CHAPTER 3. ELIGIBLE SECTION 312 LOAN COSTS

This chapter details the types of costs which must be included in projects assisted with Section 312 Loan funds (including items which must be included in the Section 312 Loan and items which may be included in the Section 312 Loan), as well as additional costs which may be included in Section 312-assisted projects and Section 312 Loans, and costs which cannot be included. It also describes the conditions under which refinancing is an eligible Section 312 cost.

3-1. ITEMS WHICH MUST BE INCLUDED IN PROJECTS ASSISTED WITH SECTION 312 LOAN FUNDS

a. Items Which Must be Included in the Section 312 Loan. The following items must be included in projects assisted with Section 312 funds, and, if the conditions detailed in this Paragraph 3-1-a are met, must also be included in the Section 312 Loan.

(1) Accrued Interest on Section 312 Loan. Interest on Section 312 Loan drawdowns which will accrue during the construction period, from the first draw through the Amortization Effective Date, must be included in the Section 312 Loan. (See Chapter 7 for additional information on accrued construction interest.)

(2) Real Estate Taxes and Hazard and Flood Insurance. Real estate taxes and hazard and flood insurance premiums coming due during construction, and the amounts that accrue for those items between loan settlement and the AED, must be included in all Section 312-assisted projects. In addition, these items must be included in the Section 312 Loan if the borrower qualifies for a three percent (3%) Section 312 Loan and appears unlikely to be able to pay these expenses on his/her own. The costs for these items must be included in Section 312-assisted projects even if they are not eligible Section 312 expenses. (See Paragraph 2-3-a of this Handbook for additional information on qualifying for three percent loans, Paragraph 9-2-e of this Handbook for details about escrows for real estate taxes and hazard insurance premiums, and Paragraph 3-2-g for additional information on using Section 312 funds to reimburse a borrower for an initial hazard or flood insurance premium.)

(3) Liability and Worker's Compensation. The cost of liability and worker's compensation insurance during the construction period for borrowers who are non-professional contractors acting as their own general contractors must be included in the Section 312 Loan if the borrower has not paid for these items prior to settlement to cover him/her for the entire estimated construction period. (See Paragraph 6-2-a for additional

insurance requirements applicable to all contractors participating in the Section 312 program.)

(4) Section 312 Application Fee. The application fee ($200 for borrowers for one-to-four unit properties or $300 for all other borrowers) must be included in the Section 312 Loan, unless the borrower chooses to pay this fee in full with his/her own funds or supplemental funds prior to settlement. (See Paragraph 2-4-a of this Handbook for additional information on the application fee.)

b. Costs Which Must be Included in Section 312-Assisted Projects and Which May be Included in Section 312 Loans

(1) Local Rehabilitation Standards. At a minimum, borrowers in all projects assisted the Section 312 funds must complete all work necessary to correct any deficiencies in the property under applicable Local Rehabilitation Standards. This includes completing additions to the property, if necessary to meet Local Rehabilitation Standards or to meet minimum living space requirements for current or planned occupants. The cost for these items may be included in a Section 312 Loan. (See Chapter 1 for a definition of Local Rehabilitation Standards.)

(2) Cost Effective Energy Standards. All properties being rehabilitated with Section 312 funds must meet Cost Effective Energy Standards (as set forth in 24 CFR Part 39). The Cost Effective Energy Standards set forth energy conservation and efficiency standards which must be met, as long as the modifications are financially feasible and do not require work on elements that would not ordinarily become exposed during the rehabilitation. The cost associated with meeting these standards may be included in a Section 312 Loan.

(a) Assessing Energy Needs. LPA's must determine, by using their own staff or an outside, professional firm, what, if any, improvements must be made to the property so that it meets the Cost Effective Energy Standards. If the LPA determines that an official energy audit, conducted by an outside, professional firm, is necessary, the cost of this audit may be included in the Section 312 Loan.

(b) Required Work. If the LPA determines through the assessment described in Paragraph 3-1-b-(2)-(a) of this Handbook that improvements must be made to the property so that it meets the Cost Effective Energy Standards, these improvements must be made unless otherwise specifically determined by HUD.

(3) Historic Preservation Standards. For all Section 312-assisted projects, LPA's must ascertain if the property is on the National Register of Historic Places or eligible for inclusion on the National Register of Historic Places. If so, the rehabilitation must be done in accordance with standards set by the U.S. Secretary of the Interior, and the rehabilitation costs associated with meeting these standards may be included in the Section 312 Loan. See Paragraph 12-8 for additional information on historic preservation requirements.

(4) Other Costs Which Must be Included in Section 312-Assisted Projects, and Which May be Included in Section 312 Loans

(a) The reasonable cost of rehabilitating the property so that it conforms to environmental requirements. (See Paragraph 12-8 of this Handbook for additional information on environmental requirements.)

