DEVELOPING STATE POLICIES ON THE SALE AND RESYNDICATION OF SUBSIDIZED HOUSING

by

William N. Rumpf

Working Paper No. W83-8

This paper was done while the author was a research assistant at the Joint Center for Urban Studies and a student in the master's degree program in public policy at the John F. Kennedy School of Government. The author would like to acknowledge the help of William C. Apgar, Jr., Avis Vidal, David Smith, and Eve Sternberg during the preparation of the paper.

The findings of this report are not subject to detailed review and do not necessarily reflect the official policy of the Joint Center.

Copyright © 1983 by the Joint Center for Urban Studies of MIT and Harvard University. All rights reserved.

ISSN No. 0275-2964

EXECUTIVE SUMMARY

The Economic Recovery Tax Act of 1981 created unprecedented incentives for investment in existing subsidized housing. The tax shelter benefits of "second-user" subsidized housing were substantially boosted. State housing finance agencies have an opportunity to influence this investment to benefit tenants and to improve the financial security of their projects.

This paper examines the guidelines on sales of existing projects presently used by the U.S. Department of Housing and Urban Development (HUD) and the housing finance agencies in Michigan, Illinois, New Jersey, New York, and Massachusetts. Housing agencies are still exploring their roles and appropriate procedures in responding to the proposed sales of projects in their portfolios. In the last few months, three of these state agencies have adopted new rules on transfers of ownership, and HUD is working on regulations to reflect its policies.

A survey of existing property sales to date shows that HUD projects are being transferred at a faster pace than state agencies' projects, and the level of both state and HUD activity is predicted to increase over the next few years.

This paper proposes that state housing finance agencies adopt the role of "not-so-silent partner" in directing some share of the proceeds of transfers of ownership into improving the physical and financial condition of their properties. This role requires an understanding of how subsidized housing tax incentives work, and a reasonable scale for agency requirements so that the buyers and sellers of subsidized housing both benefit from completing these transactions.

The paper covers three key policy issues:

1. <u>Should Agencies charge fees or place restrictions on the use of some share of the proceeds from sales of subsidized housing?</u>

   This section develops a guideline for transfers, requiring that 10 percent of the net cash payments from buyers, or sufficient funds to correct existing problems, be placed in a Development Security Escrow. This escrow would be available to cover operating deficits, repair and replacement reserves, and other project needs. Any unused funds in the escrow would be returned to the managing general partner after five years to create incentives for good management.

2. <u>What rules should Agencies adopt on secondary financing?</u>

   Agencies can require language in the transfer of ownership documents to prevent secondary financing from jeopardizing the security of their first mortgages. The analysis here concludes that it is not advisable for agencies to adopt prohibitions, or use the HUD-established ceiling, on the amount of secondary financing. Prohibiting secondary financing completely would discourage the sale of healthy properties, and agencies would lose the chance to benefit from these transfers. The HUD ceiling on debt appears to be so high that it constrains few transactions, but it tends to inflate the sales price of transfers.

3. <u>How can Agencies extend the period of subsidized operation of their projects?</u>

The owners of many state-finance properties have the option to convert their projects to unregulated use after 20 years. The efforts of two states to extend the term of lower-income use as a condition of approving a sale would discourage the transfer of healthy properties now. This would not accomplish the goal of prolonging the subsidized operations, however, because the original owners can still sell when the projects reach 20 years of age. Combining an extension with reduced contributions to the Development Security Escrow or with favorable financing might work to keep good properties in the subsidized stock.

TABLE OF CONTENTS

I. INTRODUCTION

The Economic Recovery Tax Act (ERTA) of 1981 drastically altered the tax laws relating to housing. It has generated new potential for private investment in existing subsidized housing developments. For state housing finance agencies, facing an end of federal new construction subsidies and an uncertain future for their tax-exempt financing powers, encouraging and focusing this potential investment represents one of the main opportunities to attract resources to the subsidized housing market.

In the past, sales of subsidized projects have occurred mainly to relieve the owners of the risk of foreclosure. Little new capital was put into the property. Agency requirements were primarily intended to insure that the new owners were bound by agency operating and security covenants. Since late 1981, proposed sales have been submitted to agencies on strong as well as marginal projects with substantial new equity being raised.

This paper will compare the guidelines on transfers of ownership of existing housing used by the U.S. Department of Housing and Urban Development (HUD) and the agencies in the five states with the largest and oldest portfolios of state agency financed subsidized housing. These states are Michigan, Illinois, Massachusetts, New Jersey and New York. This analysis of the issues raised in developing an agency policy on transfers of ownership is timely because many state housing finance agencies have not issued formal policies on transfers, and most of those with written guidelines are making periodic modifications. In the past several months, the housing finance agencies in three of the states studied have adopted new policies on changes of ownership.

Criteria for Evaluating Policies on Transfers of Ownership

The goals and operating styles of each agency are a product of different personnel and enabling legislation; however, this paper will propose three criteria on which to evaluate the effectiveness of each agency's policies. The premise of the paper is that a good policy on transfers of existing projects will incorporate the following three principles:

1. All transfers of ownership that are approved should provide some economic benefit to the individual project, its residents, or to other subsidized properties. As a corollary to this criterion, the scale of project or agency benefits must allow sufficient incentives for both the buyer and seller to complete the transaction. This criterion reflects a judgment about how a public agency can use market incentives to accomplish its mandated purposes, but does not try to calculate the broader "public" benefit of this use of tax expenditures versus alternative forms of housing assistance or non-housing uses.

The past role of state housing finance agencies has been to create profitable opportunities for developers and owners, providing below-market interest rates through the use of federally tax-exempt bonds and allocating largely federal rent subsidy contracts, to produce decent housing for lower-income households.

Now, the federal tax laws have created the potential for economic gains that were not envisioned by the state agencies or by the original developers of subsidized developments. The model suggested here for states is that of "not-so-silent partner", reaping some benefit from the new Federal resources that are available through the tax code. To assume this role implies a certain staff capacity and commitment to understand the private incentives in a transfer of ownership to make the agency an informed "partner".

2. <u>The agency's primary objective should be attracting new investments in projects with physical or financial problems.</u>

If some share of the sale proceeds benefit the project or its tenants, it is in the agency's interest to encourage transfers of ownership. The transfer procedures should be drafted in a way, however, that partially offsets or at least does not accentuate, the relative disadvantages to buyers of troubled properties. To purchase a project with substantial physical or financial deficiencies, the buyer must inevitably engage in extensive negotiation with the seller and agency staff over the schedule and extent of corrections, and the existence of severe project needs may require greater or more immediate cash payments from the buyer. If an agency policy promotes fast processing and minimal cash requirements for healthy properties, purchasers have an overwhelming economic incentive to concentrate on these properties.

3. <u>The agency should seek to create long-term incentives for good management.</u>

Tax shelter benefits provide most of the compensation to owners of subsidized housing, and, short of foreclosure most of these benefits flow regardless of the level of maintenance or the quality of management. If agency requirements on the use of syndication proceeds are made contingent on future operations, owners wil have more sustained economic incentives to maintain the projects.

In suggesting the role of the agency as a not-so-silent partner, it should be stressed that the transfer of ownership of a subsidized housing project is a complicated business transaction between the buyer and seller. The function of agency guidelines on transfers should be to reduce the involvement by agency staff in individual transactions, while insuring that agency purposes are promoted by each transfer.

Structure of the Paper

The paper will begin with an overview of how the Economic Recovery Tax Act of 1981 has changed the incentives for investment in existing subsidized housing. This paper will not tackle the objective of fully explaining the business aspects of second-user syndications. A number of practitioners' references are available for this purpose, and the business is rapidly changing, so a sound discussion of the technical tax, legal, and finance considerations would greatly lengthen and probably confuse this analysis.[1]

A survey will be presented reporting the number of transfers that have occurred to date on properties administered by HUD and selected state agencies. The subsequent analysis will conclude that the slower than expected pace of transfers of ownership is caused by the fact that most properties have not reached the age when a sale is most lucrative to the original owner.

The next three sections will deal with the major components of a state housing finance agency policy on transfers of ownership. The first of these sections will review current policies on agency control over the proceeds of a transfer. Then the paper will discuss rules on secondary financing. The final section will analyze efforts to keep properties in subsidized use beyond the time at which owners have the option of converting to unrestricted operation.

Probably the most important factors in determining the successful operation of a project after a change of ownership are the capabilities of the general partner and management agent. There will be only a minor discussion of these factors in this paper because most agencies have adopted the same procedures that have been worked out for the approval of participants in a new development, and it is assumed that state agencies would not allow transfers of ownership to owners that did not meet their minimum standards.

