Housing Trust Funds: Addressing America's Affordable Housing Crisis

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In the last half of the twentieth century, the U.S. Department of Housing and Urban Development (HUD) has stimulated the construction of assisted housing for the nation's elderly and working poor by providing low-interest loans, interest buydowns, direct loans, capital grants, and Section 8 housing assistance contracts to both for-profit and nonprofit developers, many of which are operated by faith-based organizations. In many cases, the original board of directors of the owner corporation is responsible for operating the nonprofit development; not surprisingly, these boards have aged. In a few cases, the nonprofit owner has recruited new membership in affordable or assisted housing, and the board is active and interested in continuing its original mission. In most cases, however, the board is tired, not interested in continuing to govern the project, and looking for a credible exit strategy that guarantees the units continue to be available for the low-income residents at their current rent levels.

This scenario has led to housing trust funds in combination with restructuring, a very effective program for preserving existing HUD-assisted housing, maximizing the value of these real estate assets, and creating new affordable housing inventory and improved services. The trust funds discussed in this commentary are not the same of those established by state and local governments and funded by public revenue sources. The trust fund type analyzed here derives its funds from a specific housing development. This program accomplishes the following major goals:

1. Continues to accept HUD Section 8 housing assistance contracts and provide the assisted units for qualifying elderly, handicapped, or economically disadvantaged families
2. Provides affordable housing for a minimum of fifty-five years in California (thirty years in other states) in accordance with the requirements of the Low Income Housing Tax Credit (LIHTC) program
3. Facilitates the complete rehabilitation of the property to current code requirements and to like-new condition using the advantages of the LIHTC program
4. Significantly enhances the community-use facilities available for the residents of the development

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5. Significantly enhances the quantity and quality of social services available to the residents of the development to assist them in improving the overall quality of their life
6. Provides proceeds to the original owner, restricted to investments or expenditures for furthering the overall quality and quantity of affordable housing available nationally, to reduce the extreme shortage of affordable housing for qualifying families

What is surprising, actually astonishing, is that these goals have been met without new legislation or a new housing development initiative by the federal government. This has all been accomplished by converting the equity in these buildings into liquidity at a time when there are no other sources of development moneys to assist with the housing shortage. Although managers of the existing properties, for whom reserves and equity can never be sufficient, might be somewhat reluctant to participate, the existing inventory will decline if there is no program for stimulating some new development.

Historic Perspective

HUD has utilized four primary programs for financing or stimulating the development of multifamily subsidized housing: Section 236, Section 202, Section 221 (d)(3), and Section 221 (d)(4). Under some circumstances it is possible for the owners of such housing to refinance or sell these projects to either nonprofit or for-profit developers. The sale of a property allows the owner to take out his equity in the property at the time of sale.

A nonprofit owner taking equity from a sale could be said to have profited from ownership of the project, which would render the owner in default of the terms of its nonprofit designation; therefore, the equity cannot be handled in the same manner as it would be if the original owner were a profit-motivated developer. The equity in the case of a nonprofit owner would be termed *sales proceeds*, and those proceeds would be subject to Internal Revenue Service (IRS) regulations. The IRS would evaluate all outlays on the annual tax return for consistency with the purpose of the organization as stated in the application for the 501(c)(3) designation. In other words, if the entity is organized for the purpose of providing care for senior citizens, the IRS would screen all documentation proving that the outlays were consistent with that purpose.

HUD has an overriding interest in the use of these proceeds created by the housing resources of the federal budget. In Southern California, HUD, with approval from headquarters, has directed that 75 percent of the proceeds of such a sale be used for the more narrow purpose of expanding the inventory of affordable housing or for improving the social services provided to the residents of affordable housing. HUD does not expect a nonprofit organization with sales proceeds to have an immediate plan for investment of those proceeds, so it has allowed a housing trust fund to be established for the investment of those proceeds over five years, with the possibility of one five-year extension. This concept was first utilized by the Los Angeles Multifamily Hub in the sales of Section 236 projects from nonprofit owners to profit-motivated entities, but it applies to all transactions in which a nonprofit owner accrues sales proceeds from a HUD project.

All existing inventory has regulatory agreements that will expire, causing valuations to increase. If nothing is done now while the opportunity exists, HUD and the nation's economically disadvantaged population will be faced with a more serious housing crisis.

What Is a Housing Trust Fund?

