

Chapter 16

Master Lease Structuring to Facilitate the use of Historic or New Market Tax Credits

16.1 Introduction

This chapter addresses the use of Master Leases when Historic and/or New Markets Tax Credits are used in conjunction with an FHA-insured loan. These transactions may or may not have Low Income Housing Tax Credits (LIHTCs) as well. HUD's goal is to accommodate this type of structuring without compromising appropriate regulatory oversight and controls.

This chapter does not address ground leases or leasehold interests in an entire project for purposes other than Historic or New Market Tax Credits, commercial leases or sublease agreements (of either commercial space or residential units).

16.2 Background

Master Leases maximize the benefits of combining Federal or State Historic Tax Credits and New Markets Tax Credits. The projects may or may not use Low Income Housing Tax Credits as well. Investors and developers participating in these programs benefit from increased leverage for project financing and premium pricing for equity, while reducing the need for additional debt.

Typically, these leases are structured to permit a combination of investments by one or more investors under one or more tax credit programs in a single development project. A sample organization chart for a master lease ownership structure is included in Appendix 16A. Generally, the Master Lease structure involves the following parties, which often have total or partial identities of interest and common ownership:

- FHA Borrower – the Single Asset Entity (the Lessor for the Master Lease);
- Master Tenant – the lessee; and
- Master Lease Sub-lessees for Residential units, and for Commercial space.

The Master Tenant must pay the Borrower/Lessor rent that equals or exceeds the amount necessary to satisfy all financial obligations required under the insured mortgage and to operate the property in accordance with all HUD directives, regulations and contracts. The Master Tenant and all Master Sub-lessees (but not the individual residential and commercial tenants) will execute HUD Regulatory Agreements and submit financial reports to HUD.

The HUD Multifamily Regional Center or Satellite Office will be responsible for approving Master Lease ownership structures in accordance with this chapter's requirements. The Regional Center Director retains waiver authority, but waivers of any provisions of this chapter should be discussed with and reviewed by Headquarters (HQ) Office of Multifamily Production prior to approval.

16.3 General - Programmatic Requirements

In addition to other program requirements, the following are conditions for projects that use a Master Lease structure:

- A. The insured mortgage must be in first lien position with respect to all project collateral. The fee simple ownership in the land and improvements provides the security for the mortgage.
- B. All documents should include conflict language giving the HUD documents supremacy over other documents, except as otherwise permitted by HUD, and may not include indemnification provisions. In some cases, HUD may allow non-monetary matters such as affordability use restrictions to be recorded ahead of HUD's mortgage, but such variances are allowed only on a case by case basis.
- C. The Master Tenant and Master Sub-lessees must be single asset entities. Tenant-in-Common structures, Delaware Statutory Trusts, Maryland Business Trusts, Natural Persons, foreign entities are not eligible, though such entities may hold an "upper tier" interest in the single asset entities. The Master Tenant and Master Sub-lessees may not engage in any other businesses or activity, including the operation of any other rental project, or incur any liability or obligation except as permitted by HUD in connection with the project.
- D. The Master Tenant and Master Sub-lessees must execute the standard HUD Regulatory Agreement and Rider, to address various ownership and operational responsibilities with respect to the mortgaged property.
- E. The Master Tenant and Master Sub-lessees (as well as the Management Agent) must file management certifications and management entity profiles (Forms HUD-9839-A, 9839-B and -9832). HUD may require a management agreement to be terminated, in accordance with the terms and conditions contained in the management certification.
- F. Net rentable commercial area as a percentage of gross floor area and income will be determined in accordance with the applicable FHA program limitations.
- G. The Master Lease and all Sub-leases (sometimes collectively referred to as "Leases") shall be subordinate to the insured mortgage and subject to approval by HUD prior to execution. The Leases may not be modified or amended thereafter without the prior written consent of HUD and may be terminated by HUD in the event that the insured mortgage is assigned. Any proposed modifications or amendments to the Leases must be approved by HUD's Regional Counsel. The Leases must incorporate by reference the Regulatory Agreement, HUD rules,

regulations and directives, and contain an agreement to comply with their requirements. The Leases must include an obligation to pay all rent due to the Lender, in the event of a default under the loan documents. The loan documents may be amended to provide notice of default to the Master Tenant contemporaneously with the giving of notice to the Borrower/Lessor, and the acceptance of a cure of such default, during such notice period, from the Master Tenant on behalf of the Borrower/Lessor. Any such cure must occur prior to the assignment to HUD and will be limited to one opportunity to cure during each 12-month time period.

- H. Surplus cash determinations will be made in accordance with the Regulatory Agreements and will be made as if the entire project is owned and operated by one single purpose entity.
- I. All financial operations and reporting are governed by 24 CFR, Part 5, Subpart H.
- J. The rent paid by the Master Tenant must equal or exceed the monthly principal and interest payments due on the insured mortgage and all required escrows and reserves.
- K. All business agreements must be disclosed and are subject to HUD approval during loan underwriting (including, for example, inter- or intra-company loans, investor or outsider loans other than the insured mortgage, investor controls over operations, actions and deliverables that affect regulatory or contractual compliance or performance, etc.). The Firm Commitment will incorporate any conditions imposed by HUD with respect to such agreements.
- L. Any proposed payments (equity contributions, fees, income, etc.) to the Borrower, Master Tenant, Master Sub-lessees by a syndicator or investor must be disclosed to HUD and approved during loan underwriting, and thereafter be reflected on the annual financial statement filings and on any required monthly reporting. If such payments are made while any party is in non-compliance with the Regulatory Agreement, enforcement action will be taken against all principals in the organization, subject to the notice and cure provisions in above subsection E.
- M. Master Leases and Sub-leases must prohibit assignments or subleases (except to the end-users of the commercial spaces and apartment residents), unless previously approved by HUD in writing.

