MILLENNIAL HOUSING COMMISSION
TAX ISSUES AND PRESERVATION TASK FORCES
BACKGROUND PAPER: PRESERVATION TAX INCENTIVE

OVERVIEW

Illustrative Example. See Appendix 1 for an illustrative example of a typical situation, and for explanations of the various technical tax issues involved.

The Issue. There is widespread agreement that it is good policy to preserve existing affordable housing that is at risk and that serves, and is occupied by, very-low-income households. For a synopsis of preservation risks and why preservation is considered good policy, see Appendix 3. Experienced affordable housing professionals generally agree that the single largest barrier to transfer and preservation of pre-1986 properties is the seller's income tax due on sale (hereafter, "tax on sale"), usually exceeding the cash proceeds of the sale. This barrier could be removed or reduced if sellers were relieved of some or all of this tax as a result of transfer that resulted in long-term preservation.

How The Problem Arises. The tax on sale problem arises as a direct consequence of tax-shelter syndication, under which investors expected to receive a return on their investment in the form of tax losses greatly in excess of their cash investment. This excess ("negative capital account") would in turn generate taxable income ("minimum gain"), and tax liability ("tax on sale") at the time of sale. This tax on sale could be delayed by delaying the sale of the property. Moreover, under the Internal Revenue Code, the tax on sale can be avoided entirely if the investor dies before the property is sold. Thus, the existence of the tax on sale acts as a powerful disincentive for sale of the property. There are other disincentives as well, as discussed below.

The Potential Solution. The Commission is considering recommendations for some form of preservation tax incentive. In general, the incentive would work in the following manner. The seller of an eligible property (which must be both "at-risk" and "preservation-worthy") would agree to sell the property to a desirable owner ("preserving entity") who agrees to a long-term affordable housing commitment ("use agreement") and who agrees to finance and operate the property in a way that assures its long-term physical and financial viability ("sustainability"). The seller would not be subject to federal income tax with respect to some or all of the seller's minimum gain. This would create an economic incentive for the sale of eligible properties for long-term affordable housing use. It would also be intended to make a preservation-oriented sale preferable to a sale that did not include long-term preservation as affordable housing.

Why The Issue Is Important. Often, the transfer of a property to a new owner is helpful or essential in order to preserve the property as affordable housing. This occurs when the purchaser has access to subsidy resources (or, for that matter, debt or equity resources) that the seller does not, when the seller is not able or willing to continue operating the property as affordable housing, and when – for whatever reason – the purchaser is a more desirable long-term owner from a public purpose standpoint[1]. Most affordable housing experts believe that having the wrong owner in place leads to a number of material but partially invisible costs, such as lack of attention to the property, likely higher operating costs, and a higher likelihood that the property is building up a backlog of major repairs and replacement.

Barriers to Sale. In theory, the decision to sell vs. hold is a made almost solely for rational economic reasons. However, as a practical matter, it is far from a simple financial calculation. Decisions to sell vs. hold involve at least these factors:

- **Partnership Structure.** In the typical limited partnership structure, decisions to sell or refinance must be proposed by the general partner and approved by a percentage of the limited partners. Thus, general partner acts as gatekeeper. A potential purchaser must first satisfy the general partner that the transaction is sufficiently attractive to be worthy of the general partner's scrutiny, and is sufficiently likely to close that the general partner is justified in pursuing it.

- **Economics.** The general partner (and sometimes individual limited partners as well) performs an after-tax, net present value analysis of selling, holding without refinancing, and holding with refinancing. All else equal, the approach with the most value (or, for adverse situations, least cost) is the preferred approach. Economic analysis by The Compass Group suggests that, under current tax law, holding with refinancing is generally the economically superior option, followed by holding without refinancing. Selling becomes the superior option in severe phantom-income situations (see Appendix 1) and when the value of the property to the purchaser is significantly higher than its value to the seller. Hence the relatively low volume of sale transactions.

- **Deferral of Pain.** If an investor faces a large tax on sale upon sale, the path of least psychological resistance is to continue to own – whether or not holding is superior to selling on a purely objective economic basis.

- **Avoiding Finality.** By selling, the investor gives up the chance to gain from upside events such as: favorable legislative change, a lower tax bracket, dramatic market improvement, and a future purchaser who is willing to dramatically overpay. Selling also avoids potential downside risk of other future events, but it is second nature for many investors to assume that good things will happen to them and that bad things happen only to other people.

- **Divergence of Interest Among Partners.** In a typical limited partnership structure, there are at least these three groups with divergent interests: general partners, limited partners with tax on sale problems, and limited partners without tax on sale problems. In practice, first the general partner needs to be in favor of the transaction, and then a majority of each limited partner group needs to vote in favor of sale before the property can be sold. The practical implication of this barrier is that offers to purchase are unlikely to succeed unless they are clearly attractive to each group.

[1] If the existing owner is facing "phantom income" (see Appendix 1), the owner may be sorely tempted to make the property generate enough cash to pay the tax, which might have the effect of starving the property for cash.

- **Unilateral Option.** Limited partners who have tax on sale problems have the unilateral option to trigger their tax on sale by donating their interest (either to charity -- possibly for a small charitable deduction -- or to another partner in the partnership). If this occurs, then over time the effect is to replace partners who want to sell with partners who generally do not want to sell.

As will be seen later, a preservation tax incentive has the potential to push each of the preceding factors toward sale.

Scope of The Issue. The tax on sale problem is an artifact of pre-1986 tax law. Thus, tax on sale problems are limited to properties acquired at least a year or two before 1986[2]. With respect to pre-1986 properties held in partnership structures, tax on sale problems are restricted to those investors in such properties who made their investments well before 1986 and have not transferred their interests.

Structure of This Paper. This paper will explore the various issues involved in assessing whether it is likely to be good public policy to grant sellers full or partial relief from tax on sale, when the sale results in the long-term preservation of the property as affordable housing. For each issue, various points mentioned by proponents and opponents of this preservation tax incentive are discussed. An assessment of each point is included in italics. The paper includes two appendices. The first presents an illustrative tax on sale situation together with explanations of the various tax issues. The second presents an estimate of the number of properties in the RHS- and HUD-assisted portfolios that might transfer to preserving entities as a result of the enactment of this preservation tax incentive.

CREATE A PRESERVATION TAX INCENTIVE, OR NOT?

Issue. Leaving aside the particular approach to a preservation tax incentive, is granting a preservation tax incentive likely to be good public policy?

Points In Favor of Creating A Preservation Tax Incentive. The following points are mentioned by advocates for a preservation tax incentive:

- **Preservation.** By stimulating preservation transfers, a preservation tax incentive would preserve some number of at-risk properties for long-term affordable housing use, over and above the number that would have been preserved absent a preservation tax incentive. *This seems certain.*

- **Recapitalization (Volume).** Some owners of troubled properties are not able to access the additional funds needed to stabilize the property[3]. This occurs in part because some resources are available only to purchasers or only to certain types of purchasers, in part because some resources are attached to governmental programs that the current owner is unable or unwilling to access, and in part because the existing owner of the property may

[2] Investments made just prior to 1986 are relatively unlikely to have tax-on-sale problems.

