E X E C U T I V E   O F F I C E   O F   T H E   P R E S I D E N T

13-Nov-1995 06:12pm

TO: Molly Brostrom

FROM: Francis S. Redburn
Office of Mgmt and Budget, HTF

CC: Adam Hoffberg

SUBJECT: RE: MTM tax proposal

Treasury continued to resist.

The outcome finally was that Bob got Les to agree, after much pressure, only to allow HUD to say that alternatives including tax relief were still being explored.

Not entirely satisfactory from HUD's or our perspective, since signalling at least a willingness to not oppose tax relief might be the key to getting any industry support for MTM. The alternative of no reform would obviously cost the Government a lot of money in the long run.

Tax, & other inducements — lang in S. bill unclear

HH 1[?] 1) tenant-based
2) 3rd party negotiator

- need inducements to establ momentum

Dear ____:

This letter follows upon our meeting of November 2, 1995. As we discussed, the Administration is contemplating the enclosed tax relief proposal as part of its mark-to-market initiative. As promised, I am providing you with the attached description of that proposal so that you can circulate it among your colleagues, and invite any comments they may have.

This tax proposal is designed to address only the limited universe of adverse tax effects of mark-to-market. We would expect that you and your colleagues will work with the Administration to make the mark-to-market initiative a success.

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Mark-to-Market Tax Relief Proposal

A. The Relationship between Mark-to-Market and Taxes

The Administration's mark-to-market proposal is to permit FHA-insured multifamily properties supported by project based section 8 subsidies to operate at market. In many cases this can be accomplished only by a restructuring of the project's debt and/or ownership structure. The Administration recognizes that such restructurings can have adverse tax impacts, including income recognition due to cancellation of indebtedness and capital gain recognition. Concern over such impacts has resulted in resistance by investors an owners to various restructuring and exit strategies that would, but for their tax effects, be in their own best interest.

This proposal would extend certain tax relief (described in section B., below) in order to facilitate the mark-to-market process that the Administration has proposed. There is, therefore, a direct linkage between the tax relief proposal and the Administration's mark-to-market proposal. Although legislation will be necessary in order to implement this process, the essential features are clear enough to be incorporated in this tax relief proposal.

Tax relief would be available only in the context of mark-to-market, which is limited to those multifamily projects that are both insured by FHA and receive project based rent subsidies under section 8. In addition, the following conditions precedent would have to be satisfied in order to qualify the investors for tax relief:

(1) There is no default under any section 8 contract, the FHA insurance contract or related loan documents, or the regulatory agreement with respect to the property, and the property complies with all applicable building codes and standards;

(2) The then existing FHA mortgage insurance has been terminated;

(3) Before the expiration of any contract of assistance under section 8, all existing project based section 8 contracts are terminated to permit a recasting to market rent levels.

(4) If there is any debt restructuring that results in cancellation of debt and a claim payment by the FHA Insurance Fund, it is the result of a negotiation with a third party designated by the Department. This negotiation would determine the debt level that is supportable by market rents and must occur prior to the contract expiration or by January 1, 1997, whichever is later.

B. The Proposed Tax Relief

Where the conditions outlined above are met, the proposed tax relief will provide for a deferral of capital gains and deferral of income due to cancellation of debt income in two situations.

(1) In the case of a cancellation of debt where neither the property nor the ownership interest that owns the property are transferred to unrelated third parties, it is proposed that there be a deferral of income until there is a transfer (or upon the death of the partner, if earlier).

(2) In the case of capital gains that result from a transfer of the property and/or change in investor/owner interests in the partnership that owns the property, the taxpayer may:

- defer the capital gains -- to the extent the proceeds of sale are insufficient to pay the gain on transfer -- through a write-down in basis of the investor's other depreciable real property or business or investment property.

- amortize any remaining deferral over a ten year period.

In the event the partner experiences cancellation of debt income in addition to capital gain, cancellation of debt income relief would also be available.

Los Samuels, Treas:

- sp. interest tax provision - no dif. than RTC
- need to make deals

Retsinas, etc

Admin has put fwd fund'l shift

- tax conseq's barrier to impl
- LR costs/savings imp't - LR need to reduce this subsidy

these owners would let props go - go into foreclosure - rather than allow HUD costs of repairing stock + bailing out

w/o tax relief, can't get deal

HD - 1/3 of stock would have neg. value

- HUD would have to forgive 100¢/$1

if MTM → $1B

if → pay now

Outcome → Samuels ~~didn't~~ agreed not to oppose in ST

- using FHA ins fund to pay higher claim

HUD cont'g to discuss w/Hill

9,000 props in MTM portfolio

U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
WASHINGTON, D.C. 20410-8000

OFFICE OF THE ASSISTANT SECRETARY FOR
HOUSING-FEDERAL HOUSING COMMISSIONER

FAX TRANSMISSION

DATE: 9 Nov 95

NUMBER OF PAGES (including this page) 4

TO: Molly Brostrom FROM: Jim Park

~~FAX#~~ PHONE: 456-7431 PHONE: 708-3600

The phone number of this fax machine is (202)708-2580.