A housing trust fund is an account, semicontrolled by local HUD officials, set up to manage proceeds from the sale of nonprofit HUD-assisted housing. Its purpose is to assure that the proceeds are used for expansion of the affordable housing inventory or for services to residents of affordable housing projects. The term *semicontrolled* conveys that the trust fund is not wholly controlled by the local HUD office. In fact, the trust fund is controlled by a nonprofit owner corporation that was established as a single-purpose entity in the original development of the project, and HUD's role is limited to assuring that outlays from the trust fund are consistent with the stated purpose of the trust fund. The local HUD official responsible for the oversight and concurrence is the director of the Multifamily Hub for the jurisdiction in which the project is located.

When Is a Housing Trust Fund Indicated?

A housing trust fund is not required for the management of a nonprofit owner's sales proceeds. If the seller has an investment opportunity for the full amount of the proceeds generated by a sales transaction, it can, at the discretion of the director of the Multifamily Hub (of HUD), divert the proceeds to that purpose without establishing a housing trust fund. If there is no immediate acceptable use for the proceeds, then a housing trust fund must be established using a format published and approved by the Hub director.

Thus far, we have not seen any proposals that would not require a housing trust fund. Typically, sales proceeds for a 100-unit development can approach $2 million, depending on numerous factors, and we have not found sellers who have extensive plans for their proceeds prior to closing the sale transaction. If the nonprofit seller of a Section 236 project has no immediate plans for any portion of the proceeds, a housing trust fund will be established for 75 percent of the total amount of the proceeds. Most sellers have some plans for the use of the proceeds, but many details have to fall into place before they can commit to using their available assets for their intended purpose. For instance, a nonprofit seller might require the proceeds to be used as the cash to close another HUD-assisted project. That seller has the commitment from HUD but cannot close the new deal without the cash made available by the sale transaction. He is in a position to use as much as 50 percent of his proceeds as an immediate infusion of cash into the new project but has no plans for the remaining balance; therefore, a housing trust fund will be established, at the discretion of the Hub director, either for at least 75 percent of the remaining balance of the proceeds or for 75 percent of the entire proceeds. If a nonprofit seller is organized for the sole purpose of owning a HUD-assisted property, that purpose would be reflected in both the Articles of Incorporation and the IRS 501(c)(3); thus, there would be no difference between the 75 percent trust fund and the 25 percent IRS funding in the seller's ability to commit its proceeds.

Restrictions of the Housing Trust Fund

Seventy-five percent of the total proceeds of a sale by a nonprofit owner will be placed into a housing trust fund; the beneficiary of the trust (the seller) will originate outlays from that fund with final approval by HUD (local Multifamily Hub director).

HUD restrictions placed upon the housing trust fund outlays include the following:

1. **Development of Affordable Housing.** The owner may use the trust amount to acquire, develop, preserve, construct, and/or rehabilitate affordable housing units in markets where there is a proven need for additional affordable housing.
2. **Ownership or Investment in Affordable Housing Units.** The owner may use the funds in the trust account to own or invest in affordable housing units in compliance with either 2(a) or 2(b).
   a) **Ownership of Affordable Housing Units.** The affordable housing units may be owned by the owner directly or by (i) a partnership in which the owner is a general partner, (ii) a partnership in which the owner is a limited partner, (iii) a limited liability company in which the owner is a member or manager, or (iv) a corporation sponsored by or affiliated with the owner. The parties acknowledge that different financing sources such as LIHTCs or HUD-insured or capital advance financing may necessitate that the owner have a de minimis ownership interest in any such partnership or limited liability company or that a single-asset, single-activity corporation be created; such de minimis or separate corporate ownership interest will satisfy the ownership terms and conditions of the agreement.
   b) **Loans and Investment in Affordable Housing Units.** The owner may use the trust account to make a loan to or an investment in an entity developing, preserving, constructing, and/or rehabilitating affordable housing units as long as the owner retains an ownership position in such entity in accordance with paragraph 2(a) above.
3. **Expenses for Affordable Housing Units.** The owner may use the trust account for any expenses related to the predevelopment, acqui-

sition, development, preservation, construction, and/or rehabilitation of affordable housing units. Such expenses may include, but will not be limited to, the following:

a) Predevelopment and development costs
b) Application fees, loan fees, and discounts
c) Appraisal, consultant, legal, architectural, and engineering fees
d) Rental subsidies
e) Reasonable administrative and office overhead expenses
f) Reasonable insurance costs
g) Fees for consultants assisting in evaluating affordable housing opportunities
h) Corporate filing fees, franchise, business, and other related taxes
i) Trustee fees and other fees related to administration of the trust account

The remaining twenty-five percent of the total proceeds of the sale will be under the control of the seller and will be restricted only by the IRS regulations for the nonprofit seller. These restrictions are not shown here.