[3] Generally, limited partners cannot be compelled to contribute additional equity if the property later runs into trouble. Thus, in practice, subsequent capital infusions typically come from the general partner, from purchasers, and/or from government.

simply not have good access to capital[4]. By removing a major barrier to sale transactions, a preservation tax incentive would facilitate the stabilization of some number of these properties, over and above the number that would have been stabilized absent a preservation tax incentive. *This seems certain.*

- **Recapitalization (Timing).** The availability of a preservation tax incentive will cause at least some troubled properties to be preserved earlier than would otherwise occur, before deterioration sets in. *This seems certain.*

- **Owner Quality.** By removing owners' primary objection to sale transactions, a preservation tax incentive would allow government to be more forceful in requiring that problem owners divest their properties (or divest their interest in their properties). That is, if the current owner is viewed as undesirable, government today is relatively unlikely to be able to encourage the owner to sell, because the owner can, in effect, say "I would be happy to sell but I can't cover my tax on sale." If the tax on sale were reduced or eliminated, government would be in a much stronger position to succeed in separating the undesirable owner from the desirable affordable housing property. *This potential benefit is plausible but not certain; undesirable owners could still resist pressure to sell even if there were no tax on sale. It is also notoriously difficult to induce an owner to sell a property. Still, government housing professionals would welcome the elimination of this barrier.*

- **Tax Cost May Be Small or Zero.** Owners whose properties are viable (whether as continued affordable housing or as converted to market rate housing) have a unilateral option to continue to own. Generally, even in the face of phantom income problems, holding the property is superior to selling and paying the tax on sale. Thus, these owners are unlikely to pay tax on sale in any event, because at least two strategies are available to them under which no tax on sale would be incurred:
    - **Hold The Property.** The owner could hold the property until death, at which point the tax on sale could be eliminated[5].
    - **Like Kind Exchange.** The owner could dispose of the property by exchanging it for a similar property[6].

  For these owners, the government is unlikely to collect any tax on sale revenue. Granting these owners a preservation tax incentive would thus, arguably, allow the public purpose benefits of the preservation transfers to be realized with little or no offsetting cost in the form of foregone tax revenue. *Under current tax law, this seems to be a valid argument that, admittedly, is limited to properties that are viable. Owners of properties that are distressed are quite likely to incur tax on sale, if only because many troubled properties are sold, donated, foreclosed, or otherwise transferred.*

- **Governmental Cost May Be Negative.** A preservation tax incentive to owners of viable properties will generate <u>savings</u> to the government to the extent that (1) the owner would not have paid tax on sale in any event; and (2) preservation via an early sale requires less government funding than a later workout or sale, after the property becomes severely

[4] For example, the property may be worth less than the outstanding debt.
[5] See Appendix 1 for an explanation.
[6] See Appendix 1 for an explanation.

troubled. *It is generally accepted that early intervention is less costly than delayed intervention, so long as the property is one that would have failed in the absence of the early intervention. In particular, foreclosure by government is a very costly action. Earlier preservation also dramatically improves conditions for residents and neighboring properties. Note: the preceding discussion reflects overall cost to the government, not necessarily reflecting the way that CBO or OMB would formally budget-score a specific tax relief proposal.*

- **Financial Efficiency.** It is reasonable to expect that the owner of a viable property will not sell unless the net proceeds of the sale are more than sufficient to cover the resulting income taxes. Moreover, many potential purchasers discover that the owner of non-viable properties will not sell unless at least a significant fraction of the tax on sale liability is covered[7]. Currently, therefore, in order to preserve a property whose market value is not sufficient to cover at least a significant portion of the seller's tax on sale, purchasers need to raise grant funds[8] from state and local governments and foundations, in order to pay the portion of the seller's tax on sale that is not covered by the property's market value. Leaving aside the question of whether the tax on sale problem should be addressed through housing funds (the status quo) or a preservation tax incentive, this is a highly inefficient way to fund preservation. The purchaser generally will not know how large the seller's tax on sale liability is. The purchaser will not know which limited partners have acquired their interests recently (and thus do not have tax on sale liability) and will not know the amounts of suspended losses held by limited partners. This situation creates an opportunity for sellers to overstate the amount of their expected tax on sale, and thereby extract a higher sales price. If, conversely, a preservation tax incentive is granted, the amount of governmental funds spent to cover the tax on sale will be exactly the correct amount. *A preservation tax incentive is clearly a more financially efficient approach, at the property level. It would, of course, be necessary to design a preservation tax incentive so that it applied to the correct set of properties and actually produced the desired results.*

- **Frozen Assets.** One of the arguments in favor of a capital gains tax cut is that the capital gains tax tends to cause investors to hold assets rather than sell them, even when selling is the right approach from a non-tax standpoint. A similar argument applies here: selling the property is the right approach for the property, the government, and the community – and the owner would probably sell if there were no tax consequences. The government and community benefit from a sale, because the purely economic motivation of the current owner is simply to avoid foreclosure, then die. In some fraction of properties, the owner will act purely in accordance with its economic motivation, with the result that maintenance will be deferred and residents and community will be put at risk. Thus, the presence of the tax on sale significantly distorts economic activity and adversely affects the public interest. Conversely, reducing or eliminating the tax on sale would allow

[7] The reluctance of owners to sell non-viable properties might seem to fly in the face of reason. However, it is understandable that some owners will refuse a known unpleasant outcome in the hope, however slim, that in the future a more favorable outcome will become available. Indeed, the potential that a preservation tax incentive may be enacted is itself a barrier to the transfer of at-risk properties. Similarly, owners might choose small annual expense from holding the property, instead of a single large tax payment upon sale of the property, even if the "hold" strategy had higher overall cost to the owner.

[8] Likely creating an additional set of tax problems, this time for the purchaser.

owners to take the action that is otherwise economically sound and consistent with the public interest. *It is certainly true that a preservation tax incentive would "unlock frozen assets" by facilitating the sale of properties that are now being held solely for tax reasons.*

- **Tax Fairness.** Pre-1986 real estate investors encountered several adverse tax law changes in the ensuing years (see Appendix 1). A preservation tax incentive would provide some redress. *The extent to which the price of the investments included an adequate premium for the risk of adverse tax law changes is debatable. That said, it is fair to say that the actual tax law changes were highly unfavorable to these types of investments. The government got what it wanted – production of desired market rate and affordable housing – without giving investors what they wanted (the expected tax benefits). As against that, the 1986 changes were comprehensive (not just targeted to real estate) and are generally regarded as having been good tax policy in the aggregate.*

- **Barrier to Preservation.** There is wide agreement that it is good public policy to preserve existing affordable housing that is doing a good job of meeting local needs[9]. Tax on sale is perhaps the most significant barrier to the preservation of many such properties. Eliminating the tax on sale is therefore the most efficient means for facilitating the preservation of these properties. Arguments about whether investors deserve relief are beside the point. *This is a practical and utilitarian line of argument, supporting a preservation tax incentive as the most direct means to a desirable societal end. It does seem clear that tax on sale is the most significant barrier*[10]*. As discussed above, a preservation tax incentive is also more financially efficient than the status quo. Whether these benefits are powerful enough to overcome concerns that a preservation tax incentive constitutes a windfall to investors is ultimately a political question having mostly to do with perception and thus not readily lending itself to analysis.*

Points Against Creating A Preservation Tax Incentive. The following concerns are mentioned as potential reasons not to provide a preservation tax incentive.

