U. S. Department of Housing and Urban Development
Office of Inspector General
New York/New Jersey Office
Jacob K. Javits Federal Building
26 Federal Plaza – Room 3430
New York, NY 10278-0068

MEMORANDUM NO.
2005-NY-1802

January 21, 2005

MEMORANDUM FOR: Walter Kreher, Director, Multifamily Program Center, 2FHM

Edgar Moore

FROM: Edgar Moore, Regional Inspector General for Audit, 2AGA

SUBJECT: Arlington Arms
Multifamily Project No. 031-35237
Jersey City, NJ

INTRODUCTION

We recently issued a report[1] on the performance of the Jersey City Housing Authority as contract administrator for the Section 8 Program at the Arlington Arms and Audubon Park Apartments projects. While performing our work, we identified some questionable expenditures reported by Arlington Arms. Arlington Arms inappropriately used project funds to pay $10,661 in trustee fees and to make a $1,138 loan to some of its project partners to pay their personal taxes. Since oversight of the projects' financial operations was not within the scope of the contract administrator's responsibilities, a review of the questionable expenditures was not considered a part of the audit scope of our review of the Jersey City Housing Authority. Instead, we performed a separate survey to determine whether these expenditures complied with the project's Regulatory Agreement and other U.S. Department of Housing and Urban Development (HUD) regulations. The results of our survey are contained in this memorandum.

In accordance with HUD Handbook 2000.06, REV-3, within 60 days, please provide us for each recommendation in this memorandum, a status report on (1) the corrective action taken (2) the proposed corrective action and the date to be completed or (3) why action is considered unnecessary. Additional status reports are required at 90 days and 120 days after the report is issued for any recommendation without a management decision. Also, please furnish us copies of any correspondence or directives issued because of this review.

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[1] Audit report (2004-NY-1005) on the performance of the Jersey City Housing Authority was issued on September 27, 2004.

Should you or your staff have any questions, please contact John Harrison, Assistant Regional Inspector General for Audit, at (212) 264-4174.

METHODOLOGY AND SCOPE

To accomplish our objectives, we reviewed applicable HUD regulations and the project's regulatory and management agreements. We interviewed appropriate HUD field office and Real Estate Assessment Center staff and the staff of the project management agent and Independent Public Accountant. We also reviewed the audited financial statements of the project for calendar years 2001 through 2003.

We performed our survey work from September 3 through November 12, 2004.

BACKGROUND

Arlington Associates is a limited partnership formed in 1983 pursuant to the laws of the State of New Jersey. The purpose of the partnership is to acquire, develop, and operate a HUD-insured project, Arlington Arms (Federal Housing Administration project number 031-35237), containing 51 rental apartments in Jersey City, NJ, of which 50 units are federally subsidized under Section 8 of the U.S. Housing Act of 1937, as amended. The partnership is subject to HUD regulations.

SURVEY RESULTS

Our limited survey work disclosed that Arlington Arms made expenditures in violation of HUD regulations. The project paid trustee fees totaling $10,661 related to calendar years 2001 through 2003 and $1,138 for nonresident partners' state income tax withholdings. We recommend that HUD require that these funds be returned to the project's operating account.

Arlington Arms paid $10,661 in trustee fees ($3,066, $3,914, and $3,681 during calendar years 2001, 2002, and 2003, respectively). These expenses were classified as project miscellaneous financial expenses in general ledger account 6890. The project's Independent Public Accountant advised that these expenses represented fees charged by the project's escrow account trustee. HUD Handbook 4370.2, REV-1, chapter 4, specifies that trustee fees paid to an independent third party to manage the affairs of the project's long-term debt and protect both the interests of the lender and the borrower should be charged to the trustee in general ledger account 7700. The handbook further states that these expenses cannot be charged against project operations without prior written approval of HUD. The HUD field office did not have any documentation pertaining to these fees, and agreed that these charges represent ineligible expenses. Absent any approval, these fees should be considered entity expenses that should be paid by the owners or from allowable distributions. Accordingly, we believe that these ineligible expenses should be reimbursed to the project.

Arlington Arms' 2003 financial statements reported $1,138 as a receivable due from the partners. The project's Independent Public Accountant advised that the receivable represented State withholding taxes paid by the project on behalf of State nonresident partners. The Independent

Public Accountant explained that, effective January 1, 2002, the State required all entities that have taxable income to withhold State withholding taxes on behalf of State nonresident partners. Since there were no distributions in 2003, the withholding taxes were reclassified as due from partners. The amount is non-interest-bearing and is payable on demand. HUD Handbook 4370.1, REV-2, chapter 2, section 5, states that project assets and revenue may only be used for purposes directly related and essential to the operation of the project. Use of project assets for other than necessary and reasonable operating expenses of the project or for the payment of authorized distributions to owners constitutes a violation of the Regulatory Agreement. An official of HUD's Real Estate Assessment Center further advised that partners are responsible for their own taxes. Consequently, this transaction appears to represent a loan to the partners in violation of the Regulatory Agreement.

