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MERRITT MESSENGER

THE NEWSLETTER OF MERRITT COMMUNITY CAPITAL CORPORATION

INSIDE THIS ISSUE:

KENT GARDENS *will be equipped with safety amenities that serve the needs of senior residents.*

Kent Gardens

Nonprofits and For-Profits Working Together

"Kent Gardens was the first project in California to close under the new Section 202 mixed financing guidelines," said Jennifer Dolin, the project manager for this Mercy Housing property. The HUD 202 program has been available to nonprofit housing developers and owners for the past 40 years. However, the program has recently been modified under "mixed financing" guidelines to allow participation by for-profit limited partner owners with nonprofit general partners. Mercy Housing California serves as the nonprofit in this partnership. Merritt Community Capital Fund X is the for-profit Limited Partner.

Eighty-three newly constructed units of affordable housing will be available to seniors this spring in the Ashland neighborhood of Alameda County when the construction of Kent Gardens Senior Housing wraps up. Mercy Housing California is the developer and guarantor for the property and will also be the property manager.

Development of Kent Gardens began in 2002, when Alameda County Redevelopment Agency purchased the land in order to build affordable senior housing. They put out a request for bids in 2003 and Mercy Housing California was selected to move forward with the project.

For more than 70 years the site where Kent Gardens is being built was a nursery. Environmental investigations detected pesticides and metals in the soil. Dieldrin was the only material that needed remediation. Six inches of soil from the site was removed, tested and dumped. This investigation and remediation process increased costs and caused delays in the start of construction.

The construction bid for Kent Gardens was originally developed in 2003. Then Hurricane Katrina hit the New Orleans area in 2005. Increased demand for construction materials resulted in a dramatic rise in estimated construction costs. Consequently, staff at Mercy realized that they needed more funding to complete the project. "We went back to HUD

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BERNARD T. DEASY

MESSAGE FROM THE PRESIDENT

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The Mortgage Meltdown – or Just Another Wall Street Lesson?

We all watched in horror as the Dow Jones headed south last August and has continued its decline into the first quarter of 2008. It seems that Wall Street is about to learn yet another lesson on the tricky subjects of risk and leverage.

Hardly the first time, but some of our financial types are really slow learners. This time the event was triggered by overcapacity in the mortgage business following years of low rates and a record volume of refinancing. This coincided with vast sums of capital seeking above market returns, mostly in the form of hedge funds and private equity funds. This "Perfect Storm" converged on unsuspecting borrowers to produce a huge backlog of non performing mortgages and an ensuing credit crunch in the mortgage markets. Those in the business of making fee income have made huge short term gains at the expense of homeowners who found out the hard way that "if it's too good to be true, it probably is."

While the Bear Stearns *High Grade Structured Credit Strategies Enhanced Leverage Fund* (that is some handle!) had a debt to equity ratio of about 17:1, some would be homeowners found themselves in a similar predicament. In a recent San Francisco Chronicle article, there were examples of Bay Area homeowners facing adjusted mortgage rates in excess of 10.5% with more adjusters kicking in over the next few years. Coupled with the fact that the market value of their homes was either flat or sinking, they found themselves in a genuine financial bind. If the property is worth less than the outstanding debt and the monthly payments are difficult if not impossible to make, then walking away may be the only viable response. If that happens on a large scale, then we may be in for some serious financial weather.

There are lessons to be learned from situations such as these, but what specifically are the relevant issues of concern for those of us in the affordable housing sector? First, it should be clear that homeownership is not always the best answer. Those at the entry home purchase level were often the most adversely impacted by the introduction of many of the new adjustable mortgage products. Loan features such as adjustable rates, negative amortization, teaser rates, annual resets, interest only loans and the like presented what looked like a real opportunity for homeownership, but in fact were really a basket of slick financial traps that may leave many of these families in a much worse financial predicament once the dust settles.