16.4 Processing Requirements

A. Firm Commitment Special Conditions:

1. The policies and procedures involving master lease structuring to facilitate the use of tax credits are incorporated herein and made a part of this Commitment for insurance of advances, specifically including, without limitation, the terms and conditions contained in Chapter 16 of the MAP Guide. All information submitted to HUD with the Application for Multifamily Housing Project, Form HUD-92013, to evidence the satisfaction of such terms and conditions shall be true and correct as of the date submitted and must continue to be true and correct at the time of Initial Endorsement.
2. This commitment is subject to, and has been issued upon the reliance of, the successful (a)

allocation to the project of LIHTC, Historic Tax Credits or New Markets Tax Credits and (b) syndication of such credits, with an appropriate agreement for the timely investment of equity, as shown on Forms HUD-2880 and HUD-92013, to assure completion of the project and pay other associated and incidental costs. In addition to the standard provisions that must be included in the organizational documents for the borrower entity, a provision must be added that prohibits any changes to the organizational documents that affect the obligations of the tax credit investor without the written consent of the Lender and HUD.

3. Notwithstanding the issuance of this commitment, this commitment remains subject to, and HUD's obligations hereunder are conditioned upon the satisfactory resolution, as determined by HUD, of the adverse items determined by HUD during the Previous Participation Review process.
 4. As an accommodation, this commitment has been issued and based upon schematic drawings, instead of the final Drawings and Specifications, if allowed by the State Historic Preservation Office (SHPO) and/or Memorandum of Understanding (MOU) for historic tax credits. At least 30 days prior to the scheduled date for initial endorsement, HUD must receive the final Drawings and Specifications for review and approval to ensure consistency of design and cost. In the event that there is a net cumulative construction cost increase or change in the design concept, if allowed by the State Historic Preservation Office (SHPO) and/or MOU for historic tax credits, or a net cumulative construction cost decrease in the amount of more than 5%, this commitment shall be subject to and conditioned upon the further approval of HUD, to be evidenced in writing, and may be terminated and voided by HUD, or additional conditions may be imposed, at HUD's option.
 5. (See Chapter 5 Section 5.6, Streamlined Processing Instructions for Projects Requiring Professional Design Services, for further policy guidance on the deferral of final plans and specifications at Firm Commitment when tax credits are involved.)
- B. The following forms should be revised to reflect the lease structure and HUD requirements:
1. Form HUD-92434M, Lender's Certificate - To include language that clearly states that the Master Tenant and Sub-lessees must report lease payments during the construction period as rental income.
 2. Form HUD-93305M, Agreement and Certification - To include language that clarifies that the Borrower must report all receipts and disbursements from the date of first occupancy and during the rehabilitation period for substantial rehabilitation cases.
- C. Each Master Lease or Master Sub-Lease must be recorded in the appropriate real estate records, along with the Regulatory Agreement executed by each Master Tenant or Master Sub-Lessee. These documents must also be included in Schedule B, Part II of the title insurance policy. In jurisdictions where recording these leases would result in a substantial tax, a Memorandum of Lease may be used. In lieu of recording the lease(s), a lease memorandum approved by the HUD Multifamily Regional Center Director, after consultation with field counsel, may be filed.

16.5 Cost Certification and Final Endorsement

- A. The Borrower/Lessor, the Master Tenant and all Master Sub-lessees will be required to cost certify the actual costs of the project unless the property contains Low Income Housing Tax Credits and HUD determines at the time of Firm Commitment issuance that it has a loan to cost ratio of less than 80 percent. The cost certification must contain a certification signed by an authorized agent of each entity, audited by a CPA or IPA, and contain a Schedule of Tax Credit/Syndication Proceeds that includes the following:
1. The amount of syndication proceeds received from the investing partner to date.
 2. The purposes for which syndication proceeds received as of the cut-off date were used.
and
 3. The dates, terms, and conditions under which future investor contributions are to be made.
- B. Total income of the Borrower/Lessor, including lease payments, is recognized during the construction/rehabilitation period.

If the replacement cost mortgage (Criterion 3) is not the controlling mortgage and there is excess NOI (net operating income) generated during construction, it may be applied to cover shortfalls in mortgageable soft costs, change orders, initial operating deficit and escrows. At Final Endorsement, funds not needed to cover shortfalls in costs or operating deficits may be distributed to the borrower or deposited into the project's Reserve for Replacement account or applied toward the amortization of the mortgage principal.

If Criterion 3 is the controlling mortgage amount, HUD will determine if the balance of the NOI is equal to or greater than 1% of the original mortgage amount and, if it is, will deduct this amount from the certified replacement cost. When the NOI does not meet this 1% threshold, it can be used toward shortfalls as noted above. Any remaining balance must be deposited into the project's Reserve for Replacement account at Final Endorsement and there is no distribution to the borrower. The Borrower/Lessor, Master Tenant and Master Sub-lessees are required to submit a certified operating statement which reflects the income collected and expenses incurred in accordance with the lease agreements and all documents required by HUD. Refer to Chapter 13 for further details on cost certification and the exemption from cost certification for LIHTC applications.

- C. A final Sources and Uses Statement must be included in the cost certification report as supplemental information and will be reviewed to determine actual sources and uses.