The paper will conclude with a summary of recommendations drawn from the three sections on elements of an agency's policy.

II. OVERVIEW OF SALES OF EXISTING SUBSIDIZED HOUSING

A. Description of Second-User Syndication

Tax benefits provide most of the return to investors in subsidized housing. Understanding how subsidized housing tax incentives work, and how these incentives were changed by the Economic Recovery Tax Act (ERTA) of 1981 is crucial to disentangling the issues faced by housing finance agencies in considering ownership transfers of their existing housing stock. This section will outline the operation and structure of tax shelter investments in existing subsidized housing.

Owners of any real asset are allowed to deduct from their taxable income the cost of interest on debt used to finance the purchase of the asset, and to deduct some portion of the cost of the asset each year over its useful life to account for depreciation. Accelerated depreciation schedules allow owners to take depreciation deductions far in excess of the real economic depreciation. For all assets except real estate and certain oil and gas investments, the amount of deductions allowed are limited to the amount of cash an investor has actually invested or has at risk.[2] Investors in real estate are allowed to take deductions based on the full cost of a property, regardless of the amount of actual equity. Because sponsors of subsidized housing receive government-subsidized mortgages for up to 90 percent of development costs, the combination of high leveraging and accelerated depreciation allowances produce tax deductions far greater than the amount of cash invested.

Developers of subsidized housing obtain their profits by selling the rights to the tax losses and any cash benefits from a project to high tax bracket investors. This sale of interests is called an "equity syndication." Virtually all real estate syndications are structured as limited partnerships. The general partner, usually the developer, has full authority over managing a project and has unlimited liability for its debts. This form of ownership appeals to investors because limited partners are not personally liable for the partnership's debt beyond the amount each has initially invested.

When a project is syndicated, limited partners usually pay in their share of equity over a three to six year period. The amount of equity that investors are willing to contribute depends largely on the amount of tax shelter they will receive. Thus, the sales price of a subsidized property is heavily dependent on the provisions of the federal tax code.

Prior to the Economic Recovery Tax Act of 1981, the initial owners of a subsidized development could use the 200 percent declining balance method of depreciation, but subsequent owners were only eligible to use the 125 percent declining balance or straight-line methods of depreciation. For this reason, syndications of existing subsidized housing provided lower discounted tax benefits to second-users.

ERTA 1981 changed the mathematics of tax shelters and spawned a new interest in existing housing. All capital investments were allowed fast depreciation writeoffs under the Accelerated Cost Recovery System (ACRS).[3] ACRS abandoned any connection between accounting depreciation and the useful economic life of an asset. Prior to ERTA, depreciation had to be calculated based on estimates of the useful lives of the respective building components. This was subjective, but the main structural components were typically depreciated based on a 30 to 35 year life. Under ACRS, both new and used low income housing is depreciable under a fixed schedule based on a 15 year cost recovery period, using the 200 percent declining balance method of depreciation. The 1981 tax law also reduced the top marginal tax bracket from 70 percent to 50 percent, which reduces the tax savings per dollar of tax deductions, but overall the new law provides substantially more tax shelter benefits to high tax bracket investors.

To prevent changes of ownership from being done simply to take advantage of the new depreciation provisions, ERTA contained "anti-churning" rules that require 90 percent of the interests in a property to change before the second owner is eligible to use ACRS. Since many subsidized properties are owned by partnerships, a sale under this definition involves buying out at least 90 percent of the current partnership interests and selling them to new limited partners in a different partnership. The general partner can remain the same but cannot hold more than a 10 percent of the financial interests of the new partnership. These transfers of ownership can be accomplished by selling the property outright or by selling the ownership interests to new partners without actually forming a new partnership; all of these transfers from one set of limited partners to another are called resyndications.

A resyndication is a rather complicated transaction involving many participants. David Smith has outlined how the objectives of each party overlap and contrast with the others:[4]

The Seller

The general and limited partners will be in agreement over one major aspect of a transaction: money to the sellers, though how that money will be divided may cause disagreements that rule out a transfer. The selling partnership will want to maximize proceeds, minimize funds put into the property, speed up the schedule of payments from the buyer, and eliminate contingencies on the buyer's contributions.

The limited partners will be primarily concerned with covering their contingent tax liability. Often existing partnership agreement did not envision a sale with compensation combining cash and residual notes. The allocation must be worked out between the general and limited partners. Often the limited partners will trade more cash to cover their taxes and give up a large share of the proceeds from the second note.

The Buyer

The buyer will be a syndicator or general partner/developer that will negotiate the purchase and then syndicator the equity to a new set of investors. In some cases, a developer performs both the packaging and general partner functions. When that is not the case, the compensation and liabilities will be negotiated between these two parties. Both the syndicator and new general partner want to see some of the proceeds going into the property. They will want to minimuze the cash portion of the purchase price, stretch out the schedule of cash payments as long as possible, provide large reserves for repairs or operating deficits, and put contingencies on the later investor contributions.

HUD or State Housing Finance Agency

The financing agency will have the sometimes conflicting objectives of improving the security of the housing in its portfolio and keeping the housing affordable to lower-income tenants. Agency requirements will be discussed in detail in subsequent sections, but generally agencies will try to get a share of the syndications proceeds to be used to address physical or financial problems in the property, to replenish replacement reserves, or to set up escrows to cover potential operating deficits. The agency also wants as good or better a general partner and management agent as in the original partnership.

In some respects, the buyer and the regulatory agency will be allied in wanting to see funds put into project uses. The buyer, however, will probably be more willing to forego making property improvements than the agency. If the seller sets an absolute minimum on the net proceeds it will receive to cover termination taxes and perhaps some capital gain, the buyer will have to make cash contributions sufficient to cover this minimum and the required project investments to secure agreement on the sale.

A typical structure for a sale of an existing subsidize housing project is for the buying partnership to assume the first mortgage, pay some amount of cash over a 3 to 6 year period, and give the selling partnership a secondary note. The second note will carry a set interest rate and usually a term of 10 to 20 years. Payment of both interest and principal on the secondary note will come only from surplus cash or proceeds from a resale. Surplus cash is defined by the mortgage regulatory agreement as the excess revenue from rent after paying all operating expenses and required contributions to reserve accounts.[4] In most states' regulatory agreements, annual surplus cash is limited to 6 percent of the original developer's equity. The amount of surplus cash is usually much smaller than the debt service that would be required if the second note were self-amortizing, so most of the principal and interest on the secondary financing is accrued and unpaid until the note comes due.

The justification underlying relatively large secondary indebtedness that is not serviced from project income is that a subsidized property is subject to certain lower-income use restrictions that suppress the financial return from the property. At such time as the restrictions expire, the market value of the property would reflect the most lucrative potential use, possibly as conventional rental housing or as condominiums. Section 236 projects financed by HUD, or by the Michigan or Illinois housing finance agencies, or by the Massachusetts Housing Finance Agency prior to 1973, have the option to prepay the 40 year mortgages any time after 20 years and convert the properties to unrestricted operations. The current value of a 10 year old subsidized housing project with this option reflects the value of the tax benefits and cash that can be generated during the period of subsidized use, plus the discounted present value of the market value of the project when it reaches 20 years of age.

It would be helpful for agency staff, in negotiating with existing owners or potential buyers of projects in their portfolio, to have an easy formula for estimating the amount of capital that could be raised through a resyndication. Unfortunately, it is more difficult to make such an estimate than it is for new construction syndications. The benefits to an investor in a low-income housing syndication are comprised of three elements: tax shelter benefits, "surplus cash" from operations, and the discounted value of the expected gain from resale. As discussed above, the allowable cash distributions from a subsidized project are kept low by the mortgage regulatory agreements. In a new construction project, the present value of the gain from resale is also low because the property must be operated as low-income housing for at least 20 years. The primary economic benefits, the tax deductions, are determined by the taxable basis, which is a fairly consistent function of the mortgage. Consequently, the yield from syndicating a new project can be predicted accurately as a given percentage of the agency's mortgage loan.

Resyndications are a different story. On a twelve-year old project, for example, with strong potential for condominium conversion at the expiration of subsidized use restrictions in eight years, the present value of the expected resale price would be a substantial component of the current price. To estimate the resyndication yield would require a judgment about real estate value as well as tax shelter benefits.