History of Existing Housing Trust Funds

The first local housing trust fund to be established in Los Angeles was Northwest Manor I & II in Pasadena, California. That trust fund was followed by Montebello United Methodist Church and Long Beach First Congregational Church. Other trust funds still in process include Cathedral Towers in San Diego, Golden West Terrace in Torrance, Beth Am Manor in Los Angeles, and Anaheim Gardens in Harbor City (Los Angeles). There were at least ten additional restructuring transactions in progress on January 1, 2005, that could spawn local housing trust funds.

Vision for the Future of Housing Trust Funds

With the growing demands on the federal budget, it is becoming less likely that this administration will introduce any new housing development initiatives during its tenure. Growth of the only tool for preservation of existing housing and development of new housing, the LIHTC program, is not forecast either. The need for housing will undoubtedly significantly increase as older buildings are removed from occupancy and new development is profoundly limited.

Housing trust funds have traditionally been used by local government agencies to create "revolving" accounts that funnel money into the housing sector in exchange for both set-asides for affordable housing and return of the original loan with sufficient interest to keep the fund in existence. Recently this concept has been adopted by the Los Angeles Multifamily Housing Hub of HUD to assure the set-aside of proceeds earned by certain sales transactions. A project can be restructured through a sale to a limited partnership, which will use the LIHTC program to rehabilitate the units and extend their affordability for fifty-five years (in California) from the initiation of the transaction. This sale allows the original owning entity to extract its equity from the project. Since a nonprofit seller is unable to withdraw equity as profit, it must establish either (1) an immediate need for the money for a contribution to other affordable housing (or services for residents of affordable housing), or (2) a housing trust fund to assure the eventual use of the money for the intended affordable housing needs.

In Southern California alone, there are over 400 projects that are potential sales/restructures and housing trust funds. We project the establishment of a hundred trust funds throughout Southern California. The average trust fund would control about $2.5 million. We could see a hundred, or more, individual organizations each competing for the attention of housing developers or preservationists, competition that would drive down the effectiveness of the funds due to the pressure to use the funds and attain results very quickly. This would be counterproductive, minimizing the intended impact of these moneys.

A superior approach would be to network these funds, and the owners of trusts, to provide consistent and informed leadership and to facilitate the efficient and fair administration of the funds for optimum impact on the affordable housing inventory. Ideally, there would be one point of contact for developers of affordable housing seeking loans or grants; this point of contact would have the resources of all the trusts combined to assist in housing those families or people in the community earning less than 80 percent of the median income for the geographical designation. The point of contact would assist the trust fund owners and assure HUD that it is pursuing the most effective uses of the trust fund proceeds with the full intention of meeting the trust fund requirements.

This central point of contact is a new function that complements HUD's requirement for administration of a housing trust fund: HUD's concern is that a qualified governmental agency, either HUD itself or a substitute city or state agency or local housing authority, be identified as "administrator" and have the single duty of assuring that the monies expended by a housing trust fund are for affordable housing or for supportive services for affordable housing residents. The point-of-contact concept is, essentially, an advisory-type clearinghouse for the owners of all local housing trust funds. It would be important to maintain the impartiality of this clearinghouse and not ally it with an existing housing provider that has an established agenda.

Conclusion

The nonprofit owners of HUD-assisted projects (that is, projects with a Section 8 Housing Assistance Payment Contract, a below-market rate interest loan, or an interest buydown [Interest Rate Payment] under the Section 236 program or the Section 223(d)(3) program) should consider the benefits of restructuring at this time. Typically those projects nearing their twentieth year of operation are in need of sufficient rehabilitation, modernization, and/or code upgrades to justify the use of LIHTCs in sale and restructuring transactions.

The boards of nonprofits organized about twenty-five years ago often encounter declining interest in governing these projects and want to assure the future of the projects once the boards are no longer in the picture. A board, or its management agent, should contact potential buyers to determine which of them will most closely meet the requirements of the board for a sale and restructure transaction. The board should look for purchasers who will guarantee to continue to accept HUD's assistance, guarantee affordability for at least fifty-five additional years, rehab the project to like-new condition, and enhance the supportive services provided to the resident population.

Nonprofit owners must use the proceeds of such sales in accordance with HUD (and IRS) regulations. For those nonprofit owners who have no immediate affordable housing–related plans for their sales proceeds, there is an attractive alternative that addresses America's affordable housing crisis: housing trust funds.