If we are to promote a Homeownership Tax Credit and homeownership in general for families in the lower Area Median Income groups, it is essential to create a comprehensive financial counseling and document review assistance program. Families need to understand the risks as well as the rewards of homeownership; that the value of residential property does not always grow at double digit rates and that debt is an obligation that must be met over the long term. Sure, there will be periods of lower interest rates in the future and a potential refinancing in the out years, but those are not sure things that can be relied upon. They may or may not happen. Making judgments now about the level and the structure of debt that one can reasonably handle over many years in the future is not an easy task for anyone, but information and the participation of knowledgeable housing finance counselors can be of great assistance to the first time homebuyer.

A New Year and a New Chairman – The Outlook for Merritt Capital

As I begin my term as Chairman of the Merritt Community Capital Board of Directors, I want to express the appreciation of my fellow Board Members and Staff to John Sheldon, the immediate past Chairman, and thank him for guiding Merritt over the past two years.

We moved through a very difficult market phase and, with the closing of Fund XI, we are in very good condition as we face a set of new challenges. Merritt Community Capital has raised over $300,000,000 in equity capital and invested in over 55 affordable housing developments since its founding in 1989 and we are very proud of this achievement. Needless to say, our first priority is to continue as a leading source of tax credit equity for nonprofit housing developers in California. However, during my term as Chairman of the Board of Directors, I plan to take a close look at our role as a successful nonprofit organization within our immediate community and explore new and nontraditional ways for us to make even greater contributions.

As we start 2008, we in the Low Income Housing Tax Credit investing business are facing a new and very uncertain outlook. The recent crisis in the subprime mortgage sector has spread like a Southern California wildfire throughout the financial markets, with huge losses being reported by such financial giants as CitiBank, Merrill Lynch and Morgan Stanley. It is also being reported that Fannie Mae and Freddie Mac may sharply reduce or entirely eliminate their participation in tax credit investments in 2008. Record losses on the part of major banks and the possible withdrawal of Fannie Mae and Freddie Mac from the tax credit market does not bode well for the affordable housing industry. While my crystal ball remains foggy as I write these notes, we at Merritt Capital are positioning the organization to weather the approaching storm.

In 2007, Merritt closed our Fund XI at $42,000,000 and placed the entire fund in four outstanding properties. So, as we start 2008, the slate is clean. We are evaluating several project investments and are reviewing plans to raise adequate capital at a reasonable return for our investors while maintaining the viability of our lower tier investments. Such a scenario requires caution. There is risk in any investment and we must not lose sight of that underlying principle. Sometimes, it appears that tax credit pricing bears no imprint of the analysis of risk and that may be a problem.

Low Income Housing Tax Credit investments are based on a partnership between the sponsor/developer and the investor entity, and partnerships need to operate to the benefit of both partners if they are to succeed over the long term. We plan to work closely with our project partners and potential investors to make sure we are on the market, while ensuring the viability of our prospective project investments. This will not be an easy task and will require a great deal of flexibility from all parties to any transaction. We need to place increased emphasis on the analysis of risk in our pricing models. This will require careful analysis of underlying real estate valuations, the asset management challenges over the 15-year project partnership and, finally, the exit strategy. All of these factors will be reflected in our pricing decisions. While we may need to move cautiously in the near term, we do anticipate moving forward with sound investments, just as we have done in past periods of volatility in the tax credit marketplace.

I also want to welcome our readers to a new format for the Merritt Messenger and I hope you will enjoy keeping in touch with Merritt via our newsletter.

BILL LOFTON

REPORT FROM THE BOARD CHAIR

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The California Tax Credit Allocation Committee Looks at the IRS 8823 Guide

Birute Skirdenis *is an Asset Manager and Trainer for Merritt Community Capital Corporation.*

Early in 2007, the IRS published its long promised Guide for Completing Form 8823. The Guide provides standardized definitions of the options on IRS Form 8823, the form used by state agencies to report noncompliance with Low Income Housing Tax Credit requirements to the IRS.