A further complication in valuing resyndications is that the amount of tax shelter benefits generated depends not only on the level of total debt, but also on the relative proportions of the first mortgage and secondary financing. Secondary financing is a paradoxical element of the proceeds from a transfer -- through creative structuring of the debt, both the buyer and seller benefit from increasing the amount of the secondary note.

The fact that the seller receives some benefit from the secondary financing, assuming the debt is paid, is clear. The example below illustrates the less obvious point, that the buyer gains from giving the seller a secondary note. Consider the choice of owning a project with the following debt characteristics:

Option A: $15,000 first mortgage; no secondary note

Option B: $18,000 first mortgage; no secondary note

Option C: $15,000 first mortgage; $3000 secondary note

If the mortgage terms, net operating income, and expected appreciation were the same under all three options, one might guess that Option A would be most favorable to a buyer because it has the lowest outstanding debt. In fact, Option C is preferable to either of the other options. Table 1 summarizes the economic consequences of each financing option. A fuller display of the calculation of the net economic effects is given in the Appendix.

The secondary note can be added to the depreciable basis, so, under Option C, an investor would receive more ACRS deductions than under Option A.

Options B and C have the same total debt and generate the same amount of deductions. Nevertheless, the secondary financing can be structured to make Option C advantageous. As described above, the actual payment of secondary financing in most resyndications will come from surplus cash or at the end of the term of the note. The buying partnership will keep its accounting records on an accrual basis, which means that they recognize income or debt payments at the time these payments are obligated, even if the payments are not yet made. The limited partners of the buying partnership can take deductions each year for the amount of interest accrued, and not pay the interest until the note comes due. This arrangement is preferable to Option B in which debt service is paid on the total debt.

If the seller receiving the secondary note remained on an accrual basis, it would have to report income and pay tax on the accrued interest, even though payments were not actually received. To avoid this liability, the selling partnership is usually liquidated and the interests in the secondary financing are distributed to the individual limited investors. These investors usually keep their income records on a cash basis for tax purposes, which means that they do not have to recognize any gain from the note until they receive payments. Most of the payments, and their tax liability, do not come until 10 or 15 years after the transfer. The structure of the secondary financing thus accomplishes an arbitrage against the U.S. Treasury.

Under most assumptions about discount rates, the present value of the tax deductions to the buyer from the added ACRS deductions and interest deductions exceeds the present value of the amount owed to the seller at the end of the term of the note. In this example, the present value of the benefits of ownership under Option C, with secondary financing was \$8,693. The net present value of Option A, which had a lower amount of total debt and no secondary financing, was \$8,003. Option B, with the same amount of total debt as in Option C but with no secondary financing, had the lowest present value: $7,814.

Table 1: Economic Consequences of Secondary Financing

Constant Assumptions:	
1st Mortgage Term:	40 Years
1st Mortgage Int. Rate:	10.0%
Net Operating Income:	$1528
Period of Ownership:	15 Years
Option C Assumptions:	
2nd Note Principal:	$3000
2nd Note term:	15 Years
2nd Note Int. Rate: (Principle and int. accrue until note comes due in Year 15)	10%

	Option A	Option B	Option C
1st Mortgage Principal	15,000	18,000	15,000
2nd Mortgage Principal	0	0	3000
Initial Taxable Basis	15,000	18,000	18,000
Year 1-15 Tax Deductions	37,030	44,430	44,530
Tax Benefits (50% bracket)	18,515	22,215	22,265
Debt Service-1st Mortgage	(22,920)	(27,510)	(22,920)
Net Operating Income	22,920	22,920	22,920
2nd Note Payments	0	0	(7500)
Net Economic Effect (Income+Tax Benefits-Debt Service)	18,515	17,625	14,675
NPV @ 15%	8,003	7,814	8,693

The incentive for both the buyer and seller to set the secondary financing as high as possible creates the potential for abuse. The Tax Equity and Fiscal Responsibility Act of 1982 increased the penalties for overvaluation of properties for the purpose of inflating tax deductions. The American Bar Association has also issued ethical guidelines for attorneys reviewing partnership offerings that require them to inform potential investors of questionable tax assumptions. Secondary financing must be supported by a reasonable estimate of market value, so an independent appraisal by a qualified appraiser will be an essential element of any legitimate transfer.

B. Summary of Transfer Activity

Virtually all of the state housing finance agency projects to experience tax-motivated transfers of ownership have been financed under the Section 236-uninsured program. Created in 1968, this program was the first federal subsidy program that state agencies could participate in, and it spurred the establishment of most of the pioneer state housing finance agencies. Ninety-six percent of the state-financed Section 236 projects were built in the states of New York, Massachusetts, Illinois, Michigan and New Jersey.[5] Most of these projects are 10 to 12 years old since the height of production under the Section 236 program peaked prior to the Nixon housing production moratorium in 1973.

As the following table indicates, the number of transfers for the purpose of second-user syndications completed by agency ranges from one to six.

By way of contrast, HUD has approved 458 transfers of federally-insured projects, including both its subsidized and unsubsidized properties since ERTA took effect. An estimated 50 percent, or about 230 of the transfers completed have been subsidized projects generally financed under the Section 221 (d)(3)BMIR or Section 236 programs. HUD staff expect to do 600 transfers during 1983.

Because of incomplete data, only a rough comparison can be made between the aggregate state and HUD activity. The number of federal subsidized units combined is about 4.2 times as great as the number of state Section 236 units. The number of HUD subsidized projects transferred was 8.8 times as great as the number of state agency projects transferred. It is unreliable to compare ratios of projects vs. units; however, unless the state projects transferred are, on average, much larger than the HUD projects transferred, it appears that the pace of existing subsidized projects sales is faster for the HUD portolio. Even so, the percentage of HUD subsidized projects that have changed ownership represents just 3 percent of the agency's subsidized projects.

Given the numerous professional conferences on resyndication, the lucrative tax benefits for buyers, and the need for new money in existing subsidized housing, the number of transfers actually completed since the passage of ERTA 1981 seems low. Most state agency staff interviewed concurred that the number of transfer requests has been lower than they initially expected.[6] Many cited preliminary discussions with prospective buyers that have not yet led to formal transfer proposals. Some agencies, in particular, the New York Mortgage Loan Enforcement Corporation and the Illinois Housing Development Authority, anticipate that the number of transfers and second-user syndications will increase significantly this year.

Table 2: Number of Transfers of Ownership Approved by State Housing Finance Agencies and HUD, Aug. 1981-March 1983

Transfers Approved		Total Sec.236 Units In State HFA Inventory
New Jersey HFA	2	12,220
New York HFA	2	43,996
New York UDC/MLC	5	
Massachusetts HFA	5	14,025
Connecticut HFA	1	197
Wisconsin HFA	2	205
Michigan SHDA	6	9,792
Illinois HDA	3	7,503
TOTAL	26	87,938

HUD	Transfers Approved	Total HUD Projects	Total HUD Units
Subsidized Properties	230	7,132	372,780
Total	458	27,000	*

Ratio of Subsidized Transfers		Ratio of Subsidized Units	
$\frac{\text{HUD}}{\text{States}}$	$\frac{230}{26} = 8.8$	$\frac{\text{HUD}}{\text{States}}$	$\frac{372,780}{87,938} = 4.2$

Sources: Figures on transfers from: Kevin Quince, New Jersey; Tish Armstrong, New York HFA; Bill Purcell, New York MLC; Brian Frawley, Massachusetts; Otto Bonaparte, Connecticut; Tim Radelet, Wisconsin; Richard Pennings, Michigan; John Glenon, Illinois; Jimmy Bell, HUD.

State project figures from New York Mortgage Loan Enforcement Corporation, Memorandum from Paul Zoubeck, April 21, 1981. HUD unit figures from MHCP Subsidized Housing Handbook, 1982, p.2-1,2-5. HUD project figures from HUD Survey of Troubled Multifamily Properties, 1977.

Note: The New Jersey Housing Finance Agency has completed 28 additional conversions from non-profits to limited dividend ownership. All of these conversions were done shortly after initial occupancy so they were not treated as "second user" syndications.

C. The Future Pace of Transfers of Ownership

The summary of transfers of ownership reveals less activity, thus far, than state agencies and some syndicators expected. This section will suggest that the somewhat slow development of transfer activity can be explained by the time involved in establishing a new market and by the fact that most state-financed properties have not reached the optimal time for original owners to sell. This section will also predict that agencies will see a rapid escalation in the number of transfer proposals in the next few years.