(b) The cost of flood proofing required by Executive Order 11988 and the National Flood Insurance Program. (See Paragraph 12-4 of this Handbook for additional information on flood insurance requirements.)

(c) The cost of remedying identified lead-based paint hazards for the property. (See Paragraph 12-9 of this Handbook for additional information on lead-based paint requirements.)

(d) The cost of rehabilitating the property so it is accessible to the physically handicapped. (See Paragraph 12-12 of this Handbook for requirements on making properties accessible to the handicapped.)

(e) The cost of remedying structural problems caused by termite infestation, and of eliminating the infestation itself, if there is evidence of such infestation, as determined by an inspection of the property by a qualified LPA official and/or an outside expert. In addition, if the LPA determines as part of its initial inspection of the property that it is possible that the property has termite infestation, but that the LPA staff is not qualified to properly inspect the property for termite damage, the LPA must obtain a termite inspection of the property from an outside termite inspector or extermination company. The fee for this termite inspection is an eligible Section 312 Loan cost, so long as it is reasonable and customary.

3-2. ITEMS WHICH MAY BE INCLUDED IN SECTION 312-ASSISTED PROJECTS AND SECTION 312 LOANS. Within the maximum loan amounts, Section 312 Loans may also include the following;

a. Removing Incipient Deficiencies. Section 312 Loans may include the cost of rehabilitating the unit to correct or remove incipient problems or defects which, if not repaired, would reasonably be expected to deteriorate into deficiencies of Local Rehabilitation Standards within two (2) years. LPA's should encourage borrowers to include such work, but borrowers must not be forced to do so. However, if the property will not be sound enough after the proposed rehabilitation to be considered an acceptable underwriting risk, the loan must not be approved. (See Chapter 7 for additional details about underwriting standards and the value of the security.)

b. Making General Property Improvements

(1) General Requirements. General Property Improvements (GPI's) are improvements other than the required improvements listed in Paragraph 3-1-b of this Handbook or Incipient Violations described in Paragraph 3-2-a, but which are nevertheless necessary to put the property in a generally good and readily maintainable condition. General Property Improvements are eligible Section 312 Loan costs so long as all required improvements are completed, and the General Property Improvements are reasonable and customary for the area and are not considered luxurious. (See Paragraph 3-4-e of this Chapter for a more detailed discussion of "luxury" items; if LPA's have any questions about whether a GPI is a luxury item, the HUD area Office Rehabilitation Management Specialist should be consulted.) In addition, the total cost of General Property Improvements must not exceed forty percent (40%) of the total amount of the Section 312 Rehabilitation Loan.

(2) Examples of Eligible GPI's. Eligible General Property Improvements include but are not limited to the following:

(a) Work which will result in reduced maintenance and/or will extend the useful life of a part of the property.

(b) Work to expand livable space and eliminate inefficient design, such as moving or removing walls.

(c) Installation of permanent work-saving elements which are customary for the locality, such as garbage disposals where permissible but not required, built-in dishwashers, and other permanent elements which benefit the health and safety of the residents of the property, such as security systems.

(d) Remodeling a kitchen, bathroom or currently under-utilized space to improve efficiency, to modernize and/or to make it aesthetically pleasing.

(e) Non-luxurious items, where rental properties are involved, which will render the units in marketable condition for the particular area.

(3) Encouraging Quality Repair. LPA's should encourage borrowers to undertake rehabilitation work that goes beyond the bare minimum of correcting deficiencies in Local Rehabilitation Standards, so long as they can afford the additional cost and the higher grade materials and workmanship are reasonable and customary for the area and not a luxury item and the total cost of General Property Improvements do not exceed forty percent (40%) of the total Section 312 Rehabilitation Loan. In encouraging these quality repairs, LPA's will be helping to insure that improvements financed with Section 312 Loans have as long as economic life as possible, thereby contributing to the security of the loan.

For instance, while a standard-grade linoleum might correct deficiencies of Local Rehabilitation Standards regarding flooring, borrowers may use higher quality floor tile if they so desire as long as they can afford the additional cost and the higher quality floor is reasonable and customary for the area and the total cost of General Property Improvements does not exceed forty percent (40%) of the total Section 312 Rehabilitation Loan.