- **Owner Quality.** If a preservation tax incentive were enacted, government might allocate scarce resources disproportionately to purchasers vis-à-vis existing owners, to the detriment of good existing owners. *A few years ago, most housing policy experts believed that housing policy should actively encourage sales to nonprofit purchasers. Today, the weight of expert opinion is much more divided, recognizing the merits of good existing owners, the merits of desirable for-profit purchasers, the relative lack of nonprofit purchasers in many areas, and the fact that not all nonprofits are desirable owners for multifamily properties. Accordingly, it is reasonable to expect that policy will not blindly encourage transfers when continuation under the current owner is the appropriate outcome.*

- **Tax Cost May Be Material.** Owners whose properties are troubled are likely to pay tax on sale (either through foreclosure or distress-sale). Granting a preservation tax incentive

[9] For one thing, the cost to preserve an existing property is almost always a fraction of the cost to produce equivalent new housing. See also the Commission's background paper on Preservation.

[10] See the Commission's background paper on Barriers to Acquisition By Preserving Entities.

is likely to reduce tax revenue with respect to such owners. *This is a valid concern. Because distressed properties are in more urgent need of recapitalization and preservation, distressed properties represent a material proportion of the properties that advocates would hope to preserve via a preservation tax incentive. As against that, curing a distressed property is a valuable social goal that may also save the government money, vs. allowing the property to deteriorate further.*

- **Tax Fairness.** Investors received tax benefits pre-1986 in the form of losses, over and above the amount invested. Investors were allowed to offset these losses against salary and business and investment income. The tax on sale is simply the recapture of those benefits. Moreover, owners took the losses at (high) ordinary income rates and will pay the tax on sale at (lower) capital gains rates. *Leaving aside the fact that the benefits actually realized by investors were well below the benefits originally expected (see Appendix 1), this line of argument is fundamentally correct as to tax theory. However, as discussed above, even if a preservation tax incentive does create a windfall for investors, that may not be a sufficient reason to oppose it.*

The preceding discussion suggests that creating a preservation tax incentive would be very sound <u>housing</u> policy, because it solves a serious housing problem in the most direct and efficient way (indeed, it would be difficult, perhaps impossible, and certainly more expensive to solve this problem through any other mechanism). However, considered solely as <u>tax</u> policy, the preservation tax incentive is not particularly compelling, because it would be overstating the case to claim that the tax *status quo* is unfair or theoretically unsound.

How Much Relief?

Issue. Owners would prefer full relief from tax on sale; so would purchasers. However, it is not clear that full relief is needed in order to achieve the public policy result.

Considerations. The following considerations shed light on the question of the overall amount of relief, in relation to the full tax on sale:

- **Phantom Income[11].** One way of looking at the 'phantom income' issue is to realize that, absent refinancing or death, owners will recognize taxable income at least equal to their negative capital accounts over the remaining term of the mortgage loan[12]. So, for troubled properties or other properties that cannot refinance (and whose owners do not expect to die before the mortgage amortizes), the owner's point of indifference is related to the net present value of the stream of taxes the owner would pay over the remaining mortgage term. To the extent that owners expect to pay significant taxes (over and above the property's cash flow) if they hold the property, or if they expect to lose the property via foreclosure, full relief may not be necessary in order to cause a sale to occur. *Economic analysis suggests that the phantom income problem is quite significant in the later years of mortgage amortization.*

[11] "Phantom income" denotes taxable income in excess of cash distributions. See Appendix 1.

[12] As the loan approaches maturity, the principal payments rise relative to the interest payments, thereby exacerbating the phantom income problem. Once the loan is paid off, as a matter of accounting it is almost impossible for there to be a negative capital account.

- **Investor Life Expectancy.** On the face of it, older investors, who expect to hold the investment until death, do not expect to pay any tax on sale[13]. However, some of these investors may intend to dispose of the property during their lifetimes for other reasons, such as not to burden a surviving spouse with a complex and illiquid asset. *Perhaps oversimplifying, for many of these investors, nothing short of full a preservation tax incentive is likely to stimulate a sale.*

- **Market Value.** The market value of the property may cover some or all of the owner's tax on sale. To the extent the market value significantly exceeds the mortgage balance, full relief may not be necessary in order to cause a sale to occur. *This suggests that a preservation tax incentive could be phased down as net sales proceeds increase. In any event, the amount of relief should be based on the "minimum gain" so that sellers pay normal capital gains taxes on any net cash proceeds.*

- **Economic Sell vs. Hold Analysis.** Economic analysis suggests that holding the property is generally economically superior until relatively late in the property's life. At that point, however, the decision whether to continue to hold and operate the property, refinance it, sell it, or abandon it is highly situation-specific. In particular, whether the original building investment has been substantially depreciated seems to be a critical factor. Other important issues include the size of the negative capital account, the size of the mortgage principal payments, the sharing arrangements between the general and limited partners, and the degree to which expenditures from the reserve for replacements can be expensed vs. capitalized. Accordingly, there is no rule of thumb that expresses the degree to which the existing owner may be willing to sell. Moreover, not all of these factors can be ascertained by a purchaser. *This suggests that the degree of a preservation tax incentive necessary to facilitate a sale may vary widely among potential sellers.*

- **Seller Psychology.** Experience suggests that, faced with a marginal transaction, many sellers will simply choose to wait in the hope that something better will come along. Sellers may hope for a future tax law change that is more favorable, for governmental economic stimulus that raises the value of the property, for dramatic improvement in the neighborhood real estate market, or simply for a lower tax bracket as they enter retirement. Experience also suggests that a simple explanation ("you won't pay any tax on the sale") will be more effective than a complicated explanation ("you will pay some tax, but on a net present value basis it's less than you would have paid if you had lived through the end of the mortgage term, based on reasonable assumptions about property performance, interest rates, inflation, and your personal tax situation …").

When taken together, these points indicate that it is not possible to calculate an accurate "point of indifference." *This suggests that full relief of the tax on sale may be the optimum policy approach.*

Potential Mechanisms.

[13] David Smith reports an elderly investor saying, "I just hope the project lasts longer than I do."