The complexity of second-user syndications has caused more delay than anticipated by either public or private interests. The use of secondary financing and the greater importance of residual value raise a number of structuring and legal issues that syndicators and developers have had to learn to use advantageously. Existing and potential investors, and HUD and state agency personnel have had to be educated about the resyndication business. A number of practitioner seminars have taken place, but much of the education has been in the form of "learning by doing." This is reflected in the 3 to 5 month processing time that is common for the agency approval process and 6 to 9 month overall period of negotiation between the private parties to complete a transaction. As the many participants in each transfer of ownership become more familiar and some standard operating methods emerge, these transfers will be accomplished more quickly.

The age of a property is an important determinant of the decision to transfer. Most state-financed Section 236 projects are 10 or 12 years old, and there are strong tax incentives for the original limited partner investors to continue ownership for several more years.

Tax benefits are generated by the accelerated depreciation deductions and by interest deductions on debt. The size of these deductions decreases each year as the first mortgage principal is amortized and as accelerated depreciation allowances decline. An investment provides tax shelter as long as the taxable losses from depreciation and interest exceed the taxable income. In general, the Section 236 projects built in the early 1970s have 40 year mortgages and had to be depreciated over a 30 to 35 year useful life, and rent increases have usually only been allowed to meet increased expenses so rental income has not grown much. As a result, most projects will continue to provide some tax shelter benefit or at least negligible taxable income for at least 12 to 15 years.

A more significant tax factor is the declining "recapture" provisions that apply to low-income housing investments. When a property is sold, the taxable gain is defined as the difference between the selling price and the owner's current tax basis. The current basis is calculated by subtracting the accumulated depreciation from the initial cost. Because of accelerated depreciation, the taxable basis is reduced more quickly than the mortgage is amortized for at least the first 15 years of ownership. Thus, even the owners of a project that experienced no appreciation, but was sold for the amount of its outstanding mortgage, would incur a substantial gain on sale.

A portion of the gain, the difference between accelerated depreciation taken on the property and the amount of depreciation that would have been taken over the same period if the straight-line method had been used, is treated as "excess depreciation." Excess depreciation is "recaptured;" that is, taxed at the time of sale at ordinary income tax rates. The remaining portion of the gain is treated as a capital gain, and taxed at lower rates.

For subsidized housing, the recapture of excess depreciation is phased out after the property is held for a specified period, creating an incentive to hold the property long enough for the recapture liability to decline. The prevailing recapture provisions reduce the percentage of excess depreciation subject to recapture by one percentage point for each month the property is held beyond 100 months (8 years and 4 months). Thus, the longer a property is held after 100 months, the greater the share of gain on sale that is taxed at capital gain, rather than ordinary income tax rates. After 200 months (16 years and 8 months) of ownership, all gain is treated as capital gain.

Some syndicators have suggested that it may be possible to postpone triggering the large taxable gain by the sellers, while providing large ACRS deductions to the buyer, by structuring the transfer with a wraparound mortgage and a land contract. Under a land contract sale, title does not pass until the full purchase price is paid to the seller. With a wraparound mortgage, the existing first mortgage remains in place, with the seller as mortgagor. The buyer gives the seller a new "wraparound" mortgage with payments at least as large as the payments due on the underlying mortgage.

The very aggressive tax position would be to argue that since the seller was not fully relieved of his obligation on the original mortgage, he was only liable for taxable gains as the buyer slowly paid off the principal on the underlying mortgage. At the same time, this position would hold, the buyer could take ACRS deductions on the full amount of the wraparound note. The I.R.S. has disagreed with this position.[7] If the wraparound/land contract structure is ruled to postpone the seller's gain on sale, obviously this minimizes the importance of the recapture provisions. This paper will make the assumption that the I.R.S. view is correct because the I.R.S. view has a compelling logical basis: only the owner of an asset can depreciate it for tax purposes. If the seller is still the owner, the buyer would not be entitled to full deductions. If the buyer is the owner, the seller's gain on sale should be triggered.

In deciding whether to sell or resyndicate, investors would consider the recapture phaseout, and whether the sales price of a project is likely to increase or decrease in the future. Owners of Section 236 projects financed by the Michigan and Illinois housing finance agencies and those financed by the Massachusetts HFA before 1973 have the option to prepay the subsidized mortgage after 20 years and convert the property to unregulated use. For properties with good market potential, the shorter the remaining term of restricted operations, the higher the sales price will be. If they can expect strong appreciation in the sales price, owners of healthy projects in these states are most likely to postpone transfer because their recapture liability will decline.

For Section 236 projects financed by the New Jersey Housing Finance Agency or the Massachusetts HFA after 1973, owners are not allowed to prepay the mortgage without permission of the respective Boards of Directors. In general, these projects will experience slower appreciation in value because they do not have a sure option to convert to "market" operations. With less potential for a high sales price, the tax considerations will have a great impact on the timing of transfers.

The properties that would be expected to transfer now would be 1) those with owners that want to terminate their management responsibilities, 2) those with a majority of investors that have shifted to lower tax brackets so the taxable gain on sale is reduced, 3) properties with financial or physical problems, provided the original investors receive enough from the sale to cover their tax bill from the sale.

In the next few years many healthy properties with the option to escape subsidized use restrictions after 20 years that are 10 to 12 years old now could be sold and provide a lucrative return to their owners. A perception that the provisions of ERTA 1981 were about to be changed would speed up the pace of transfers. The age of the older state agency portfolios implies that these states should develop procedures and staff expertise to handle the anticipated increase in second-user syndication and project sales.

III. AGENCY CONTROL OVER PROCEEDS FROM SECOND-USER SYNDICATIONS

As a condition of providing favorable mortgages to developers of subsidized housing, state housing finance agencies and HUD retain the right to approve any sale or refinancing of a project. This gives the regulatory agency an absolute veto, and, hence, major leverage over the terms of a transfer of ownership. The agency can use this leverage to influence the use of some portion of the proceeds of a second-user syndication. Uses that an agency could conceivably require include:

-- fees to cover agency costs of reviewing the transfer request,

-- expenditures to correct any current physical or financial problems of a project,

-- contributions to an escrow to be used in the case of future operating deficits or financial needs, or to offset proposed rent increases,

-- contributions to be used on other projects in the agency's portfolio.

Both the amount and predictability of agency requirements influence the likelihood of transfers of ownership occurring. Any use of sale proceeds required by the agency that the buyer or seller would not have chosen to do imposes a "toll" on the transfer. A high toll will prevent some projects from being transferred. On the other hand, if the agency makes no requirements, it would forego an opportunity to further its purpose. The agency dilemma is to make a tradeoff between capturing a large share of benefits for its portfolio and discouraging transfers altogether.

This section will discuss the uses of transfer proceeds that agencies currently require, and propose a way to establish these requirements to guarantee some benefit to the project being transferred, or to its residents, and at the same time minimize the disincentive effect on transfers.

A. Analysis of Current Agency or Project-Oriented Use of Sale Proceeds

Transfers of ownership are not a new phenomenon. Most agencies' requirements placed on transfers are based on practices developed over the past six or eight years in the course of dealing with projects in financial difficulty. All of the older state housing finance agencies and HUD have experience in judging the incentives and potential to raise capital for problem projects under the pre-ERTA tax laws, because a significant share of their portfolios have had problems. The financial difficulties of the Section 236 and Section 221 (d)(3)BMIR projects were caused by the combination of ambitious development goals and hasty underwriting at the time of construction, and by the fixed nature of the interest subsidies and restrictions on increases in the face of rapid inflation of operating expenses. A 1981 survey of states with sizeable Section 236 portfolios found that 20 to 50% of projects financed under that program were experiencing some sort of financial arrearages.[8]

Prior to ERTA 1981, owners were unable to attain much money from a sale of a subsidized project, so the transfers that occurred were usually done on severely-troubled projects as the lesser of two evils, instead of foreclosure. In these transfers, the agency's primary objective was to be sure that the new owner was subject to its operating and security agreements. The agencies tried to see that most of the cash that the buyers were willing to contribute went to address the project deficiencies, but often neither the buyer nor seller had sufficient incentive to fully cure the existing problems.

To protect their bondholders and the tenants, agencies have given financial assistance to current or new owners in the form of mortgage increases, mortgage modifications (lengthening the payment schedule or foregoing some payment), short term loans or Section 8 allocations.

The tax benefits created by ERTA have increased the chances of resolving project deficiencies through resyndication if the original owners are not willing or able to make the necessary investment in problem projects. The tax benefits will also encourage transfers of projects without significant physical or financial problems. The potential for lucrative transfers of existing projects raises the question of whether agencies should place requirements on the use of any share of the transfer proceeds.