AUDITEE COMMENTS

Arlington Arms Associates' management agent believes that the trustee fees should be allowed as a normal operating expense since it is a cost related to the bond financing, and is standard with respect to the processing of the mortgage payments. The management agent further stated that the fee was disclosed to HUD during the initial and final endorsement of the mortgage.

Arlington Arms Associates' management agent also stated that the payment of the partner withholding taxes is a lawful obligation of the partnership. However, the general partner has advanced funds to reimburse the project the $1,138 paid on behalf of partners' state tax liability. A copy of check 11037, dated December 20, 2004, made payable to Arlington Associates was provided.

OIG EVALUATION OF AUDITEE COMMENTS

HUD Handbook 4370.2, REV-1, chapter 4, specifies that trustee fees paid to an independent third party to manage the affairs of the project's long-term debt and protect both the interests of the lender and the borrower should be charged to the trustee in general ledger account 7700. The handbook further states that these expenses cannot be charged against project operations without prior written approval of HUD. While the management agent stated that the fees were disclosed to HUD during the initial and final endorsement of the mortgage, no evidence of such disclosure was provided.

The remittance of a check for the amount due from partners is responsive to our recommendation. Therefore, we have modified recommendation 1C to recommend that HUD ensure that the funds were deposited into the project's account.

RECOMMENDATIONS

We recommend that the Director of the New Jersey HUD Multifamily Program Center:

1A. Instruct the partnership to reimburse the project from non-project funds the $10,661 used to pay ineligible trustee fees.

1B. Advise the partnership that, if these types of fees will be incurred in the future, written HUD approval should be obtained before payment of these types of fees.

1C. Confirm that Arlington Arms was reimbursed from non-project funds the $1,138 remitted by the management agent as repayment of the amount paid on behalf of partners' state tax liability.

SCHEDULE OF QUESTIONED COSTS AND FUNDS PUT TO BETTER USE

Recommendation Number	Type of Questioned Cost: Ineligible 1/	Type of Questioned Cost: Unsupported 2/	Funds Put to Better Use 3/
1A	$ 10,661		
1B			
1C	$ 1,138		
Total	$ 11,799		

1/ Ineligible costs are costs charged to a HUD-financed or HUD-insured program or activity that the auditor believes are not allowable by law, contract or Federal, State, or local policies or regulations.

2/ Unsupported costs are costs charged to a HUD-financed or HUD-insured program or activity, and eligibility cannot be determined at the time of audit. The costs are not supported by adequate documentation, or there is a need for a legal or administrative determination on the eligibility of the costs. Unsupported costs require a decision by HUD program officials. This decision, in addition to obtaining supporting documentation, might involve a legal interpretation or clarification of Departmental policies and procedures.

3/ Funds Put to Better Use are costs that will not be expended in the future if our recommendations are implemented; for example, costs not incurred, deobligation of funds, withdrawal of interest, reductions in outlays, avoidance of unnecessary expenditures, loans and guarantees not made, and other savings.

AUDITEE COMMENTS

RECEIVED

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USDHUD
OIGA

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Alexander Malloy
U.S. Department of Housing and Urban Development
Jacob K. Javits Federal Building
26 Federal Plaza Room 3430
New York, NY 10278

Re: Arlington Arms, Jersey City NJ

Dear Mr. Malloy

Pursuant to your letter of December 15th 2004 I would like to comment as follows:

With respect to the $1,138 receivable due from the partners for state withholding tax, we would like to observe that this is a requirement of the State of New Jersey. Several years ago, the State required that a partnership advance taxes at a stated rate on behalf of its non-resident partners. The State did not distinguish between when the partnership had sufficient funds and when it did not. The State determined this to be a lawful obligation of the partnership. However, rather than continue this dispute which, in our opinion, is between HUD and the State of New Jersey, the General Partner has advance the funds so that this money has been paid to Arlington Arms (see attached check copy and deposit slip).

Regarding the $10,661 in trustee fees, we feel that this is a cost that should be allowed as a normal operating cost since it is a cost related to the bond financing and is standard on all bond financed deals with respect the processing of the mortgage payments. Sometimes this fee is included in the rate charged to the borrower; in this case it is charged separately. This financing is the financing that HUD approved at Initial Endorsement and reapproved at the Final Endorsement. It was disclosed to HUD at those times, in every filing since then and has not changed. (See the attached original 2013 approved at initial and final endorsement.)

If you have any questions , please feel free to contact me at your convenience.

Sincerely

Richard Doetsch
President