The IRS developed the Guide to encourage consistency among states in applying regulations. After attending an excellent training given by the California Tax Credit Allocation Committee's monitoring staff and hearing from folks who attended the 2007 National Council of State Housing Agencies' (NCSHA) Housing Credit Conference in San Francisco, it looks like the IRS may only partially reach its goal. While the 8823 Guide is a useful tool, states will still forge their own way through the compliance minefield, aided by national training organizations which can never satisfactorily cover the nuances of local compliance situations.

First, let's take a look at TCAC's Training. In Spring 2007, Rose Guerrero and her staff presented their latest training in five different cities. Using the 8823 Guide as their template, TCAC staff provided their interpretation of the IRS's guidance. They also took the opportunity to introduce the new Child/Spousal Support Affidavit that replaces California's required Child Support Affidavit.

One surprise from the IRS is that a state does not need to report noncompliance issues that are corrected before owners receive notice of a state agency inspection. Only noncompliance found uncorrected at the time of the TCAC inspection, or corrected after a TCAC notification of inspection should be reported. This puts greater responsibility on owners and property management compliance staff to carefully review all initial move-in files. While most property management companies say that they do this, without proper oversight, procedures can often devolve into approval signatures without a real review.

The most welcome rule change for property managers is the extended effectiveness of income verification material. The material can now be used for up to 120 days prior to the Effective Date of the Tenant Income Certification (TIC). Property managers no longer have to re-verify stale material after 90 days. However, as in the past, third party verifications cannot be used if they were received more than 120 days prior to the effective date of the income certification.

TCAC stressed management's responsibility to compare initial certifications to the first recertification to uncover potential fraud. TCAC expects management to take steps to remove fraudulent households from properties, including establishing policies on when new members can be added to the household. For those who are desperate for affordable housing, it can be tempting to manipulate household membership to qualify for tax credit housing. Sometimes it takes the form of adding higher earning family members after move in or "borrowing" children, or other relatives to increase household size and the applicable household income limit. New additions to a household must now be income certified and have their income added to the existing household's. If the household is now "over income," the Next Available Unit Rule applies. If the household becomes "over income" with the additional resident(s), the new residents are limited in their ability to remain at the property should the original household members move out. TCAC wants all property managers to develop adequate policies on adding household members, and documenting identity, especially where there is a question of adult responsibility for minors.

TCAC mentioned some of the standards that indicate adequate due diligence. These include: updating information on applications more than a year old, requiring a two year housing history, securing verification of discontinued employment and questioning creative financing for home purchases or other intra-family loans that raise questions on home ownership and sources of money in bank accounts.

Managers were advised to complete annual recertifications on time. TCAC will report patterns of repeated, late, retroactive recertifications to the IRS.

Training participants were informed that TCAC inspection policy is to not leave the property until serious health and safety concerns are addressed. Maintenance staff should be available and ready to handle the most common health and safety issues. TCAC staff does not handle keys, open doors and will not be in a unit alone or perform an inspection when there are only minors in the unit.

TCAC's new database now allows them to highlight data relating to the Next Available Unit Rule. Properties that are less than 100% Tax Credit should be prepared to document how they track compliance with the Rule. The IRS has relaxed its rule concerning transfers between buildings at a tax credit property. A household transferring between buildings with different Building Identification Numbers (BINs) can now earn up to 140% of the current income limit for the unit and still transfer. In the past, households transferring between buildings were treated as new move-ins.

The IRS made several clarifications on the Student Rules. The 8823 Guide confirmed that the IRS definition of a full-time student should be used. Someone who has been a full-time student for 5 months during the calendar year is considered a full-time student, even if they are not currently a full-time student, or they have graduated. Also in the Guide, the IRS confirmed that all members of the household are included

> The most welcome rule change for property managers is the extended effectiveness of income verification material. The material can now be used for up to 120 days prior to the Effective Date of the TIC.