(4) Determining if GPI's Exceed 40% of the Section 312 Loan. For GPI's that are not required, in part, to correct deficiencies or incipient deficiencies in Local Rehabilitation Standards, the entire cost of the improvement must be counted towards the forty percent limit. When the GPI constitutes the use of higher grade materials or workmanship, rather than the standard grade, to correct deficiencies or incipient violations of Local Rehabilitation Standards, the cost of the GPI may be calculated as the difference between the standard grade improvement and the upgrade. For instance, if a property has deficiencies in Local Rehabilitation Standards concerning flooring, and if the borrower chooses to use a higher grade flooring to solve the problem rather than the standard grade, and if the higher grade is an otherwise eligible GPI, the cost of the GPI may be calculated as the difference between the standard grade and the upgrade.

c. Land Acquisition. The cost of purchasing a small parcel of adjacent land, but only if required to bring the property into conformance with local code requirements for minimum lot size and dimension, is an eligible Section 312 cost.

---

d. Professional Services. The reasonable and customary costs of architectural, engineering and related professional service required in the preparation of rehabilitation plans, drawings, write-ups, or specifications of work, if those services are beyond those normally provided by the LPA or the borrower, are eligible

Section 312 costs.

e. Processing and Settlement Costs. The cost of processing and settling the loan, other than those services normally provided by the locality, the costs necessary to obtain security for the loan, are eligible Section 312 costs. These costs may include but are not limited to:

(1) The cost of building permits and related fees, required to carry out the proposed rehabilitation work, if not included in contractors' bids.

(2) Origination fee, if the loan is originated by a private financial institution.

(3) Credit Reports.

(4) Fees for acceptable title evidence, reasonable corrective title work and other legal fees related to giving HUD an acceptable title report.

(5) Fees for recording and filing legal documents related to the loan.

(6) Appraisal fees.

(7) Fees for an independent rehabilitation cost estimate.

f. Contingency Reserve. A contingency reserve fund may be included in the Section 312 Loan to cover unanticipated construction interest or construction costs or to cover increases in other eligible loan costs. (See Paragraph 7-3-b regarding the calculation of construction interest.) Contingency reserves of up to ten percent (100%) of the total Section 312 Loan amount may be included in a Section 312 Loan, except in the case of self-help/sweat equity projects, in which case the contingency included in the Section 312 Loan may be up to fifteen percent (15%) of the total Section 312 amount.

LPA's should use a great deal of care in dealing with contingency reserves. Contingencies need to be high enough to cover unforeseen expenses so that default does not occur if additional work is found to be necessary and there is no source of funds to pay for it. (HUD has no obligation to increase a loan beyond the amount approved and stated in the Promissory Note and, in fact, may be unable to do so because of the statutory loan limits. See Paragraph 9-2-a of this Handbook concerning the Promissory Note, and Paragraph 9-9 on

increasing the loan amount.) On the other hand, LPA's should not authorize a contingency amount that is higher than necessary so as not to increase the borrower's monthly payment unnecessarily.

g. Reimbursement for Initial Premium for Hazard or Flood Insurance. Section 312 funds may be used to reimburse a borrower at or after loan settlement for an initial hazard or flood insurance premium paid just prior to loan settlement, but only if this insurance is required for the Section 312 Loan and if the borrower qualifies for a three percent (3%) Section 312 Loan. (See Paragraph 3-1-a-(2) for additional information on using Section 312 funds for hazard or flood insurance, Paragraph 2-3-a for additional information on qualifying for a three percent loan, and Paragraph 9-2-e for additional information about escrows for hazard insurance premiums.)

3-3. SPECIAL REQUIREMENTS FOR REFINANCING. Under limited circumstances. the cost of refinancing an existing debt secured by the property to be rehabilitated is an eligible Section 312 Loan expense, provided it is within the prescribed loan limits, the property is to be used for single family residential purposes after rehabilitation, and the refinancing meets all the other requirements in this Paragraph 3-3. The purpose of refinancing is to allow low and moderate income owner-occupants with large existing housing debt, who would be unable to afford a rehabilitation loan in addition to this debt, to rehabilitate their homes and thereby contribute to the revitalization of their neighborhoods.

a. Eligible Refinancing Costs. A Section 312 Loan may be used to refinance an existing loan debt secured by the property to be rehabilitated including:

(1) The unpaid principal and accrued interest on a mortgage, deed of trust, or similar security instrument or the balance due under a land sales contract eligible for refinancing. (See Paragraphs 3-3-b-(2) and (8).)

(2) Termination fees, prepayment penalties, revenue stamps, or state or local transaction-related taxes (such as transfer taxes, recordation taxes and the like) required in connection with the release or renewal of a mortgage or transfer of title.

(3) Property taxed, including back taxes, may not be paid through refinancing with Section 312 funds, except as otherwise eligible pursuant to Paragraphs 3-1-a-(2) and 3-2-g of this Handbook. (Delinquent property taxes are the borrower's personal responsibility, and must be corrected before any Section 312 Loan is made.)

b. Requirements

(1) Approval by Field Office. All Section 312 cases in which refinancing is involved must be approved by the Director of Community Planning and Development in the HUD Field Office.

