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TO: State Directors
Program Directors
Multi-Family Housing
Rural Development

FROM: Richard A. Davis /s/ ***Richard A. Davis***
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Rural Housing Service

SUBJECT: Allowable Expenses in Multi-Family Housing Properties

PURPOSE

The purpose of this Unnumbered Letter (UL) is to clarify allowable expenses to be charged against project income in Rural Development-financed Section 515 and Section 514 multifamily properties. It is one of a series of ULs intended as a reminder to Servicing Officials to ensure the appropriate use of project funds. This is in further accordance with an audit recommendation from the Office of the Inspector General (OIG) in their audit "Review of Rural Rental Housing's Tenant and Owner Data using Data Analytics", Audit No. 04901-001-13.

The Agency previously issued a UL on this subject on January 22, 2016. Multi-Family Housing (MFH) will continue to issue periodic updates to this UL subject.

BACKGROUND

OIG previously conducted an audit of expenses charged to properties financed under the MFH Direct Loan programs. A recommendation agreed to by the Agency was a periodic reminder to program participants about allowable and unallowable expenses. Also, this UL addresses questions received from State and Servicing Offices.

The Direct Loan programs are governed by the MFH Regulation 7 CFR 3560; allowable expenses appear in §3560.102 (generally, management fee-related) and §3560.303 (project-related). Procedural guidance to Servicing Officials about reviewing proposed budgets and actual expense reports is set out in the MFH Asset Management Handbook, HB-2-3560, Chapter 4. The clarifications in this UL supplement that guidance by listing the existing allowable expenses listed in §3560.102 and §3560.303 and providing supplemental clarification.

AGENCY ACTION

Servicing Officials have a responsibility to ensure that MFH project funds are being used appropriately. MFH properties rely on project income to maintain operations and provide safe,

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decent and sanitary housing for our residents. Rent increases are necessary at times to generate needed revenue to pay for ongoing maintenance, capital improvements, and immediate repairs, as well as to cover administrative costs associated with management of the property. To achieve these objectives, it is necessary and proper for Servicing Officials to thoroughly review budget submissions, ask questions, and seek documentation that supports budget requests or actual expenses.

While Servicing Officials should not appear to micro-manage the property for the management agent, they are advised to more closely review certain expense categories that have the potential for abuse, and to apply reasonableness tests where needed. 7 CFR 3560.102(i)(3)(iii) addresses this reasonableness determination and further suggests that, where administrative expenses exceed 23 percent, or those typical for the area, of gross potential basic income, a need for closer review for unnecessary expenditures is called for. This does not mean there is a 23 percent cap on administrative expenses or that expenses above 23 percent are not allowed; rather, the Servicing Official should examine more closely those line items to ensure the charges are appropriate.

Conversely, this does not mean that if administrative expenses are less than 23 percent, no further review is necessary; to the contrary, the Servicing Official still needs to determine if the charges are allowable.

As a reminder, RD Form 3560-13, "*Multi-Family Project Borrower's/Management Agent's Management Agent Certification*", includes the following section:

"4. The Agent agrees to:

a. Ensure that all expenses of the project are reasonable and necessary.
b. Exert reasonable effort to maximize project income and take advantage of discounts, rebates and similar money-saving techniques.
c. Obtain contracts, materials, supplies and services including the preparation of the annual financial reports on terms most advantageous to the project.
d. Credit the housing project with all discounts, rebates or commissions including any sales or property tax relief granted by the State or local Government received.
e. Obtain the necessary verbal or written cost estimates and document reasons for accepting other than the lowest bid.
f. Maintain copies of the documentation and make such documentation available for inspection during normal business hours.
g. Invest project funds that Rural Development policies require to be invested and require to be invested and take reasonable effort to invest other project funds unless the borrower specifically directs the Agent not to invest those funds."

IMPLEMENTATION

Servicing Officials identified certain expense items that have raised questions during reviews of proposed budgets and actual operating expense reports. On Attachment A, these items have been associated to the related citation in the MFH regulation, and procedural clarifications are provided; these procedural clarifications will appear in the next revision of HB-2-3560, the MFH Asset Management Handbook.

Servicing Officials are to bring this guidance to the attention of MFH borrowers and management agents to ensure they understand program regulations concerning allowable expenses and the responsibilities of MFH staff to critically evaluate proposed operating budgets and actual operating expenses.

Servicing Officials should direct questions regarding the subject of this UL to their assigned Portfolio Management Analyst or any staff member of the Portfolio Management Division.

Attachment

GUIDANCE ON CERTAIN ALLOWABLE EXPENSES

Text in boxed Italics following the Regulation citation provides clarification on allowable expenses.