Setting agency fees to cover processing costs has caused little debate. Agencies have always charged loan origination fees, and the staff or contracted time involved in reviewing the transfer of ownership is clearly an extra expense. Most agencies have set fees as a percentage of the original or remaining mortgage principal, and the amounts typically range from $2500 to $10,000.

There is also little opposition, in concept, to agencies requiring that some share of the proceeds from a second-user syndication be used to correct existing shortcomings in the project. All the agencies surveyed, either formally or informally, do a site inspection of the project, review past financial records, and condition approval of transfer requests on remedying some or all of the outstanding problems.

The implemention of this basic guideline is not uniform. The definition of what constitutes a physical problem involves discretion, and the agency's minimum can range from dealing only with code violations to correcting deferred maintenance, inefficient energy systems, or design problems. Syndicators dealing with a number of HUD field offices operating under the exact same guidelines noted distinct differences in the aggressiveness of the field staff in pressing for investments in physical repairs or improvements.

Agency policies diverge on the issue of whether to place additional requirements on the use of resyndication proceeds. HUD and the Illinois Housing Development Agency place no explicit restrictions on the use of the new capital raised beyond meeting current needs. The New York Mortgage Loan Enforcement Corporation was established in 1975 to manage the projects financed by the New York Urban Development Corporation. The MLEC has no written guidelines on transfers, but since their portfolio is mostly very financially-troubled projects, the issue of whether to address any objective beyond remedying the current problems has not arisen.

Michigan and Massachusetts have both adopted policies that retain greater discretion for agency control of the sale proceeds. The Michigan State Housing Development Authority policy on changes of ownership states the possibility that transfers may be conditioned on increasing the project escrows or establishment of a "sinking or reserve fund to obtain funds to subsidize rents on non-Section 8 developments."[9] In Massachusetts, the Housing Finance Agency has significantly increased its requirements for annual contributions to reserves for repairs and replacement in the years since its earliest projects were financed. As part of approving several transfers, the agency has required extra contributions to the reserve accounts to bring them in line with expected future capital needs.

The experience with the HUD guidelines on transfers suggests the likely effect of requiring expenditures only for current financial and physical problems. Several of the syndicators interviewed had done transfers of HUD projects in which literally none of the buyer's contributions went toward repairs or improvements in the financial position of the project. Syndicators generally agreed that the combination of lower net proceeds to the sellers and the longer time required to satisfy HUD staff and the private parties in devising plans to meet current problems makes it easier and faster to do transfers of healthy projects. To date, the split between healthy and troubled properties transferred has been roughly half and half because large tax recapture liabilities offset the attractiveness of selling properties in good condition. As the Section 236 and Section 221 (d)(3) portfolios age a few more years and the recapture provisions are reduced, the expected result is that investors, developers and syndicators will be drawn to the cream of the subsidized properties. Placing minimal requirements on these transfers means that many good properties will be turned over and redepreciated, but little new capital will go into the existing stock.

Because second-user investors would look forward to the option to prepay the mortgage and convert to unrestricted use after 20 years, the potential residual gain would create some incentive to maintain properties well in the interim. Another period of rapid inflation, however, could cause a repeat of the financial problems that hit the fixed-subsidy projects in the mid- and late-1970s because second-user owners could earn a substantial return simply from tax shelter benefits and avoid contributing additional capital to cover operating deficits.

There are several grounds on which to base agency control over some share of the proceeds from a transfer. On a purely pragmatic basis, the agency could mandate the specific use of some share of the proceeds because it is in a strong bargaining position. Agency approval is necessary for the change in ownership, and if agency demands are predictable and of reasonable scale, they will not deter a transfer from occurring.

A stronger case can be made on the basis of historical precedent and agency purpose. The function of a housing finance agency is not only to promote the construction of lower-income housing; the agency has an obligation to project residents and bondholders by moderating the financial and management risks that a subsidized project encounters. Recognizing that the main source of profit for developers of subsidized housing comes from syndication of the tax benefits to limited partner investors, several state agencies have restructured the manner in which the developer receives these benefits to improve the financial security of the project.[11]

The Michigan State Housing Development Authority used an "operating assurance policy" to ease rent increases or to cover operating deficits for some of its later Section 236 projects. During the early years of operation, the developer was required to post security to cover any financial difficulty. Gradually, this security was returned to the developer and replaced with a "development cost escrow" contained in the mortgage, which added about 8 percent to the inital mortgage for 236 projects. Rather than paying off this escrow from tenant rents, investors had to agree to reduce the allowable annual cash dividend from 6 percent down to 3 percent. The security provided by the escrow reduced the chances of foreclosure. The increase in the mortgage to fund the escrow could be added to the depreciable basis so it increased the deductions available to investors. One author estimates that investors were willing to increase the amount of capital they contributed to the developer by about 25 percent because of the greater security and tax deductions.[12] The Illinois Housing Development Authority adopted a modified form of this operating assurance policy in 1974.

The Massachusetts Housing Finance Agency has placed requirements on partnership contributions to provide some guarantee regarding increases in property taxes. In Massachusetts, local assessors are empowered to negotiate tax assessments based on a percentage of gross rents. If developers are unable to secure such agreements, MHFA has generally required the developer to provide an escrow account to avoid the need for large rent increases based on tax reassessments. Again, since the property tax escrow increases the security of the project, investors presumably increase the amount they are willing to pay for a share of ownership.

B. Recommendations for Guidelines on Agency Control of Sale Proceeds

The preceding discussion raises a number of objectives that well-designed guidelines should meet. Guidelines should provide some agency benefit without discouraging transfers. Guidelines should improve the relative appeal of troubled properties, and provide long-term incentives for sound management and maintenance. They should be consistent so that private parties can negotiate the terms of a transfer without constant consultation with state agency personnel. They should be flexible so that agency requirements are still reasonable when changes occur in the second-user syndication market.

This section proposes that agencies establish the following guidelines:

> Approval of transfers of ownership, in which a majority of partnership interests will change, shall be conditioned on the scheduled expenditure or contribution to a Development Security Escrow of an amount equal to the greater of 10 percent of the capital contributions from the new partnership, or the amount of funds needed to correct current physical problems or financial arrearages. Any funds not needed immediately to remedy current physical or financial deficiencies shall be placed in an escrow account, managed by agency staff or by a mutually acceptable third party, to be released in the event of an operating deficit, underfunded replacement reserves, physical problems posing immediate health hazards or other purposes to be defined. Unused funds in the Development Security Escrow shall be returned to the managing general partner of the new partnership five years from the date of deposit in the Escrow. Acceptable forms of contribution to the Escrow include cash, irrevocable letters of credit, certificates of deposit, or pledges of limited partners' capital contributions.

The structure of the Development Security Escrow is designed to insure that a reasonable, predictable share of the proceeds from a transfer benefit the project or its tenants. Using a proportion of the capital proceeds from a sale rather than a fixed per unit contribution avoids the selection bias that would tend to discourage transfers of less valuable properties. Requiring that 10 percent of the proceeds be placed in the Escrow would reduce the difference between requirements placed on transfers of healthy and troubled properties. The choice of 10 percent is arbitrary, but it is the judgment of this paper that this share would not prevent a significant number of transfers. Agencies could require greater expenditures if current problems cannot be corrected with 10 percent of the proceeds.

The agency could retain the right to require contributions sooner in the case of projects with serious physical problems, but the standard timing of escrow contributions could be 10 percent of each scheduled payment from new investors.

For administrative simplicity, the percentage requirement avoids the need for staff to estimate what amount of money can be required without spoiling a deal. It might be argued that, conceptually, agency staff could negotiate the level of capital put into project or agency uses on a case-by-case basis, and perhaps more accurately determine the threshold at which agency requirements would jeopardize the deal. In practice, this is unlikely because this would complicate the already cumbersome negotiations that take place between the buyer and the selling general partner and limited partners. For an agency to do better with a case-by-case approach, it would need staff who would be apprised of the changing conditions of the resyndication market. Agencies are unlikely to acquire this expertise until the number of transfers greatly increases.

The escrow agreement should be carefully drafted to insure proper use of the funds and to prevent disputes or excessive delay in releasing the funds when needed. If funds are paid in annually over a four year period, each contribution would be returned five years after its deposit, so that the unused portion of the last contribution would be returned nine years after the transfer.