- **Full Relief.** Full relief is simple. It is predictable. By all accounts, it would result in significant numbers of transfers, particularly if implemented with a relatively near term sunset date. *It also is the most expensive approach.*

- **Ten-Year Amortization.** An alternative, advanced by HUD and Treasury during the Clinton Administration, is to allow the owner to pay the tax on sale in ten equal annual installments. This amounts to a roughly 40% discount, valuing the installments at a 10% IRR. Both sellers and purchasers expressed the opinion that this would be inadequate to cause sales to occur in any volume. *An amortization approach also might involve significant tax paperwork over the amortization period, possibly equaling the paperwork associated with limited partnership K-1s.*

- **Discounted Payoff.** The owner could be allowed to pay only a percentage of the tax on sale (paying 30% -- an 70% discount – would be midway between full relief and the NPV of the ten-year amortization). By comparison to an amortization approach, this has the advantages of simplicity and finality (no ten year paperwork obligation). *All else equal, a discounted payoff approach seems preferable to an amortization approach because it relieves both parties -– taxpayer and government – of the need to track a complicated transaction over a long period of time*[14].

If full relief is not selected, the best option appears to be a discounted payoff.

ENTITLEMENT VERSUS ALLOCATION

Issue. Relief could be granted to the entire class of owners who met statutory criteria and sold to purchasers meeting statutory criteria. Alternatively, transactions meeting the criteria could be eligible to compete for relief that would be allocated based on public purpose benefit[15].

Points In Favor of Entitlement.

- **Predictability**. Transactions will be difficult to accomplish if there is uncertainty as to whether a preservation tax incentive will be available. Properties with urgent needs, and owners with viable options other than preservation, may not be able and willing to wait for the next round of allocations. *It seems clear that an entitlement approach will be superior for at least some preservation-worthy properties.*

- **Cost of Allocation System.** The allocation system will have a cost that is likely to be material. All else equal, eliminating that cost will allow more properties to be preserved. *Administrative costs of 5% to 10% of foregone tax revenue would not be surprising.*

Points In Favor of Allocation

- **Ability to Manage the Cost to Government.** To the extent that a preservation tax

[14] However, because tax expenditures are budget-scored at their nominal (non discounted) ten year cost, an amortization approach may "score" better than a discounted payoff approach that has the same net present value.
[15] The State HFAs would be the logical allocating entities, as this task would require roughly the same skill set as their current duties in allocating LIHTCs.

incentive is determined to have a cost to government, allocation allows government to manage the actual cost. Note: from a Congressional budget-scoring perspective[16], allocation may be a political necessity because otherwise the cost to government may be impossible to predict. *This is a powerful factor in favor of allocation. There are, however, other cost containment approaches such as using a sunsetted program, and accepting transactions on a first come first served basis until a statutory limit is reached.*

- **Alignment With Public Benefit.** The participation of an allocating agency gives greater assurance that a preservation tax incentive will be granted only when, and to the extent, its public benefits exceed its public costs. *If both the eligibility for relief, and the degree of relief, were allocated, the allocating agency would have considerable ability to target the relief for greatest public benefit. Admittedly this would come at the cost of greatly reduced predictability for sellers and purchasers.*

Entitlement and allocation approaches each have strong advantages and disadvantages. It seems clear that the entitlement approach is more likely to stimulate a large number of transactions quickly. Thus, entitlement may be the appropriate approach if the objective is to preserve as much of the at-risk universe as possible. Conversely, if the objective is to preserve only a portion of the at-risk universe, an allocated system will be more likely to preserve the properties having the greatest public-policy value.

Entitlement plus Cost Control. The Commission could consider a hybrid approach in which sellers would receive relief on a first come, first served basis, subject to an overall statutory cap on the total volume of transactions. Under this approach, State HFAs would preliminarily certify each transaction, on the basis of information provided by purchaser and seller, as a "preservation transaction" – an eligible property, transferred to a preserving entity, structured and financed under sustainability principles, and under an acceptable long-term use agreement. The seller would present the HFA preliminary certification to the IRS, which would tentatively register the seller's eligibility for tax relief so long as the overall statutory cap had not been exceeded. This tentative IRS registration would allow a reasonable period of time to close the transaction. After the closing, the HFA would issue a final certification that the transaction, as closed, was in fact a preservation transaction. The seller would submit the HFA final certification to the IRS, which would provide the seller with a certificate of eligibility for tax relief. The seller would attach the IRS certificate to its tax return for the year of sale. The IRS would periodically publish the amount of statutory cap remaining. Under this approach, sellers and purchasers would have predictability and would have the ability to negotiate and close complicated transactions, but the government would also have the ability to control and monitor the overall cost of the program.

PERMANENT VERSUS SUNSETTED PROGRAM

Issue. Relief could be enacted on a permanent basis, or on a demonstration basis, requiring Congressional reauthorization after a demonstration period.

- **Factors Regarding Permanency.** Predictability. Transactions take time to research, negotiate and close. To the extent that sellers and purchasers can rely on the availability

[16] Tax expenditures are scored in nominal dollars over a ten year window and must be "paid for" by new revenues or offsetting reductions in expenditures.

of a preservation tax incentive, they will be more likely to invest the time needed to successfully complete transactions. Moreover, a sunsetted program might result in a rush of transactions that could overwhelm the capacity of preserving entities.

- **Factors Regarding Sunset.**
  - Sense of Urgency. The tax on sale problem is concentrated in a large but finite universe of pre-1986 properties, most of which are facing more or less immediate opportunities to convert to market rate use. A time-limited a preservation tax incentive program could have the effect of stimulating large numbers of transfers in a relatively short time frame.
  - Demonstration Period. Given the size of the at-risk portfolio and its diversity, a relatively short period such as three years would risk failing to achieve the desired results. Five to six years is more likely to be a workable demonstration period.
  - Window of Opportunity. It is likely that those transactions that can occur, will occur within five to ten years. After ten years, many limited partners will have died, many properties will have failed, and the main opportunity for a viable preservation tax incentive will have passed.

Observation: there is relatively little practical difference between a permanent program and a five to ten year sunsetted program, suggesting that a permanent program may be optimal (inasmuch as it avoids the need to revisit the issue if, as is likely, some significant number of transactions are pending as of the sunset date).

WHAT QUALIFICATIONS SHOULD PURCHASERS BE REQUIRED TO MEET?

Issue. There is general agreement that a preservation tax incentive should result in (1) transfer to a highly desirable owner (sometimes termed a "preserving entity") and (2) imposition of a very-long-term affordable housing use agreement.

What is a "Preserving Entity"? Some argue that only nonprofits (or only certain sub-categories of nonprofits) should qualify. Others argue that business capability, commitment to the affordable housing mission, and financial capability are the most relevant criteria. Moreover, in many areas of the country, there is an inadequate supply of highly capable nonprofits. *It seems clear that both nonprofit and for-profit entities should be able to qualify. Extension of 'preserving entity' status to for-profit entities places additional emphasis on the long-term use agreement. Governmental agencies (e.g., public housing authorities, redevelopment authorities) should also be able to qualify.*

Potential "Preserving Entity" Requirements.