All regulatory citations refer to 7 CFR §3560.303

(b) Allowable and unallowable project expenses. Expenses charged to project operations, whether for management agent services or other expenses, must be reasonable, typical, necessary and show a clear benefit to the residents of the property. Services and expenses charged to the property must show value added and be for authorized purposes.

(1) Allowable expenses. Allowable expenses include those expenses that are directly attributable to housing project operations and are necessary to carry out successful operations.

(i) Housing project expenses must not duplicate expenses included in the management fee as defined in §3560.102(i).

> *"Sales tax" on management fees is not an allowable project expense.*

(ii) Actual costs for direct personnel costs of permanent and part-time staff assigned directly to the project site. This includes managers, maintenance staff, and temporary help including their:

> *Payroll and fringe benefits expenses included in the proposed budget must agree with the number of employees, positions, salaries, fringe benefits, health plans, etc. in the pre-approved management plan. Large increases in site payroll or site maintenance should be supported by management plan changes. RD does not have to approve a budget that includes positions that are not shown in the management plan. Payment of supervisory positions are paid from the management fee bundle of services and not from project operations. See §3560.102(i)(1)(i).*

(A) Gross salary;

(B) Employer FICA contribution;

(C) Federal unemployment tax;

(D) State unemployment tax;

(E) Workers compensation insurance;

(F) Health insurance premiums;

> *The management plan should identify site personnel. If there is a question about health insurance coverage for site employees, Servicing Officials should review the health insurance policy for confirmation of coverage and appropriate charges to the project. Management's central office staff's health insurance is not a project expense.*

(G) Cost of fidelity or comparable insurance;

(H) Leasing, performance incentive or annual bonuses;

This expense is for project-specific site personnel and should be included as part of the site compensation.

(I) Direct costs of travel to off-site locations by on-site staff for property business or training; and/or

On-site staff travel to and from the management company office to the property is an allowable expense. However, such travel should be reasonable. For example, maintenance staff should not routinely be sent out from the main office to do one thing each day when it would be more efficient to combine trips, or can be completed by the on-site maintenance person. Other management company staff travel to and from the property is a management fee expense (see §3560.102 (i)(1)(xiii)(I)) Purchase of "company vehicles" for such travel is not an allowable project expense.

(J) Retirement benefits.

(iii) Legal fees directly related to the operation and management of the property including tenant lease enforcement actions, property tax appeals and suits, and the preparation of all legal documents.

Such legal fees are for the borrower or the project, and not for third-parties, such as investors or syndicators.

(iv) All outside account and auditing fees, if required by the Agency, directly related to the preparation of the annual audit, partnership tax returns and 401-K's, as well as other outside reports and year-end reports to the Agency, or other governmental agency.

The account, auditing, partnership, and year end reports must be directly related to the property. This does not include individual tax filing expenses for any member of the ownership entity. Properties may have financial reporting requirements beyond that required by the Agency. If these are directly related to the property, and not the partnership or ownership, they are allowable project expenses.

There is no regulatory cap on the audit expense. However, audit expenses in 2015 averaged $3500-$4000 for an RD property. If costs exceed that range, confirm the audit is not of the partnership, etc., which is a Borrower expense.

(v) All repair and maintenance costs for the project including:

Repair and maintenance expenses appear on the RD Form 3560-07 in Part II, lines 1-11. Capital expenses, which are discussed in §3560.103(c), should not appear in the operating repair and maintenance costs; capital budget expenses appear in Part V. There should be no manipulation of the budget or expenses to avoid taxes. The reserve account should not be used to pay for unit turnover or routine maintenance costs; these should appear in the operating budget. Servicing Officials should question unusually low maintenance and repairs costs, especially in an aging property.

(A) Maintenance staffing costs and related expenses.

(B) Maintenance supplies.

Servicing Officials should carefully review this item. Small tool purchases, such as hammers, putty knives, and sprayers, which could be used repetitively, should not be repeatedly purchased by the property.

(C) Contract repairs to the projects (e.g., heating and air conditioning, painting, roofing).

(D) Make ready expenses including painting and repairs, flooring replacement and appliance replacement as well as drapery or mini-blind replacement. (Turnover maintenance).

(E) Preventive maintenance expenses including occupied unit repairs and maintenance as well as common area systems repairs and maintenance.

(F) Snow removal.

(G) Elevator repairs and maintenance contracts.

(H) Section 504 and other Fair Housing compliance modifications and maintenance.

It is not a reasonable expense to complete a transition plan every three years, especially if none of the items have been corrected or completed since the initial plan. Management should be able to review the existing plan annually with a year-end update. The Servicing Official should determine if the borrower's financial situation has changed such that completion of the transition plan can be accomplished. There is no requirement that a transition plan be done by a third party.