TCAC clarified that management should not charge rent for managers units, unless the manager is fully qualified as a tax credit household, meaning a full TIC with verifications. Resident Managers should not be housed at a tax credit property other than their own.

One noncompliance option on the 8823 presents a problem for Californians who have been innovatively using the Low Income Housing Tax Credit program for all types of supportive housing. The IRS requires that properties be available to the General Public. Rose Guerrero acknowledged that California has one of the most creative collections of supportive housing, from survivors of domestic violence to young adults moving out of the foster care system. TCAC relies on attorney opinions on whether a property meets the IRS' guidelines for General Public use.

in determining whether a household is comprised completely of full-time students. However, an IRS opinion issued over the 2007 year end holidays appears to contradict this. TCAC continues to follow an NCSHA recommendation that minors required to be in school are not treated as full-time students. So, a family that included parent(s) who were full-time students would meet the Student Status exemption because their school-age children were not considered full-time students. However, TCAC is waiting for further clarification from the IRS and if there are changes to TCAC's current stance on the Student Status Rule they will issue a directive to tax credit housing managers. When a household claims a Student Status exemption, TCAC's guidance is that the file should include proof of that status (e.g. copies of tax returns showing dependents, proving that

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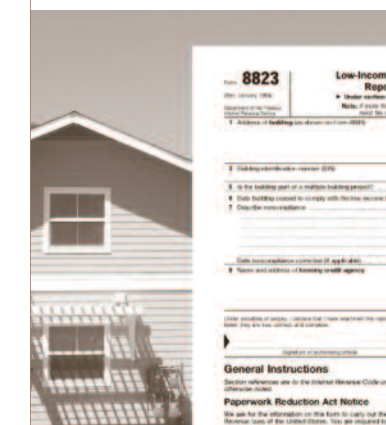

The California TCAC *addressed policies that qualify household members for affordable housing.*

AFFORDABLE SENIOR HOUSING OPPORTUNITIES *at Kent Gardens will include good proximity to transportation, shopping and hospitals.*

Kent Gardens

Continued from page 1

to ask for amendment money [to cover these costs]," said Dolin. "But since it was part of the mixed finance program we couldn't get more money, so we had to find other money."

Mercy staff decided the Low Income Housing Tax Credit program was the answer and Merritt bid on the deal. "We got the deal," said Karen Smyda, Acquisitions Director at Merritt Capital, "Because we understand HUD, we're flexible and we could provide good pricing." This is Merritt and Mercy's fifth partnership together. "We're thrilled to be doing another deal with Mercy," said Smyda. "The development team is knowledgeable, responsive, and they know how to move things along."

Kent Gardens Senior Housing will be a single 3-story wood frame structure with a manager's unit. Apartments will be equipped with emergency cords in each bedroom and bathroom with a direct connection to a staff office. There will be community space, a resident services coordinator and a social service office. The property is centrally located near freeways, bus lines, and several BART stations with good proximity to shopping and hospitals.

Mercy Housing California (MHC) is the largest regional development corporation in the Mercy Housing System. MHC develops housing throughout California with offices in San Francisco, Sacramento, Orange and Santa Cruz. Mercy Housing California has about 100 properties in California serving more than 10,000 people including families, seniors and people with special needs.

To round out the financing on Kent Gardens, tax exempt bonds were issued by Alameda County and privately placed with Silicon Valley Bank. The financing structure includes significant soft debt provided by Alameda County and by the Redevelopment Agency. Permanent financing will be a Capital Advance under the HUD Section 202 Program. In addition, 82 units will receive operating subsidies under a HUD Project Rental Assistance Contract. Merritt Community Capital Fund X Partnership will provide an equity investment of $8,678,000. Fund X investors are Bank of America, Bank of the West, Fannie Mae, Freddie Mac, Washington Mutual and Wells Fargo Bank.