- **Access to Capital.** Ability to finance the acquisition of the property plus any renovation needed. One potential qualification would be the expressed willingness of the state housing finance agency to have the entity as a borrower[17].

[17] This is not to suggest that the HFA should actually be the source of financing, but to indicate the general quality of purchaser.

- **Capability.** Demonstrated capability to acquire, finance, rehabilitate, and manage affordable housing. In the world of market rate apartments, capability is measured primarily based on experience and past performance.

- **Commitment to Affordable Housing.** Though essential, this would admittedly be difficult to measure. In an allocated system, the state allocating agencies could develop their own criteria. Perhaps the most practical approach is to determine that any entity willing to accept the use agreement has a sufficient commitment.

- **Independence.** The preserving entity can have no identity of interest with the seller.

Use Agreement Characteristics

- **Length.** There is general agreement on two points. First, the term should be as long as practicable. Second, the longer the term, the more carefully the use agreement must be drafted, in case it later makes sense to demolish, redevelop, or change use.

- **Priority.** Most argue that the use agreement should be a covenant running with the land. As such, it would prime the 1st mortgage and would survive foreclosure. However, such a structure would make financing more difficult to secure, more expensive, or both. *It is likely that the financing markets will adjust. It is less likely that affordability would survive a foreclosure, absent a use agreement that primes the lender.*

- **Number of Units.** Comparable programs restrict 20% to 100% of the units. In the context of a preservation tax incentive, a strong argument can be made for 100% restriction because the a preservation tax incentive covered 100% of the units. *Restricting 100% of the units seems fully appropriate.*

- **Affordability Standard.** There is much to be said for the LIHTC standard (maximum rent at 30% of 60% of area median income). However, the LIHTC restriction is often above local market rents and thus is "out of the money." The affordability could therefore be expressed as the lower of the LIHTC standard, or [10]% below market. *A potentially attractive hybrid approach is to apply the LIHTC standard (not to exceed market) to all units and to further require a percentage of units, distributed across unit types, to have rents [10]% below that level.*

- **Recapitalization Needs.** In theory, a priority could be given to projects with significant unmet capital needs (in practice, determining which properties to prioritize would be complicated). *In an allocated system, this decision should be left to the allocating agency.*

- **Use Agreement Monitoring.** It should be noted that there would be a need for someone to monitor compliance with the use agreement.

WHICH HUD- AND RHS-ASSISTED PROPERTIES SHOULD QUALIFY?

Issue. Should all existing HUD- and RHS-assisted properties qualify for a preservation tax incentive (if sold to a preserving entity)?

Potential Qualification Issues:

- **No Cash Sales Price.** It may be good policy to restrict a preservation tax incentive to sellers who donate their properties. Alternatively, the preservation tax incentive could be phased out for transactions in which the seller receives net proceeds from the sale. *The phase-out approach seems best, if only because market reality demands that properties with different market values carry different sales prices*[18]*. Or, said differently, requiring no cash sales price is likely drive the more desirable properties away. A phase-out approach also makes it likely that sellers will not negotiate quite as vigorously on price, inasmuch as they will not keep as large a share of each incremental dollar. This would serve the public policy interest in facilitating the preservation transfers.*

- **No Charitable Contribution Deduction.** It may be good policy to restrict a preservation tax incentive to sellers who are not also claiming a charitable contribution deduction for the donation of the property. *This issue parallels the "no cash sales price" issue. One alternative approach is to reduce the amount of the preservation tax incentive if the seller is claiming a charitable contribution deduction.*

- **"Not The Worst."** It may be good policy to require properties being preserved via a preservation tax incentive to meet some threshold requirements as to neighborhood quality, physical condition, and general "preservation worthiness." A process similar to HUD's Mark to Market "Rental Assistance Assessment Plan" could be followed, evaluating each property according to standard criteria, based on comments from key stakeholders. *In an allocated system, the allocating agency would perform this function.*

- **"Not The Best."** It may be good policy to allow the highest-value properties to convert to market rate use, on the grounds that preserving them will be too expensive relative to the cost to preserve other at-risk housing. *With a phase-out of a preservation tax incentive based on net cash to the seller, this issue probably becomes moot.*

- **Preference for Troubled Properties.** It may be good policy to prioritize properties with physical or financial distress. This would require developing a methodology for measuring distress. One such approach is to obtain a comprehensive property analysis as is done under HUD's Mark to Market program. *In an allocated system, the state allocating agencies could include distress in their allocation plans, or not, as appropriate for housing needs and conditions in their individual markets.*

- **Sustainability.** The property should be required to be in (or be brought into) sustainable physical and financial condition. See the Commission's background paper on Long Term

[18] One example is to reduce the a preservation tax incentive by 35 cents for each dollar of net proceeds. This is based on an assumption that each dollar of additional proceeds generates 30 cents of capital gains tax and 70 cents of after tax proceeds to the seller, and amounts to splitting the 70 cents between tax on sale phase-out and the seller. Any actual phase-out approach would need to be more carefully designed, for example to consider estate tax, AMT, and other relevant tax issues. A phase-out approach would also have to be carefully designed so that it still gave sellers a better result for a sale that preserved the property than for a sale that did not. That is, the a preservation tax incentive should not be entirely phased out.

Sustainability and Affordability.

SHOULD UNREGULATED AFFORDABLE APARTMENTS QUALIFY?

Issue. It seems clear that any a preservation tax incentive should encompass expiring-use housing that is already part of the HUD or RHS assisted housing stock. Some have argued that a preservation tax incentive should also be available to owners of modest market-rate properties that could become part of the permanently affordable stock via transfer to a preserving entity.

Points in Favor.

- **Volume.** Unregulated affordable apartments comprise a significant fraction of the apartments that are affordable to low-income households. Absent preservation, much of this modest market-rate stock is likely to leave the affordable stock.

- **Phantom Income and Under-Maintenance.** To the extent that owners face phantom income problems, there will be strong pressure to maximize short-term cash flow in order to provide funds to pay income taxes. This is likely to result in postponement of major repairs and replacements.

Points Against.

- **No Immediate Rent Bargain.** If the property is preserved at current (market) rents, there is no immediate public policy benefit. However, there is a longer term "gentrification insurance" benefit. If market rents rise rapidly in the future, the preserved property's use restriction would limit the degree to which rents could rise, thereby generating a rent bargain over time. Alternatively, if the transfer is structured so as to produce an immediate rent bargain, that will have to be paid for through additional tax incentives or other subsidies. *The lack of immediate rent bargain need not be dispositive of the issue. Research suggests a significant benefit to the production and preservation of apartments that are affordable to moderate income households, whether or not those units have rents below market*[19].