The cost of providing Limited English Proficiency (LEP) services is an allowable expense.

(I) Landscaping maintenance, replacements, and seasonal plantings.

(J) Pest control services.

This includes the expense of bed bug control. If the property is experiencing unusual pest activity or an unusually high expense, Servicing Officials should request a breakdown of costs.

(K) Other related maintenance expenses.

"Other maintenance expenses" is a broad category that should be carefully reviewed by Servicing Officials to ensure that charges are appropriate and reasonable. Expenses that belong in other categories above should be moved by the Borrower to ensure that the Agency is collecting the correct data on specific property costs. If the expense appears on Part II, line 10, it must be identified.

(vi) All operational costs related to the project including:

"Other Administrative" in general: Servicing Officials should closely review this line item for potential abuse. "Other Administrative" should include only directly property-related administrative costs; for example, the Section 538 Guarantee Fee is an allowable expense. Bad debts should not appear in the operational costs: in the proposed budget, they should appear as a contingency item (Part I) or, on the actual expenses, they would be reflected in less income than expected. Other fees and charges should appear in the appropriate line item (i.e., bank charges, HFA compliance fees, credit checks, etc.) Expenses here must be accompanied by a narrative with detailed explanation. Note that for-profit borrowers are entitled to 25 percent of the interest earnings on the Reserve account in the prior year, which should be a Reserve withdrawal request; this amount should not be taken from the operating account. See §3560.306(h)(3).

(A) The costs of obtaining and receiving credit reports, police reports, and other checks related to tenant selection criteria for prospective residents.

(B) The cost of duplicating forms for those properties not owning a copier. This will include the costs of producing or purchasing forms and mailing or delivering those forms to the project site.

Photocopying or printing expense related to actual production of project brochures, marketing pieces, forms, reports, notices, and newsletters which all directly relate to the property in question are allowable project expenses no matter what location or point of origin the work is performed, including outsourcing the work to a professional printer.

(C) All bank charges related to the property including purchases of supplies (e.g., checks, deposit slips, returned check fees, service fees).

Bank charges should be typical and not extraordinary; bank-charged late fees should be closely reviewed for reasonableness. Electronic check readers are an allowable project expense.

(D) Costs of site-based telephone including initial installation, basic services, directory listings, and long-distance charges.

Cell phones issued to on-site personnel for project-related work is allowable. Cell phones issued to management personnel who oversee multiple properties must pro-rate the expense between properties.

(E) All advertising costs related specifically to the operations of that project. This can include advertising for applicants or employees in newspapers, newsletters, radio, cable TV, and telephone books.

This includes social media.

(F) Postage and delivery costs from the site including expenses to the Agency or other governmental agencies, tenants, verifying third parties, central management offices, etc.

Postage expenses associated with the site to mail out rental applications, third-party (asset income and adjustments to income) verifications, application processing correspondence (acceptance or denial letters), mailing project invoice payments, required correspondence, report submittals to various regulatory authorities to the managed property are allowable project expenses no matter what location or point of origin the mail is generated. This expense does not include *normal or routine management company responsibilities covered under §3560.102(i)(1)(xiii)(C).*

(G) Partnership or corporate business expenses including state taxes and other mandated state or local fees as well as other relevant expenses required for operation of the property by a third- party governmental unit. Costs of continuation financing statements and site license and permit costs.

(H) Expenses related to site utilities including actual costs and surcharges as well as deposits and expense of utility bonds in lieu of bonds.

(I) (A) Site office furniture and equipment including site based computer and copiers. Service agreements and warranties for copiers, telephone systems and computers are also included (if approved by the Agency).

(J) Real estate taxes (personal tangible property and real property taxes) and expenses related to controlling or reducing taxes.

(K) All costs of insurance including property liability and casualty as well as fidelity or crime and dishonesty coverage for on-site employees and the owners.

(L) Costs of collecting rents on-site including bookkeeping supplies and recordkeeping items.

Note that these costs are for supplies; costs of maintaining books and records are covered as part of the management fee. See 3560.102(i)(1)(iii).

(M) Costs of preparing and maintaining tenant files and processing tenant certifications including all office supplies, copies and other associated expenses.

The project management staff is responsible for preparing and maintaining tenant files and that cost is generally part of the salary expense. Office supplies and copies must be site-specific. Costs associated with file storage, physical or digital, are allowable expenses.

Processing tenant certifications includes the transmission of these documents to the Agency. There should be no additional charge as the property is already being charged for internet access, computer hardware, and software. Transmission/submission of tenant certifications is covered by *the management fee at §3560.102(i)(1)(xi) and is not an allowable project expense.*

(N) Public relations expense relative to maintaining positive relationships between the local community and the tenants with the management staff and the borrowers. Chamber of Commerce dues, contributions to local charity events, and sponsorship of tenant activities, are examples.