Building on its experience with Kent Gardens, in 2007 Merritt closed into a second partnership utilizing HUD 202 mixed financing. Casa Grande Senior Apartments in Petaluma is a 52 unit new construction project to be developed by Petaluma Ecumenical Properties. Merritt is pleased to build on its experience in fostering nonprofit and for-profit partnerships.

11th Annual Partnership Luncheon

On November 7, 2007, over 100 partners, investors and colleagues joined Merritt Community Capital's Board of Directors and Staff at the Lake Merritt Hotel to enjoy lunch, good conversation, a beautiful view of the lake, and a short program honoring this year's Partnership Luncheon Awardees.

For its leadership in providing both debt and equity resources in support of affordable housing developments, Silicon Valley Bank was honored as 2007 Investor of the Year. Christine Carr accepted the award on behalf of Silicon Valley Bank.

For its comprehensive leadership in the development and management of outstanding affordable housing communities, Mercy Housing California was honored as 2007 Sponsor of the Year. Val Agostino accepted the award on behalf of Mercy Housing California.

For its pioneering role as an outstanding affordable housing development in the Mission Bay-SOMA area of San Francisco, Rich Sorro Commons was honored as 2007 Project of the Year. Myrlem Balladares accepted the award on behalf of Rich Sorro Commons.

HONOREES GATHER ABOVE TO SHOW OFF THEIR AWARDS: *(From L to R) Christine Carr from Silicon Valley Bank (Investor of the Year); Justin Solomon from Mission Housing Development Corporation, Myrlem Baladares from Rich Sorro Commons and Monique Holsome from Caritas Management (Project of the Year); Val Agostino from Mercy Housing California (Sponsor of the Year).*

1 *Zachary Lopez and Johnnie Norway from TNDC discuss Asset Management with Merritt's Birute Skurdenis.*

2 *Merritt's Maria Duarte and Karen Smyda discuss fees with Merritt's counsel, Richard Power.*

3 *Merritt's Kristy Ball (center) talks with Paul Taylor and Sandra Reeder, from Eden Housing, about the "miracles" they've worked at Merritt's Union Court property.*

TCAC

Continued from page 5

TCAC clarified that full-time students claiming HUD's income disregard must be a dependent of the Household.

neither the parent nor any of the children are dependents of another, marriage certificates for married couples). TCAC will hold owners and managers harmless of past actions but expect compliance with new move-ins after July 1, 2007.

The IRS Guidelines allow states to accept utility allowances established by owners using sound methods to calculate the real utility expenses of tenants. TCAC made clear that they do not have the staff to monitor an owner-established utility allowance and, at present, will only accept allowances set by HUD, PHAs or RD.

At the 2007 NCSHA Tax Credit Conference, one presenter from a training organization stated that a student was not required to be a dependent in order to qualify for HUD's full-time student income disregard. The student only needed to be the child of the Head(s) of Household, regardless of age. This appears to contradict the IRS guide which uses different wording from the HUD 4350.3 and specifically refers to "dependent, full-time student." TCAC clarified that a full-time student claiming HUD's income disregard, had to be a dependent of the Household.

> Owners and property managers that operate in several states should be happy with this new guidance but differences will still exist between the states.

Owners and property managers that operate in several states should be happy with this new guidance but differences will still exist between the states. Whether it's different required forms or lease addenda (California is one of only a handful of states requiring the Good Cause Lease Addendum), multi-state operators will still need to be attuned to individual state requirements. In addition, supplementary guidelines for due diligence are promulgated by large national training organizations like NCHM and Quadel.

Stay tuned for more clarifications as Spectrum Enterprises has won the TCAC contract to monitor Southern California LIHTC properties. Spectrum has several state contracts to act as the state monitoring agent and is known for its tough standards. Unlike TCAC, which is the State Agency, Spectrum will have an agent's responsibility to report all conditions of noncompliance, even if State staff later decide that the noncompliance is not reportable to the IRS.

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