- **Difficulty of Judging Preservation Risk.** There is an obvious preservation risk with respect to existing assisted housing with below-market rents and whose affordability period is expiring (and existing affordable housing that is troubled). Whether an existing market rate property with affordable (albeit market rate) rents is at risk of leaving the affordable stock is less easy to determine. A preservation tax incentive for modest market rate properties thus likely would need to be coupled with a determination that there is a preservation risk. This determination would be expertise-intensive and judgment-intensive, inviting criticism at a minimum and perhaps abuse or fraud. *Moreover, it is quite unlikely that government will be able to identify the prime*

[19] Michael E. Stone, "Comment on Kathryn P. Nelson's '*Whose* Shortage of Affordable Housing'", Housing Policy Debate, Volume 5 Issue 4. Stone points out that, although the number of rental units affordable at 50% to 80% AMI exceeds the number of renter households with incomes at 50%-80% AMI, substantial numbers of 50%-80% AMI households in fact have excessive rent burdens. This is so because substantial numbers of units affordable at 50% to 80% AMI are actually occupied by households with lower incomes and by households with higher incomes.

preservation risk – imminent market improvement – before the private real estate markets also identify it and build it into the selling price.

- **Caveat.** These owners, if facing tax on sale problems, already have the ability to sell to UPREITs (for Operating Partnership units) and thereby defer tax on sale[20]. This option is not as widely available to owners of assisted housing, because most REITs are uninterested in acquiring assisted properties. Accordingly, a preservation tax incentive is likely to be less effective for market-rate properties than for assisted properties.

Observation: it seems best to restrict a preservation tax incentive to existing HUD- and RHS-assisted properties.

[20] The UPREIT exchanges operating partnership units for each investor's interest in the "selling" partnership in a tax free exchange. Once the UPREIT has acquired a sufficient interest in the "selling" partnership, that partnership is collapsed into the UPREIT. The "selling" investors are not treated as having divested of their interest, for tax purposes, until they elect to convert their OP units to REIT shares.

APPENDIX 1:
THE TAX ON SALE PROBLEM: AN ILLUSTRATIVE EXAMPLE[21]

Summary. In a tax-shelter syndication, investors contribute $1 of capital in the expectation of more than $1 of income tax savings (generated, in turn, by an even larger amount of expected tax losses) over the investment period. Rules of thumb from the 1970s and 1980s predicted that investors would contribute $1 of capital for each $1.60 to $2.00 of expected tax losses over the first few years of the investment period[22]. Obviously, the ratio between investment amount and expected losses depended on a great many factors, including without limitation: the timing of the expected losses, the investor's marginal tax rate, the level of tax risk in the sponsor's projections, the perceived level of governmental risk associated with any subsidies, the sponsor's reputation and capability, and the real estate merits of the property (location, management, …).

Example: An investor might have expected the following results over a 25-year investment period, for a HUD or RHS assisted housing property developed in the mid 1970s.

Initial Investment (in stages over a 4-6 year pay-in period)	$50,000
Expected taxable income (loss):	
Years 1-5	($100,000)
Years 6-10	($50,000)
Years 11-15	($20,000)
Years 16-20	($5,000)
Years 21-25 ("crossing over" to taxable income)	$5,000
Total	($170,000)
Expected tax savings (marginal 50% tax rate in 1975)	$85,000
Cash distributions received:	$20,000
Capital Account at year 25:	
Original Investment	$50,000
Plus taxable income (minus losses)	($170,000)
Minus cash distributions	($20,000)
Capital Account	($140,000)

Taxable Income Upon Sale = $140,000 plus amount of any net proceeds of sale

Minimum "Tax on sale" (marginal 20% tax rate in 1975)	$28,000

[21] This example is based on a presentation by Nancy Trick of Reznick, Fedder & Silverman.
[22] The ratio, and the length of the pay-in period, varied depending on tax law in effect at the time. Needless to say, expert practitioner opinions differed.

Original Expectation of Investor. The investor therefore expected to recoup his or her $50,000 investment from tax savings over the first five years, to receive an additional $35,000 in tax savings and $20,000 in cash distributions over the next twenty years. If the property were sold in year 25 for $1 above the mortgage balance, the investor would expect to pay a $28,000 tax on sale.

Surprises Along The Way.

- **Lower Cash Flow.** Typical assisted housing investments did not produce the projected level of cash distributions. See the separate Historical Context paper produced by The Compass Group for the Commission for a discussion of the various reasons for lack of cash flow in these properties. If the investor received half the projected cash flow, the investor's return would be reduced by $10,000.

- **Changes in Ordinary Income Tax Rates.** The maximum individual tax rate for ordinary income remained at 50% through 1986, then dropped to 38.5% in 1987 and 28% for 1988-1990. The top rate then rose to 31% for 1991-1992 and 39.6% thereafter. Thus, instead of a 50% marginal tax rate, the investor actually had an average 42% marginal tax rate over the 25-year investment period. Instead of $85,000 of tax savings from $170,000 of losses, the investor would only realize $71,400 of tax savings, a $13,600 reduction of the investor's return.

- **Changes in Capital Gains Tax Rates.** The capital gains tax rates for tax on sale calculation stayed at 20% through 1992 and rose thereafter to 25% (for depreciation recapture) and 28% (for capital gain, if any, in excess of depreciation deductions previously claimed). As a result, the tax on sale, originally estimated to be $28,000, will actually be $37,500 or higher, a $9,500 reduction of the investor's return.

- **Changes in "Passive Loss" Rules.** The ability of investors to deduct tax losses in excess of the amount invested was eliminated starting after 1986. For 1987, only 65% of those losses could be deducted, dropping to 40% in 1988, 20% in 1989, 10% in 1990, and 0% thereafter. Losses not deducted in the year incurred could be used to offset future "passive" income (including taxable income from the operation and sale of investment real estate). Passive losses not yet used by the investor to offset passive income are termed "suspended losses." As a result, the investor was not able to deduct $30,000 of his or her tax losses, which remain suspended. The inability to use those suspended losses delayed $12,600 of the investor's return for many years.

In summary, the investor received less cash flow (for governmental and real estate reasons), less tax savings (as a result of lower ordinary tax rates and elimination of passive-loss deductions), and faces higher tax on sale upon sale (as a result of higher capital gains tax rates), than originally expected.

Original Expectation vs. Actual Result

Using the example above, the investor expected to invest $50,000 and receive $77,000[23] over the life of the investment. Instead, the investor invested the expected $50,000, has received $68,800 of tax savings and cash flow so far[24], faces tax on sale of $37,500, and may or may not be able to realize a further $12,600 of tax savings from suspended losses. Over the life of the investment, the investor will be lucky to break even.

The Investor's Current Situation. The investor is receiving little if any cash flow. The property is generating increasing amounts of taxable income (the term "phantom income" denotes taxable income in excess of cash distributions; see discussion below). The investor is facing tax on sale of $37,500 or more upon sale (or donation, or foreclosure) of the property. However, the investor has $30,000 of suspended passive losses that can be used to offset future taxable income (from operation or sale of this property or other properties).

If the investor could hold his or her interest in the property until death, the tax on sale could be eliminated[25]. Similarly, the owning partnership could dispose of the property by exchanging it for a similar property, without triggering the tax on sale[26].