Dear ______,

Thank you for writing to me about the Administration's Mark-to-Market proposal. We are looking closely at the concerns and suggestions you raised as we work with Congress and industry groups to tackle the growing cost of project based Section 8 renewals.

As you are well aware, we cannot afford to continue funding Section 8 assistance at the current subsidy level, which in many cases are well above the market level. We must work to control this cost by installing market discipline to the federally-assisted Housing stock and by reducing the dependence on above-market subsidies.

I understand you have met with the Assistant Secretary for Housing-Federal Housing Commissioner, Nicolas P. Retsinas to work through the tax implications on a Mark-to-Market approach. I encourage your continued dialogue and cooperation in resolving this critical issue.

It is my hope that an Administration position on tax relief, that is closely linked to Mark-to-Market, can soon be put forth for Congress' consideration. Mun. mtg

We will keep your concerns in mind as we develop an approach that will address these realities and still maintain a commitment to affordable housing for low-income families. -OMB behind

-Treas. approach

Sincerely,

POTUS/VP

2:00
Rm. 246

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- which owners?
- how many props?
- how is this perceived by advocates?

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OMB, August '95

HUD'S MARK TO MARKET PROPOSAL

Description

- Mark to Market (MTM) will address long-standing problems in the portfolio of 9,000 properties which have mortgages insured by FHA and receive rental subsidies for low-income tenants. The mortgages of these properties will be written down to reflect their true economic value, resulting in mandatory claims being paid out of the FHA fund. At the same time, assistance provided to tenants will be converted to portable vouchers. This will generate discretionary savings: many properties receive subsidies in excess of market rents though others are actually below market (see Tab D). MTM uses market mechanisms to restructure mortgages, create incentives for owners to provide quality and efficient housing stock, and provide assisted tenants choice in their housing.

- The Administration estimates that MTM will save the government, in present value and total cost terms, between $9 and $12 billion. The Administration has scored MTM as neutral from a PAYGO/credit reform basis.

Status

- Passage of MTM is dependent on both appropriations and authorizations action as well as favorable budget scoring.

- In the House, support is generally strong. The Banking Committee supports the proposal. The Appropriations Committee mark for HUD authorizes the conversion of rental subsidies to vouchers and provides no funding for expenses related to the disposition of FHA-held properties (MTM converts this to mandatory spending).

- Support is less strong in the Senate. In particular, the appropriators support the short-term renewal of project-based rental subsidies--assistance linked to specific properties that tenants lose if they move.

- The Budget Resolution does not include specific dollar amounts to accommodate MTM. It does, however, include text stating awareness of the problems addressed by MTM, support for market-based solutions, and acknowledgement that scoring rules may inhibit passage of authorizations in this area. We have interpreted this to mean that the Budget Committees would not let sound policy be derailed by scoring conventions.

Criticisms and Responses

The status quo works and can continue.

- A number of properties are in poor condition and do not have the cash flow to support rehabilitation. Owners have a captive clientele--their incentives for good performance are weak. This will soon become a more visible symbol of failure, like public housing.

- Pressures on discretionary spending will not allow the continuation of rental subsidies at their current rate.

We have time to go slowly and pilot various approaches to restructuring the portfolio.

- The market is aware of the budget realities and the likelihood that subsidies will not continue at their current level. Owners are already adapting by deferring maintenance in an attempt to squeeze out the last bit of profit before an anticipated default.

Restructuring will lead to neighborhood disinvestment as properties lose tenants and fail.

- The transition to market will not be radical and sudden. Properties may receive limited-term rental assistance and rehabilitation grants, preparing them to compete in the market. MTM will minimize the disruption to tenants, communities and owners.

- Many properties are well-managed, quality projects. These are well situated to attract and retain tenants.

Tenants in properties with rents above the level provided by vouchers will be displaced.

- Most tenants who move (65,000 units) will do so because the properties are obsolete. Moving is inevitable under any housing policy and will result in better living conditions.