The return of unused funds after five years in the Development Security Escrow makes the requirement self-regulating. The escrow will have less deterrent effect on healthy transfers if the contributions are returnable. The share of compensation to the managing general partner will adjust at the time of transfer in recognition of the possibility of this future payment. Managing general partners will bear a greater share of the risk of operations, creating an incentive for good management. The escrow funds improve the security of the project, so presumably investors would be willing to pay more for their limited partnership.

For some projects in very good condition and with healthy replacement reserves, the Development Security Escrow would not add much benefit. In these cases, the agency could consider reducing the DSE requirements in exchange for other project-related uses such as the establishment of a fund to offset rent increases or an extension of the period of subsidized use. The latter topic is discussed below in Section V. The principle of setting requirements that represent a predictable share of the transfer proceeds would still apply.

Most state agencies are likely to find, however, that a Development Security Escrow would significantly improve the security of their portfolio. The Massachusetts HFA recently surveyed their projects and concluded that the level of contributions to replacement reserves in their Section 236 projects had been too low to adequately meet the expected physical needs of the properties.[13]

Policy on Agency Control of Proceeds from Transfers of Troubled Properties

On projects that have serious current problems, 10 percent of the capital proceeds from a transfer may not be sufficient. The principle of structuring long-term incentives for the managing general partner still applies. This principle may run counter to the usual instinct in troubled projects to require as large an expenditure as possible as soon as possible in the project. The following examples will illustrate:

HUD's policy on transfers of properties in default on their mortgages is to require capital contributions to remedy the problem within two years. Requiring large up-front payments on the financial arrearages greatly reduces the available funds for the original investors, who most likely face a large tax bill on sale. Thus, the investors often balk at allowing a transfer. To put pressure on these investors, HUD has referred a record high number of properties to foreclosure proceedings in the last few months.[14]

HUD is taking a gamble with this threat. The expectation behind HUD's approach is that most original investors will agree to contribute new capital or to resyndicate to salvage some proceeds to cover the tax bill. The agency's past record in completing foreclosures is so infrequent that the threat may not be credible. In 1981, HUD obtained passage of a new uniform federal foreclosure act designed to speed up the process, but a HUD memorandum on subsidized projects with mortgages assigned to HUD conceded that acquisition of title by HUD and disposition through a foreclosure sale still can take years.[15]

One cause of delay is that foreclosures must be prosecuted by local U.S. Attorney's, who usually place a low priority on these cases. In addition, investors in properties on which foreclosure proceedings have been initiated have an enormous financial incentive to use any legal or political resources available to delay the foreclosure action. Not only does postponement of the large tax liability on foreclosure represent a benefit in a present value sense, as long as investors hold title to the property, they can continue to take depreciation deductions, including deductions for the interest portion of debt service owed, even if mortgage payments are not actually made. Thus, a subsidized property may continue to be a lucrative tax shelter even with severe financial arrearages.

A concern about HUD's foreclosure strategy is the net economic cost to the government. Holding costs of a foreclosed property are estimated at $10 per day per apartment and disposition may take six months to a year.[16] If HUD has possession of a 200 unit project for 6 months, that would cost the government approximately $360,000. Congressionally-mandated regulations on foreclosure require HUD to preserve the low-income nature of the foreclosed property.[17] This can only be accomplished by allocating some form of Section 8 rent subsidy contract to the property. In the end, the subsidy contract plus the administrative costs of foreclosure can represent an expensive remedy for the federal government.

The lesson for state agencies is that carrying through a small number of foreclosures is essential to establish the seriousness of the threat. In general, however, "buying out" the original limited partners by allowing them a large enough share of the first sale proceeds to soften the tax blow of a transfer will achieve a quicker, more successful resolution.

The New York Mortgage Loan Enforcement Corporation has used the approach of accepting later payments to cure financial deficiencies, to create long-term management incentives. The agency has hired top law firms to handle its foreclosure proceedings to bring pressure on owners to contribute new capital or agree to a transfer. But, the original owners are allowed to recoup some share of their original equity from the transfer so that resyndication is done voluntarily.

The following example illustrates MLEC's approach on a property with huge mortgage arrearages. The original partnership owed the agency $3 million in back mortgage payments. In exchange for a share of the transfer proceeds equal to 40 percent of their equity investments, the original limited partners agreed to sell to a new partnership.[18] The agency took a note from the new partnership for the amount of arrearage, which increased the depreciable basis in the same manner as secondary financing between a seller and buyer. After the old limited investors received their share, $2.25 million in capital contributions was available from the new investors to be placed in an escrow account. The annual interest on this escrow will be available to supplement the funds generated from operations to help the project meet its current debt service requirements. If the managing general partner is able to increase the cash flow from operations enough to cover the debt service without the interest from the escrow, the amount of the escrow can be reduced, with some of the principal going to the partner and some to the agency. The unpaid amount of the arrearage will be paid to the agency upon sale or resyndication of the project.

If MLEC had simply taken its maximum share of the first two years of capital contributions from the buyers, it might have received a smaller, but earlier payback of the arrearage. But, the new general partner would have had much less incentive to improve operations, and without the escrow to provide assurance that debt service would be paid, new investors would have paid in much less for the ownership interests. For projects with less aggravated financial problems, the deficiencies may be corrected from the proceeds at the time of transfer. But in cases of major operating problems, the agency should stretch out the payments to the general partner to create incentives for long-term solutions.

IV. RULES ON SECONDARY FINANCING

The use of secondary financing in second-user syndications raises three concerns for a state housing finance agency:

1. The security issue: does the existence of secondary financing weaken the security of the first lender?
2. The selection issue: how do the rules on secondary financing affect the type of projects transferred?
3. The tax issue: is the amount of secondary financing excessive?

A. The Security Issue

The obvious objective of a housing finance agency, or any first lender is to prevent the borrower from incurring additional debt that would increase the likelihood of default or jeopardize the claim of the first mortgage holder in a foreclosure proceeding. Most regulatory agreements in state and federally-assisted housing have strict prohibitions against second liens on a property without the approval of the lender.

The use of secondary financing in transfers of ownership raise a number of security considerations that are not present in reviewing a new construction proposal. Since secondary financing creates an obligation from the buyer to the seller, the agency must examine the rights and incentives of both parties instead of just a single owner. The existence of a seller with a continuing interest in the property can be a threat to the agency's ability to claim the assets or regain clear title to the property through foreclosure if the note from the buyer is not clearly subordinate to the first mortgage. If the second note is to be paid from operating revenues, this could place higher rent burdens on tenants. On the other hand, if the original general partner was satisfactory, the possibility of transferring ownership back to the selling partnership without a lengthy judicial foreclosure in the case of financial or management problems is a desirable option for the agency.

As a condition of approving requests for transfers, a state agency can require that provisions be inserted in the sales agreement between the buyer and seller and in the mortgage regulatory agreement to protect the agency's security. Agency guidelines on transfers in Illinois, Massachusetts and Michigan prohibit secondary financing secured by a lien against a development or its income, and disallowing any proposal to increase rents to service the secondary financing.[19] New Jersey's guidelines require explicit recognition that the secondary financing is subordinate to the first mortgage, and require waiver of claims to project income or assets in the case of default.

Transfers with secondary financing in which the original and new partnerships both have the same general partner are particularly vulnerable to paralyzing legal disputes. The general partner is likely to have an interest in some share of the secondary note from its role in the first partnership. If the second partnership defaults on payment of the secondary note, the general partner will probably be sued by the limited partners of the first partnership if he does not foreclose on the note; at the same time, the limited partners from the second partnership will expect some defense of their interests. Before approving a transfer the agency should require the buyer and seller to agree on a resolution of this conflict, which can be accomplished by vesting some foreclosure powers in a third party.

For land contract sales, HUD requires both the buyer and seller to sign regulatory agreements. The seller must agree that payments on the first mortgage are not contingent on receiving payments from the buyer, and the seller agrees not to place a lien on project income in the case of non-payment. Both the buyer and seller must agree that in the case of default by the seller on the HUD mortgage, the buyer can cure the default and assume the HUD mortgage. The Michigan State Housing Developent Authority guidelines provide for the opposite contingency; if the buyer defaults on a land contract agreement, both parties must agree that the buyer will limit remedies to seeking possession of the property and specifically waive any rights to foreclosure.[20]

The legal staffs of a state housing finance agency must draft language to suit its state's foreclosure laws and any restrictions placed on the agency's bonds. Examples of such language are included in a HUD memorandum updating the agency's treatment of legal issues that have arisen in connection with transfer of ownership proposals.[21] The unique tax risks, and the usual operating difficulties of subsidized housing, create a perceivable chance of financial difficulty for the new owner. Agency efforts to insert clear remedies for default on either the first or secondary financing will pay dividends later in reducing the occurrence of legal disputes.

