, local government, & State (*per California State law*)
Owner mails offer to sell property to all prospective purchases on State-maintained list (*per California State law*)

90 days

Owner submits complete prepayment request to USDA

USDA reviews prepayment request

- USDA confirms eligibility for prepayment & acknowledges request is complete
- USDA notifies nonprofits & public bodies interested in preservation of the prepayment request
- USDA notifies tenants of prepayment request
- USDA evaluates importance of the project & begins incentive offer calculation
- USDA orders appraisal (if "Specific Incentive" will be offered)

30-day tenant comment period + 20 days

USDA makes incentive offer

30 days

Owner accepts incentive offer
(go to Path #1 below)

Owner rejects incentive offer
Owner sends 6-month notice to tenants, local government, & State (*per California State law*)

15 days

USDA determines minorities are not materially impacted
(go to Path #2 below)

USDA determines minorities are materially impacted

- USDA asks owner to attempt sale to nonprofit/public body, gives appeal rights
- USDA notifies tenants
- Appeal process – if requested by owner
- Establish fair market value sales price from appraisal(s)

Owner & USDA develop sales materials & marketing plan

10 days

Owner offers property for sale to interested nonprofits & public bodies

- Owner writes prospective nonprofit & public buyers
- Owner advertises for 180 days
  - First 60 days – advertise locally
  - Last 120 days – advertise locally & nationally

180 days

Bona fide offer from nonprofit or public body
(go to Path #3 below)

No *bona fide* offer from nonprofit/public body
(go to Path #4 below)

Path #1

Owner accepts incentive offer
USDA notifies tenants of resolution
USDA notifies interested nonprofits & public bodies of resolution

Process incentives
If transfer & assumption is part of incentives
USDA processes transfer & assumption application
If equity loan and/or additional RA is part of incentives
USDA processes any equity financing application – subsequent loan or 3rd party financing
Await funding of equity loan & additional RA

Close incentives with new restrictive use period
USDA notifies tenants
USDA notifies interested nonprofits & public bodies

Path #2

USDA determines minorities <u>are not</u> materially impacted

15 days

USDA finds there will still be <u>adequate</u> safe, decent, & affordable housing in market area without the project (<u>go to Path #4 below</u>)

USDA finds there will be an <u>inadequate</u> supply of safe, decent, & affordable housing in the market area without the project

USDA notifies borrower prepayment may be accepted, BUT all existing tenants must be assured rent affordability for the remainder of their tenancy
USDA notifies tenants
USDA notifies interested nonprofits & public bodies

60-180 days

Owner executes agreement protecting existing tenants rent affordability
Prepayment accepted; collateral released

Path #3

Bona fide offer from nonprofit or public body

Process purchase by nonprofit or public buyer
USDA may provide $10,000 technical assistance grant to buyer for legal, technical, & packaging costs
USDA processes transfer & assumption application
USDA processes any equity loan application – up to 102% of appraised value
Await funding of equity loan
USDA processes subordination if 3rd party equity loan is used

Close sale to nonprofit or public buyer with new restrictive use period
USDA notifies tenants
USDA notifies interested nonprofits & public bodies

Path #4

There is an adequate supply of affordable housing
OR There was no *bona fide* offer from a nonprofit or public buyer

↓

USDA notifies borrower prepayment may be made in 60-180 days
- USDA notifies tenants, offering Letters of Priority Entitlement to other USDA projects
- USDA notifies interested nonprofits & public bodies

↓ *60-180 days*

Prepayment accepted; collateral released