- Some tenants will be able to absorb rent increases. HUD estimates only 30,000 units (out of a total of 900,000) will have to move because of higher rents.

- The elderly and disabled will have special protections. They will be able to stay in their apartments without rent increases as long as the unit's rent is reasonable compared to similar, non-assisted properties.

- The cost of displacing <u>some</u> tenants who are subsidized in above-market rent apartments must be balanced against the benefit of providing <u>all</u> assisted tenants--some who have no choice but to remain in substandard units--the freedom to choose the best housing they can find.

National Association of Home Builders

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June 12, 1995

THE MYTHS AND COSTS OF MARK-TO-MARKET:

The Department of Housing and Urban Development's Proposal to Eliminate the Privately-Owned, Assisted Multifamily Portfolio

A. Introduction

The Department of Housing and Urban Development (HUD) has proposed eliminating the current system of project-based assistance, where rental assistance is tied to specific buildings that were built and financed under the assumption that the units would receive rent subsidies for an extended period. As current contracts expire, HUD would replace the project-based system with portable rental assistance certificates that qualified families and individuals could use to meet rent payments in any building in which they choose to live. Beginning in 1996 and continuing for the next nine years, project-based rental assistance contracts for properties in the private, assisted stock will expire at the rate of 80,000 to 130,000 units each year.

For the portion of the privately owned, assisted housing stock that carries Federal Housing Administration (FHA) mortgage insurance, HUD also has proposed a "mark-to-market" process where, as current project-based assistance contracts expire, FHA mortgage insurance would be withdrawn and the mortgages would be sold to private bidders. The FHA multifamily insurance fund would cover losses on the sales, that is, the difference between the bid and the face value of the mortgage. HUD has termed this process "mark-to-market" because they assume the bidding process would accurately pare project debt to market valuation and that the resulting lower debt service requirements would allow rents to be lowered to market levels.

This paper discusses the myths and costs of HUD's "mark-to-market" proposal, which NAHB believes is severely flawed, particularly when coupled with the termination of project-based assistance. HUD is proposing radical change through a highly complex mechanism without adequate provision for transition or consideration of the consequences to all parties involved. The proposal risks considerable and unnecessary displacement of tenants, especially elderly and disabled, many of whom will have difficulty finding decent alternative housing. The proposal also ignores the rights of current owners and would cause them considerable economic harm. In addition, HUD's proposed approach would be more costly than continuing the current system without change.

NAHB fully concurs that modifications should be made in the HUD-assisted portfolio, including a mark-to-market process that adjusts project debt and rents to market levels. HUD's approach, however, is not the appropriate way to proceed.

B. HUD's Current Proposal

The Department's current proposal focuses on privately-owned multifamily properties that have FHA-insured mortgages and that receive Section 8 project-based rental assistance. HUD estimates that there are about 9,000 projects with 900,000 apartments in this category. These properties have mortgages totaling approximately $28 billion.

Under the HUD plan, when the current rental assistance contracts expire, FHA-insured mortgages would be sold without ongoing FHA mortgage insurance. The sales would occur through one of four methods: 1) the sale of the mortgage to the highest bidder; 2) the transfer of the mortgage to a HUD disposition agent who would dispose of the mortgage through sale to the highest bidder, inclusion in a bulk sale, or conveyance to a state or local government; 3) the transfer of FHA's insurance liability for all mortgages to be sold to one or more private entities who would handle the resolution of the portfolio on a property-by-property basis; or, 4) the transfer, prior to default, of individual mortgages likely to default upon the expiration of the Section 8 rental assistance contract, to private entities for resolution.

HUD assumes that the purchasers of the mortgages will base their bids on market rent levels. New rents would be established at levels consistent with the sales price and new debt level. Project-based rental assistance would be provided for a two-year transition period and tenants would receive portable housing certificates at the end of the transition period. Upon completion of the transition period, HUD's role as a mortgage insurer and a provider of rental housing assistance for these projects would end.

C. How Will Tenants Be Affected?

The Department contends that residents in affected properties will be protected through the receipt of tenant-based housing certificates to secure housing of their choice. Also, they maintain that elderly residents and residents with disabilities will be protected by tenant-based certificates with special features.

In reality, as the Department acknowledges, there is no guarantee that Congress will appropriate an annual level of certificates sufficient to cover all residents in units which lose project-based assistance. In fact, as evidenced by the recent FY 1995 rescission legislation and FY 1996 budget resolutions, Congress is very likely to reduce, over time, the overall level of federal rental housing assistance to achieve major savings in the effort to balance the federal budget. It is clear that significant reduction of long-term costs to the federal government from HUD's assisted multifamily portfolio can only be achieved by reducing the number of families and individuals receiving federal rental subsidies.