B. <u>The Selection Issue</u>

The Michigan and Minnesota housing finance agencies both have policies on changes in ownership that prohibit or heavily constrain the use of secondary financing. Because secondary financing can be added to the depreciable basis and generate interest deductions for the buying partnership, investors are willing to pay more for the interests in a property with secondary debt than a property with equal income and resale potential that does not have secondary financing. The effect of these constraints on secondary financing is to limit the potential proceeds from a transfer of ownership on projects whose market value would be able to justify secondary financing. The projects affected by such prohibitions would tend to be healthy projects with strong market potential or older projects with a relatively short time before the owners have the option to prepay the mortgage and convert the property to unregulated use.

One of the criteria presented in this paper for effective policies on transfers of ownership is that agencies should seek to reduce the disparity between the incentives for transfers of healthy and troubled properties. The following analysis will suggest that prohibiting secondary financing is a poor way for agencies to reduce this disparity.

The Minnesota Housing Finance Agency's guidelines simply prohibit secondary financing. All transfers must be accomplished by cash and assumption of the first mortgage.[22] Michigan's policies allow secondary financing without restriction if the Executive Director determines that is necessary to generate sufficient funds to remedy project problems. For healthy projects on which the deed is transferred, repayment of secondary financing cannot be based on project income or expected proceeds from resale. Buyers must identify other assets as the source of payment, which meet all the following criteria:[23]

1. Its value is equal to or greater than the amount of the liability (including accrued interest);
2. It is not already committed to the project or to any other

collateral function;

3. In the judgment of the Authority (MSHDA) the asset will be available at the time the obligation is due;

4. The Authority determines that the process of realizing on the asset(s) can in no way result in a change in ownership of the project itself.

Under these criteria, acceptable sources of payment would include letters of credit, certificates of deposit or limited partner promissory notes. The agency would not allow sources of payment such as second mortgages covering the project, unsecured promissory notes from the buyer to the seller, pledges of partnership interests, or pledges of residual value of the project or subsequent sale or refinancing. One of the main attractions of subsidized housing investment is the availability of highly leveraged, non-recourse financing. The requirement that a buyer commit a substantial amount of assets to collateralize the secondary financing will probably eliminate most use of secondary debt.

One rationale for eliminating or reducing the use of secondary financing is that transfers of healthy properties are not necessary to address current problems, so there is no incentive for the agency to approve these transfers. The use of the guideline recommended in the previous section would insure some benefit to the project or its tenants in any transfer. By deterring the transfer of more valuable projects, the agency is passing up opportunities to control some share of the financial benefits created by ERTA 1981.

A second rationale behind both the Michigan and Minnesota restrictions on secondary financing is that the use of second notes that accrue a large unpaid debt will compel a sale of the property when the note comes due, and thereby hasten the end of the subsidized use of the property. These agencies are rightfully concerned that a number of projects they have financed will have the option to convert to unrestricted use after 20 years of operations. Making transfers less profitable to the owners of healthy properties will prevent many of these properties from transferring now, but the original owners will have just as great an incentive to sell at the 20 year point as if the property was transferred. Agencies would be better off allowing the transfer at a time when they have high leverage and can use it to negotiate additional contributions to the project or agreements to extend the subsidized use from the new owners. Section V will discuss agency efforts to extend the term of subsidized use.

C. The Tax Issue

The earlier discussions of secondary financing point out that both the buyer and seller have an economic incentive to increase the face value of the second note, but the value of the second note must be supported by a reasonable estimate of the property value. This section will consider the policy that HUD has issued, and which Michigan has adopted, that is intended to place a more concrete limit on excessive secondary financing.

HUD places a ceiling on total indebtedness related to the project known as the "75 percent test." The guideline states that the sum total of the outstanding principal on the first mortgage plus the principal of the secondary indebtedness, plus any interest which is projected to accrue and be unpaid (i.e., that is not projected to be paid from surplus cash or other sources) before the maturity of the secondary financing may not exceed 75 percent of the replacement cost of a project five years of age or older, or 90 percent of replacement cost for projects less than five years old.[24]

To receive approval for transfer from a HUD field office, a project must also meet a "Fair Market Test," so that if the value is not sufficient to support a level of debt equal to 75 percent of replacement cost, only a lower amount of indebtedness is allowed. It is possible to appeal for a waiver from the HUD Central office if a higher level of debt can be justified. The Michigan rules are nearly identical, though their guidelines did not explicitly mention the possibility of a waiver for higher ratios of debt to replacement cost.

The purpose of the test is to insure that, during the life of the indebtedness, the market value of the property will exceed the total amount of debt so that there will not be an incentive for a "walk away", which would occur if the potential sales price did not cover the seller's obligations. Since the interest and principal on the secondary financing is accrued but not paid, the time for a walk away would not occur until the second note comes due.

The 75 percent test was developed as an ad hoc measure; an effort was made to set the ceiling above the level of debt that was part of the earliest post-ERTA resyndications with the expectation that the percentage would be adjusted as needed.[25] It has turned out that there has been little pressure to change the percentage. Most major resyndicators have found that the ceiling does not constrain their deals.

A rough estimate of the number of waivers granted by the HUD

Central Office for a higher level of debt was less than 10 out of 480 transfers.[26] Roughly half of these transfers involved unsubsidized properties such as 221(d)(4)s, whose rents will soon be fully deregulated. If the 75 percent rule had any limiting effect, it seems likely that more of these properties would have had trouble meeting the 75 percent test. It also seems likely that with the temptations of inflating secondary financing, some number of HUD transfers have probably included excessive levels of debt and not hit the 75 percent ceiling.

This leads to several hypotheses: 1)A closer review of transactions involving secondary financing would show more properties with well-supported market values exceeding the 75% test and receiving waivers, or 2)some transfers may have circumvented the rule by not disclosing all of the secondary (or tertiary) financing, or by obtaining inflated appraisals of replacement cost, or 4)the ceiling is set so high that it is irrelevant for most transfers.

On its face, the 75 percent test is an imprecise measure. The replacement cost approach method of appraisal is to estimate how much it would cost to produce a building of "equal utility" to the property being appraised. HUD and Michigan simplify this estimate by taking 75 percent of the cost of replacing the building, without making adjustments for losses in value due to physical depreciation, outmoded or energy-inefficient design, or poor location.

Even for market rate multifamily housing, replacement cost is likely to define the upper bound of appraised value except in very tight housing market. The fact that virtually no rental housing has been built in recent years attests to the fact that rents cannot be set high enough to provide an acceptable return on this kind of investment. For subsidized housing, the link between replacement cost and market value is even weaker because the value is affected by favorable financing and/or rent subsidies, and the initial development costs are not subject to a market test. When there is not a consistent relationship between replacement cost and market value at the time of construction, it is obviously hazardous to do so after 10 or 12 years of operation.

If a debt ceiling is set too low, the most valuable properties and the oldest properties would be less likely to be transferred. Of course if a ceiling is set too high, none of the transfers would be affected.

Since a transfer application must meet a "Fair Market Test" in addition to the 75% test to receive HUD approval, it is conceivable that HUD staff are able to screen out excessive secondary financing using this criterion. If this is occurring, the 75% test is still likely to create market distortions because of the anchoring effect of setting a ceiling on indebtedness. The 75% ratio may tend to increase the indebtedness of properties with lower ratios, or conversely, lower bids on strong properties. At least one syndication firm has incorporated the ratio set by the test into its purchase bids, stating that in the event that the sum of indebtness plus accrued interest exceeds 75 percent of the appraised replacement cost, the capital contributions from the buyers will be reduced.[27] In professional conferences, meeting the 75% test is cited as a defense against I.R.S. challenges to the reasonableness of secondary financing.[28]

For HUD, the great virtue of the 75% test is its simplicity; it is an easy calculation for the staff in its 50 area offices to perform. In the period immediately following the passage of ERTA 1981, and in many area offices now, the field staff do not have the time or capacity to evaluate the fine points of a resyndication transaction. The purpose of the rule is to provide a substitute for close analysis of the reasonableness of the total debt. The problem of staff capacity is a less important factor for most state housing finance agencies because most transfers would be processed at a single office where specialized staff are available.