In this situation, it is hardly surprising that most investors decide to retain the property rather than sell it. Moreover, it is hardly surprising that most investors are unhappy with how their investments have turned out, reluctant to enter into new affordable housing agreements with the government, and reluctant to devote time and attention to what seems to have been a bad investment that has little upside potential and a great deal of downside risk.

"Phantom Income"

Phantom income results from <u>non-deductible expenditures</u>, chief among which are mortgage principal payments, deposits to the reserve for replacements. In addition, capital expenditures are virtually non-deductible; they generate deductions but only over a very long period of time.

Conversely, phantom income is reduced by <u>non-cash deductions</u>, primarily depreciation and amortization. Because the non-deductible expenditures rise as the property ages, at the same time the non-cash deductions are declining, phantom income typically arises some time after

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[23] $85,000 of tax savings plus $20,000 of cash flow minus $28,000 of tax on sale.
[24] $10,000 of cash flow plus $71,400 of tax savings at 42% minus $12,600 of savings not yet realized because of suspended losses.
[25] The deceased is not subject to normal income taxes in the year of death. Instead, the estate of the deceased is subject to estate tax. The estate tax is based on the amount (value) of the estate. For estate tax purposes, generally assets are carried at their fair market value as of the date of death. Typically, the estate of a limited partner investor will request that the general partner make an election under Section 754 of the Internal Revenue Code. This election has the effect of converting the investor's negative capital account (the day prior to death) into a positive capital account based on the fair market value of the property (as of the date of death). By eliminating the negative capital account, this process eliminates the tax on sale. Conversely, if the limited partner does not request, or the general partner does not make, the Section 754 election, the result is much less favorable.
[26] Section 1031 of the Internal Revenue Code provides for the tax-free exchange of "like kind" property. Suppose that a taxpayer owns an apartment property with a fair market value of $2 million and in which the taxpayer has a negative $500,000 capital account. The taxpayer wishes to exchange the apartment property for another apartment property. If the acquired apartment property has a fair market value of at least $2 million, and the transaction otherwise met the requirements under Section 1031, the exchange would not generate taxable income, and the taxpayer's negative $500,000 capital account would carry over to the acquired property. This is a complex area of tax law, with a number of aspects that have been ignored or simplified for purposes of this example.

year fifteen and accelerates as the property ages.

To some extent, phantom income can be reduced or eliminated if the property can be refinanced, because doing so typically reduces the non-deductible mortgage principal payments. Phantom income is particularly painful if the tax liability exceeds the cash distributions. Thus, phantom income is an especially serious problem for older properties that cannot readily be refinanced and that lack cash flow

The following is an example showing how the cash flow and taxable income of a property can be vastly different in the later years of the property's life:

Comparison of Cash Flow and Taxable Income, Late in the Property's Life	**Cash Flow**	**Taxable Income**	**Comment**
Gross Potential Rent	$540,000	$540,000	
Vacancy and Collection Loss	($37,800)	($37,800)	
Other Income	$10,000	$10,000	
Operating Expenses	($250,000)	($250,000)	
Actual Reserve Deposit	($65,000)	($32,500)	50% expensed
First Mortgage P&I	($185,236)	($135,676)	interest portion
Credit Enhancement	($8,592)	($8,592)	
Depreciation (original buildings)		$0	fully depreciated
Depreciation (capital improvements)		($32,500)	prior yr reserves
Amortization		($1,375)	of loan costs
Reserve Interest Income		$3,000	
Operating Cash Flow	$3,372		
Taxable Income		$54,557	

If there were ten limited partners, each owning a 9.9% share, and having 40% marginal tax rates, each limited partner would owe some $2,000 in taxes, over and above his or her share of the distributed cash flow. Moreover, once phantom income begins, it tends to become a more severe problem with each passing year. It is easy to see why the presence of a severe phantom income problem is a powerful incentive to sell (or refinance, or otherwise solve the problem).

Other Potential Tax Issues

Alternative Minimum Tax. This analysis does not consider the potential effects of the alternative minimum tax.

Estate Tax. Some ownership interests will have a significant fair market value (the amount on which estate tax is based). For taxable estates, that value will be subject to tax at relatively high marginal rates starting at 45%. An investor who expects his or her estate to be subject to estate tax might make different decisions than are discussed in this paper. Such an investor might well consider selling during his or her lifetime, in response to a preservation tax incentive.

APPENDIX 2:
HOW MANY PROPERTIES MIGHT BE PRESERVED?

The following tables show the HUD- and RHS-assisted portfolios[27], with estimates of the fraction of each category of the portfolio that might undergo transfers to preserving entities, in response to a preservation tax incentive that provided full relief from tax on sale:

Category of HUD- and RHS-Assisted Portfolios	Total Properties	Total Units	% Developed 1984 or Earlier	Estimated % Not Yet Resold	% Est'd to Sell for Full Relief
HUD Older Assisted	4,200	450,000	100%	50%	50%
HUD Newer Assisted	7,000	650,000	100%	80%	50%
HUD 202 and 811	4,600	250,000	50%	95%	0%
RHS 515	16,700	450,000	50%	60%	50%
RHS Farm Labor Housing	1,000	10,000	50%	60%	50%
Total	33,500	1,810,000			

Estimated Transfers in Response to Full Relief	Total Properties	Total Units
HUD Older Assisted	1,050	113,000
HUD Newer Assisted	2,800	260,000
HUD 202 and 811	0	0
RHS 515	2,510	68,000
RHS Farm Labor Housing	150	2,000
Total	6,510	443,000

The estimated number of transfers for each portfolio was estimated as follows:

- Total portfolio (e.g., 650,000 for HUD Newer Assisted)
- Times % developed 1984 or earlier, equals the portion of the portfolio that might have a tax on sale problem.
- Times % not yet resold, equals the portion of the portfolio that has not yet paid its tax on sale.
- Times % estimated to sell, equals the portion of the portfolio that might actually sell in response to a preservation tax incentive (e.g., 260,000 units for HUD Newer Assisted).

If this estimate is accurate, a very significant fraction of the assisted portfolio could be transferred for long-term preservation as a result of the enactment of a preservation tax incentive.

Comments on assumptions and methodology:

[27] For additional information, see the Historical Context background paper prepared for the Commission.

- The estimate assumes that the properties that will transfer in response to a preservation tax incentive are those for which all of the following are true: (a) developed prior to 1984, (b) not resold since development, and (c) with an ownership entity that is responsive to a preservation tax incentive (significant tax on sale problems for a significant fraction of the partners).

- 1984 was selected as a reasonable cut point for the existence of a tax on sale problem, because the ability to deduct passive losses in excess of cash invested was phased out beginning after 1986.

- Percentages are estimates of The Compass Group, LLC. Comments are invited.

- Many HUD Older Assisted and RHS §515 properties were resold between 1981 and 1984 in response to a provision in the 1981 tax legislation that had the effect of stimulating transfers.