Therefore, NAHB believes that HUD's disposal program will produce significant levels of resident displacement. Many residents will be forced from their homes before they are prepared to move. Some residents who do not wish to relocate to other areas will be forced to move from their neighborhoods. Tenants who do not receive rental assistance will have to either substantially increase their rent burden, find lower quality rental units, or double up with other families. Some will choose not to form households and, unfortunately, some will become **homeless**. Even if portable housing certificates were provided to all tenants currently in properties in accordance with the Department's proposal, we estimate that more than 170,000 households would be displaced because they could not afford to pay market rents with their certificates or because certain properties will be demolished. If, as expected, budget pressures lead Congress to curtail the availability of portable rental housing certificates, then nearly 400,000 families and individuals, including the elderly and disabled, could be displaced.

D. How Will Owners and Investors in the Properties Be Affected?

The Department maintains that current owners will benefit from having a recapitalized property in a state of good financial and physical health as the property converts to tenant-based assistance.

NAHB believes that HUD's disposal proposal is, in effect, an action that would take these properties from their current owners and investors, selling not only the debt but also transferring the current owners' and investors' equity, future cash flow, resale value, and management and mortgage servicing fees to the purchasers of the mortgages.

These "takings" would occur because the mortgages would be transferred at full face amounts while new market rents would be set at levels that will only support lower debt. The resulting cash flow deficit would permit the purchasers to immediately foreclose and gain control of project equity and other value associated with the properties. Bidders seeking project equity and other value will pay more than lenders or the existing owners seeking to purchase only the debt. The successful purchasers, therefore, will be those who will foreclose on the existing owners and investors. Foreclosure will also trigger adverse tax consequences for the current owners and their investors. Alternatively, the mortgage purchasers could use their leverage to extract equity, cash or both from ownership entities seeking to avoid adverse tax consequences.

Because owners in place have major legal rights and strong practical reasons to successfully restructure the financing of these properties, they are in the position to rework project financing at the lowest cost to the government.

E. Will the Department's Proposal Save the Government Money?

The Department contends that their proposal would save the government money when compared to renewing Section 8 project-based rental assistance contracts.

In fact, according to the Congressional Budget Office (CBO), HUD's proposal would not save the federal government money. CBO recently prepared 25-year costs estimates for both renewals of project-based assistance and the Department's proposal. **The CBO study indicates that HUD's disposal proposal would cost $4 billion more than simply renewing all expiring Section 8 project-based assistance contracts.**

HUD's proposal would produce huge up-front demands on FHA's multifamily insurance fund. Forcing 900,000 multifamily units into new ownership hands in a short four-to-five-year period would sharply depress values of all affected properties. Such forced liquidations would minimize the value of the portfolio and maximize the claims against the $28 billion federal mortgage insurance exposure. The RTC experience, which HUD's disposal proposal closely parallels, utilized bulk sales creating market values so low that the purchasers could make huge profits by simply holding the properties and selling them gradually into a non-disrupted market.

F. What are the Alternatives?

HUD should focus on solutions to principal problems affecting the privately owned HUD-assisted multifamily portfolio rather than simply selling it off and creating even more severe problems. Problems which require attention include:

- financial and physical rehabilitation of viable projects in the portfolio;
- removal of failed properties from the portfolio; and
- reduction of the long-term economic cost for continuing to operate the portfolio.

A number of principles should be observed in addressing these problems:

- The removal of apartments from the affordable housing stock should be minimized;
- Government expenditures should achieve the maximum impact on the target population;
- The effects on tenants should be minimized:
- Protection should be provided for vulnerable tenants (i.e., those tenants, such as the elderly and disabled, who would have difficulty finding alternative housing);
- The economic position of owners and equity and debt investors should be protected (e.g., no adverse tax consequences);
- Protection should be provided for sound properties that are in areas where unassisted operation is impossible;
- There should be a complete and innovative review of restructuring options for the HUD-assisted multifamily portfolio; and
- Project-based rental assistance should be the principal method of providing rental assistance to multifamily properties subjected to modification and housing vouchers should only be used for tenant protection in displacement.

Solutions need to address the central issue of the budget pressures created by renewals of expiring Section 8 project-based rental assistance contracts. NAHB has developed a proposal that deals with this problem, while incorporating the principles outlined above. We would be happy to make copies of this proposal available and discuss our recommendations.