(2) The applicant must own and occupy the one- to four-unit

property being rehabilitated, or be the purchaser-occupant under a written installment land sales contract which has been in effect for at least 180 days prior to application. Investor-owners are ineligible for refinancing.

(3) The applicant's income must not exceed ninety-five percent (95%) of the median income for the area.

(4) The amount being refinanced must not exceed fifty percent (50%) of the total Section 312 Loan amount.

(5) Statutory Twenty Percent Rule. Refinancing may occur only when the monthly payment for principal, interest and risk premium for the loan for rehabilitation costs, plus the monthly payments for principal and interest on all existing debt secured by the property (ie., if the existing debt were not refinanced), would exceed twenty percent (20%) of the applicant's total monthly income. It must be noted that refinancing may be approved if the applicant's total monthly payments for principal and interest after refinancing the existing debt also exceeds twenty percent (20%) of total monthly income, as long as the underwriting requirements detailed in Chapter 7 are met.

(6) The cost of refinancing, when added to the cost of rehabilitation, must not exceed the maximum loan amounts, as permitted under Paragraph 2-5 of this Handbook.

(7) Using Other Funds if Available. Refinancing must not be used if other sources of public or private financing are available at terms and conditions comparable to those obtainable through the Section 312 program.

(8) Except as noted in Paragraph 3-3-b-(2) of this Handbook, refinancing must not be used as a method of financing the purchase of property, directly or indirectly. Therefore, in addition to ensuring that the requirements of this Paragraph 3-3-b are met, the LPA must be satisfied, before refinancing is recommended to the Director of Community Planning and Development in the HUD Field Office, that the applicant has not acquired title through collusive pre-arrangements with the intention of refinancing the purchase of the property by means of the Section 312 Loan.

(9) No Partial Pay-off of Individual Loans. All existing debts secured by the property, including, for the purpose of this Section, eligible land sales contracts, need not be refinanced.

However, those that are refinanced must be refinanced in their entirety. In addition, any individual existing mortgage being refinanced must be entirely paid off and released at the Section 312 Loan settlement. For example, in a case where the property currently is encumbered by a first lien with an outstanding balance of $3,500, and a second lien home improvement loan of $1,000, refinancing can be used to pay off either or both of the mortgages. It cannot, however, be used to pay off $2,000 of the first lien and/or $500 of the second.

c. Procedure for HUD Field Office Approval. The LPA must include documentation in the loan file supporting its opinion that refinancing meets the requirements of this Chapter. The LPA must also obtain approval from the Director of Community Planning and Development in the HUD Field Office of all loans in which refinancing is involved, whether or not the locality has local loan approval authority.

(1) The LPA must complete the Refinancing Worksheet (see Exhibit 3-1), or a comparable form designed by the locality which includes all the requirements detailed in Paragraph 3-3-b of this Handbook, and must sign the form.

(2) The LPA must send the form to the Director of Community Planning and Development in the HUD Field Office, along with a letter requesting final approval. This may be included in the loan approval package if Field Office approval of the loan is otherwise required.

(3) Where the locality has local loan approval authority, the Director of Community Planning and Development in the HUD Field Office must respond, in writing, to the LPA before local approval can be give.

(4) HUD Field Offices should refer to the Cash Management Notice for procedures for authorizing draws for refinancing cases.

3-4. ITEMS WHICH MUST NOT BE INCLUDED IN SECTION 312 LOANS. The cost of the following items must not be financed with Section 312 Loan funds:

a. The cost of staffing or administering the loan program by the locality or the LPA.

b. Work so excessive as to be equivalent to new construction or reconstruction of the property. (This does not exclude so-called "gut" rehabilitation of a property if necessary, at least in part, to meet Local Rehabilitation Standards.)

c. Developers fees and the costs of marketing newly rehabilitated rental units.

d. Costs associated with other rehabilitation loans which are used together with Section 312 Loans, including interest costs, settlement costs, and loan fees.

e. Luxury items, i.e., fixtures, equipment, or landscaping of a type or quality which substantially exceeds that customarily used in the locality for properties of the same general type as the property to be rehabilitated. While LPA's should encourage borrowers to undertake high quality construction, even if it goes beyond the Local Rehabilitation Standards, luxury items are not eligible. The repair or construction of swimming pools (but not the cost to fill in or eliminate a pool from the property) is prohibited. LPA's should contact their HUD Field Office for additional information on luxury items.

f. Purchase, installation, or repair of furnishings of any kind, or of personal property which does not add to the value of the real estate itself, excluding refrigerators or ranges, or of trade fixtures such as display cabinets or machinery.

g. Payment of delinquent taxes or assessments related to the period before loan closing.

h. Funds to pay the borrower or family members residing in the same household for their labor.