- HUD §202 and §811 properties are owned by nonprofit entities and thus do not have a tax on sale problem.

APPENDIX 3:
THE RATIONALE FOR PRESERVATION

AFFORDABILITY OF RENTAL HOUSING: DEFINITIONS

The most generally accepted measure of affordability is the ratio between housing costs (rent plus tenant-paid utilities) and income. Housing costs at or below 30% of income are generally considered affordable[28]. Housing cost ratios above 30% represent increasingly severe affordability problems. A housing cost ratio at or above 50% of income is one of the HUD's three indicators of "worst case" housing needs[29]. Affordability discussions typically reference a range of incomes. The generally accepted measurement is HUD's Household Adjusted Area Median Income statistic ("AMI"), published for metropolitan areas and for non-metropolitan counties, by household size[30]. Generally accepted terms denoting ranges of AMI include:

- Extremely low income ("ELI") -- households with incomes below 30% AMI, corresponding very generally with households at or below the poverty level.
- Very low income ("VLI") -- households with incomes between 30% and 50% AMI.
- Low income -- households with incomes between 50% and 80% AMI.
- Moderate income -- households with incomes between 80% and 95% AMI.

HUD determined that the United States average four-person household income is $52,500 for federal FY 2001 ($56,500 for households living in metropolitan areas and $38,800 for non-metropolitan households) [31]. As discussed below, rental affordability problems are severe and pervasive among ELI households, very common among VLI households, and less frequent at higher incomes.

THE AFFORDABLE HOUSING SHORTAGE

There is a shortage of rental housing, of acceptable quality, with rents affordable to very-low-income households[32]. According to *State of the Nation's Housing 2001*[33]:

- One in eight renter households pay more than 50% of their incomes for rent and utilities.
  - Of renter households with incomes between 30% and 50% of AMI, one in five has a housing cost burden of 50% or higher.

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[28] At the lowest income levels, this definition understates affordability problems. All else equal, as household income declines, the subsistence-level costs for food, clothing and health care represent an increasing percentage of income, leaving a decreasing percentage of income available for housing costs.
[29] The other two are very poor housing quality, and overcrowding.
[30] Also often referred to as "income limit" data and available from HUD's Office of Policy Development and Research at http://www.huduser.org
[31] See http://www.huduser.org/datasets/il/fmr01/combined.pdf attachment 7
[32] "Very low income" is a defined term, signifying households with incomes at or below 50% of area median income, adjusted for household size ("AMI"). The most generally accepted measure of affordability is the ratio between housing costs (rent plus tenant-paid utilities) and income. Housing costs at or below 30% of income are generally considered affordable.
[33] Published by the Harvard Joint Center for Housing Studies and available at www.gsd.harvard.edu/jcenter . See especially the chapter on Housing Needs.

    - Of renter households with incomes below 30% of AMI, two-thirds have housing cost burdens of 50% or higher.

- Three in ten renter households pay more than 30% of their incomes for housing.
    - At 30% to 50% AMI, two-thirds of renters have 30%+ housing cost burdens.
    - Below 30% AMI, over 80% of renters have 30%+ housing cost burdens.

- Households with two workers, both earning minimum wage, cannot afford a typical two-bedroom apartment.

- The federal government provides rental assistance to roughly 4.6 million households with incomes at or below 50% AMI[34]. Another 4.8 million households at or below 50% AMI have "worst case" housing needs[35].

Preserving existing rental units that are affordable to very-low-income households is one component of an appropriate housing policy response to this shortage. An especially compelling case can be made for the preservation of units that, in addition to being affordable to VLI households, are also actually <u>occupied</u> by such households. Hence the traditional focus of preservation efforts on the HUD- and RHS-assisted stock.

PRESERVATION RISKS IN THE EXISTING AFFORDABLE STOCK

The existing affordable stock is composed of private assisted housing, public housing, and unregulated affordable apartments (market rate properties with affordable rents). In general, there are three primary risks that this stock will not continue to provide affordable housing, of acceptable quality, occupied by very-low-income households:

- **Conversion Risk.** Most private assisted housing had affordability commitments that have expired or are expiring. As markets improve, the owners of these properties can be expected to convert them to market-rate use. Over time, the number of units available to and occupied by very-low-income households will decline. Hence the need for federal support for transactions that result in new long-term affordability commitments.
    - **Existing Residents Are Protected.** Initially, the properties will continue to serve very-low-income households, because sitting tenants are protected through "enhanced vouchers[36]."
    - **Resident Profile Will Shift Over Time.** Over time, however, the property will shift to a resident profile that reflects neighborhood demographics and will not exclusively serve very-low-income households (unless that is the neighborhood demographic pattern).
    - **Risk of Full Loss of Affordability.** The most desirable properties may command rents that are not affordable to voucher holders. When that occurs, the property will not provide affordable housing after conversion.

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[34] 1.3 million in public housing, 1.9 million in private assisted housing, and 1.4 million with vouchers.
[35] Severe cost burden, quality problems, and/or overcrowding.
[36] The enhancement is that the voucher will pay the actual market rent so long as the tenant remains in occupancy. If the tenant moves, the enhanced voucher becomes subject to the normal rent limitation ("payment standard").

- **Capital Needs Risk.**
    - **Good Condition Now, Problems Later.** Affordable properties are aging and, although in good condition today, face increasing costs for the major repair and replacement of aging systems (HVAC, roofs, siding, windows, …). Many properties will not be able to finance these long-term capital needs in the absence of new government subsidies. Hence the need for federal support for recapitalization transactions that assure the long-term physical and financial viability of the property.
    - **Poor Condition Now.** Other affordable properties have quality problems today. Generally, such properties need up-front subsidies to pay for renovations that cannot be supported under the existing financial structure, plus financial restructuring to assure long-term viability. Hence the need for federal support for recapitalization transactions.

- **Abandonment Risk.** Some properties are actual or potential community assets but are located in neighborhoods with very low market rents. If the neighborhood market rents are too low to support the property's long-term viability, even with no payments for mortgage debt service, these properties will leave the housing stock entirely unless preserved[37]. Hence the need for federal support for recapitalization transactions.

"Preservation Transactions"

In response to these risks, affordable housing professionals pursue what the Commission terms "preservation transactions" that combine:

- **Sustainability.** A financial and rehabilitation approach that supports the property's long-term physical and financial viability.

- **Use Agreement.** A long-term affordable housing commitment.

- **Preservation-Worthiness.** A determination that the property should be preserved and that the amount of subsidy required to do so is reasonable.

- **"Preserving Entity."** The owner, after preservation, has the requisite capabilities and experience and commitment to operate the property successfully.

Author

This paper was prepared by Charles S. Wilkins, Jr., principal of The Compass Group, LLC, under contract to The Millennial Housing Commission.

[37] The appropriate preservation approach combines a grant to put the property into acceptable condition, and a project-based §8 contract at the minimum rents needed to support long-term viability in its new debt-free condition. The §8 contract rents will be above market levels, at least initially.