(O) Tax Credit Compliance Monitoring Fees imposed by HFAs.

This expense pays the charge from the tax credit allocator. Any cost that management agents incur for reporting on LIHTC compliance is included in the management fee and is not an allowable project expense; see §3560.102(i)(1)(xxvii).

(P) All insurance deductibles as well as adjuster expenses.

(Q) Professional service contracts (audits and compilations, tax returns, energy audits, utility allowances, architectural, construction, rehabilitation and inspection contracts, etc.)

Servicing Officials should review any professional services contracts if costs appear unreasonable. The Agency has no monthly unit inspection requirement. Inappropriate practices are covered under §3560.102(i)(4)(viii).

The cost of installation of project-wide cable or satellite TV, or wi-fi, is an allowable project expense, provided that each apartment unit receives a separate billing for the service, and it is not included in the rent charge. The property should not pay for access by each unit, including vacant units.

(R) On-site training pre-approved by the Agency provided by outside training vendors.

Training for on-site staff should be appropriate to managing affordable housing with subsidies from RD, HUD, or LIHTC. Suspected abuses should require documentation of the course or certifications received.

Borrowers who attend trainings do so at their own expense and it is not an allowable project expense. Management company meetings to discuss management policies are a management fee expense (see §3560.102(i)(1)(xiv), (xv), (xxiv) and (xxv).

Expenses during training should be reasonable and not involve costs for items previously identified by the OIG audit, especially gifts, bonuses (other than that identified in the management plan as part of the site manager's salary), or alcohol. Training expenses may include reasonable hotel charges, meals, and snacks; such expenses should not be excessive.

(S) Site manager salary for additional hours associated with congregate housing.

(vii) With prior Agency approval, cooperatives and nonprofit organizations may use housing project funds to pay asset management expenses directly attributable to ownership responsibilities. Such expenses may include:

These are organizational reimbursements for nonprofit owners. This expense is not the traditional industry definition of "asset management", but rather an effort to partially offset the cost of doing business for a nonprofit as an RD property owner. The reimbursement is pro-rated among owned RD-financed properties so no duplication of expense will be incurred.

(A) Errors and omissions insurance policy for the Board of Directors.

(B) Board of Directors' review and approval of proposed Agency's annual operating budgets, including proposed repair and replacement outlays and accruals.

(C) Board of Directors' review and approval of capital expenditures, financial statements, and consideration of any management comments noted.

(D) Long-term asset management reviews.

(2) Unallowable expenses. Housing project funds may not be used for any of the following:

(i) Equity skimming as defined in 42 U.S.C. 543 (a).

(ii) Purposes unrelated to the housing project.

(iii) Reimbursement of inaccurate or false claims.

(iv) Settlement agreements, court ordered decrees, legal fees, or other costs that result from the filing of civil rights complaints or legal action alleging the borrower, or a representative of the borrower, has committed a civil rights violation.

(v) Fines, penalties, and legal fees where the borrower or a borrower's representative has been found guilty of violating laws, including, but not limited to, civil rights, and building codes.

(vi) Association dues to be paid by the project should be related to training for site managers or management agents. To the extent that association dues can document training for site managers or management agents related to project activities by actual cost or pro-ration, a reasonable expense may be billed to the project.

(vii) Pay for bonuses or monetary performance awards to site managers or management agents that are not clearly provided for by the site manager salary contract.

(viii) Billing for parties that are large or unreasonable, such as renting expensive party halls or hotel rooms and payment for alcoholic beverages or gifts to management agent staff.

(ix) Billing for practices that are inefficient such as routine use of collect calls from a site manager to a management agent office.

(c) Priorities. The priority order of planned and actual budget expenditures will be:

1. Senior position lienholder, if any;
2. Operating and maintenance expenses, including taxes and insurance;
3. Agency debt payments;
4. Reserve account requirements;
5. Other authorized expenditures; and
6. Return on owner investment.

The expense of the return on owner investment (ROI) must be included in the proposed budget in order for the Borrower to be eligible to collect the payment. §3560.305(a) includes the conditions on the return payment. §3560.305(b) discusses when an unpaid ROI may be taken:

*"An earned, but unpaid ROI for the previous year only may be requested by the borrower and authorized by the Agency under the provisions of §3560.305(a)(2) provided the current year's ROI has been paid first and a rent increase is not required to generate funds to pay the unpaid ROI." [The Regulation reference of "§3560.305(a)(**2**)" above is incorrect and should read instead "§3560.305(a)(**1**)".]*