The general question of how to determine the market value of a subsidized property points out one of the uncertainties of these transactions. A number of large syndication firms have struggled with this issue, and are still working to develop a defensible appraisal methodology for sales of subsidized housing.[29] The methodologies being worked out are basically discounted cash flow models, including non-cash benefits from tax savings.

The problem with using these models is that some of the value of subsidized housing property is tax savings, and the I.R.S. has generally not accepted appraisals based on tax shelter value. The I.R.S. position is presumably that the losses have no value in themselves, and the amount of benefit depends on the investor having income to take advantage of the shelter and on what tax bracket the investor is in. The syndication firm would argue that there is a large enough demand for tax shelter by high tax bracket investors that these taxpayers constitute "the market" for limited partnership investments. This matter will not be definitively resolved until the I.R.S. rules on the validity of secondary financing in some of the second-user syndications that have been completed, and the matter is settled in Tax Court.

If the state agency or one of its projects stands to benefit from the proceeds of a transfer of ownership, there is a conflict of interest for the agency to try to set an effective ceiling on indebtedness. The potential for I.R.S. rulings that substantially change returns and incentives for investors confirms the importance of housing finance agency efforts to insert clear remedies in transfer documents covering cases of financial distress. State housing finance agencies should insist that any secondary financing be supported by a qualified appraisal. The above analysis suggests that the governmental responsibility to make guidelines on valuation methodology or the validity of secondary financing lies with the federal Treasury Department rather than with individual state housing finance agencies.

V. AGENCY EFFORTS TO KEEP PROPERTIES IN SUBSIDIZED USE

An major issue looming beyond the horizen of everyday concerns for most housing finance agencies is the question of what will happen to existing subsidized housing as lower-income use restrictions expire. Most state agency financed Section 236 project regulatory agreements include the option for owners to prepay the subsidized mortgage and escape these restrictions after 20 years. Many state projects will reach the 20 year point within a decade.

It is beyond the scope of this paper to address the cost-effectiveness of maintaining the existing subsidized housing stock compared to providing low-income housing assistance through the use of vouchers. It is clear, though, that some portion of this housing will not be affordable to low and moderate-income residents without the agency-imposed use restrictions.

An approach that two agencies are using to prolong the term of subsidized operations is to simply extend the term of the regulatory agreements as a condition of approving transfers of ownership. The Massachusetts Housing Finance Agency requires that all transferred projects include an agreement providing for lower-income use for twenty years from the time of transfer. Thus, a project that is 10 years old when transferred would be required to serve lower-income residents for 30 years. Massachusetts HFA incorporates this requirement into a disposition agreement so that these restrictions will continue even if the MHFA mortgage is foreclosed.

For Michigan State Housing Development Authority projects, proposed transfers accomplished by sales of partnership interests or by land contracts are only allowed to include secondary financing if the new partnership agrees to extend the low- and moderate-income character of the project for 5 years (extending that period from 20 to 25 years).

The extension of the lower-income operating requirements places legal and economic constraints on the price that can be raised from a second-user syndication. The legal issue is how long a term the I.R.S. will allow for secondary financing that is accrued but unpaid. If the repayment of a loan is very uncertain or does not begin for a many years, the I.R.S. may characterize the debt as a retained ownership position by the original partnership, and disallow some or all of the interest and depreciation deductions taken by the new partnership.[30] One syndicator objected to the Massachusetts disposition agreement on the grounds that it would be risky to project payment on secondary financing based on its unencumbered market value, if that value could not be obtained for 20 years. One of the MHFA transfers that has been completed, however, does include secondary financing with extension clauses that could make the note payable 20 years after the transfer.

The economic issue is that by causing the purchaser of an existing property to defer the time of potential resale by some number of years, this suppresses the sales price at the time of transfer. The agency's position is analogous to requiring that some share of the transfer proceeds go to serve project or agency purposes. Contrary to the recommendation that agency requirements for the use of proceeds be proportional to the amount of sale proceeds, the "cost" of an extension of the agency regulatory agreements depends on the future resale potential of the property. For a property in a poor location, there might be little expectation of future residual gains. The impact of an extension would hardly affect the decision to tranfer or reduce the resyndication proceeds.

For a very strong property, the expected value of the property in unrestricted use might be well above the return generated in subsidized operations. For these properties, requiring the owners to extend the subsidized term would substantially reduce the price that could be raised in a second-user syndication, and would discourage such transfers.

If the agency deters transfers of healthy properties, it foregoes the opportunity to control some share of the transfer proceeds, yet it still does not accomplish its objective of extending the perid of lower-income operations. The original owners will be forced to hold on to the property until the 20 year point, but at that time, the agency will have no leverage to prevent a sale.

The recommendation of this analysis is that extensions should be coupled with the agency policies for controlling the use of transfers proceeds. Lower-income use extensions can be a far-sighted agency policy. For properties with weak or moderate market potential, the discounted present value of the return from unrestricted use is small; for strong properties, the present value of an extension is large. The length of extension or the requirements placed on the use of transfer proceeds should be adjusted so that a consistent percentage of the compensation from a proposed transfer is encumbered.

An agency obviously does not want to keep only troubled properties on its portfolio. To extend the term of subsidized operation on healthy, marketable properties, the agency will have to provide financial incentives to the owners comparable to the potential gains from resale. Providing these incentives may still be relatively inexpensive compared to any new construction alternative.

One way for the agency to reduce the "cost" to the seller of a lower-income use extension on the second-user syndication proceeds would be to include an agreement to refinance the first mortgage for a higher amount at some date in the future. After 20 years, payments on the original mortgage would include a large share of principal, so a refinancing agreement would provide investors with a future increase in tax deductions by establishing a higher depreciable basis and higher interest deductions. The refinancing would also allow the owners to take some capital gain out of the property without triggering a tax from sale.

The Montgomery County Housing Opportunities Commission, a state-chartered housing finance agency, provides a current example of using favorable financing to preserve certain types of housing. The agency issued tax exempt mortgages to finance the resale of an existing multi-family rental project with 20 percent Section 8 units. The new owners had to agree to operate the project as a rental for fifteen years; and the agency retained title to the land to enforce its use restrictions.[31]

Extending the term of the regulatory agreement is not the only way that agencies could create incentives to prolong the subsidized operations. A way for a state agencies to reduce the new partnership's incentive to convert the property from subsidized use at the end of 20 years would be for the agency to trade off some requirements on the use of cash proceeds from a transfer in exchange for a share of the secondary financing. When the second note comes due, if the agency is entitled to a significant payment, it could entice the new buyers to agree to a period of continued subsidized operations by agreeing to forego some of the note.

For an agency to make the tradeoffs between controlling a share of the cash proceeds of a second-user syndication and extensions of lower-income operations would require a staff with a sophisticated knowledge of housing finance and a current knowledge of the market for second-user syndications. Taking an active "investor" approach may be a tricky, and unfamiliar role to carry out. The existing subsidized stock is a finite resource, however, and it will require the use of agency resources and leverage to extend the lower-income operation of these properties.

VI. SUMMARY OF RECOMMENDATIONS

This paper has reviewed the economic incentives for investment in existing subsidized housing created by the Economic Recovery Tax Act of 1981. The potential tax shelter benefits provided by ERTA will lead to an increasing number of proposed sales of subsidized developments. State housing finance agencies can use their approval power to attain some share of the benefits of transfers of ownership to improve the security of their properties or to benefit tenants.

All transfers of ownership that are approved should provide some economic benefit to the individual project, its residents, or to other subsidized properties. The agency's primary objective should be attracting new investments in projects with physical or financial problems. Finally, the agency should seek to create lont-term incentives for good management.

To successfully meet these criteria, the preceding analysis leads to the following recommendations:

1. <u>State housing finance agencies should develop staff capacity to handle transfers of ownership requests.</u> When agencies' primary concern was new production, the most important personnel need was for people who understood construction and development. As portfolio management became important, more staff were needed with knowledge of property management and skills in negotiating financial "workouts." Second-user syndication and sales of existing projects represent a new area of responsibility that will increase in scale in the coming years. Agencies have choices about how they want to influence these transactions, but the staff and administrative organization of the agency must be prepared to respond to a new role.

2. <u>Agencies should adopt a guideline requiring that 10 percent of the net capital payments from the new owners, or sufficient funds to correct current physical or financial problems, whichever is greater, should be deposited in a Development Security Escrow.</u> This escrow would be available to fund operating deficits, under-funded replacement reserves, or other purposes agreed upon by the agency and owner. Unused funds in the Development Security Escrow should be returned to the managing partner of the new partnership in five years to create an incentive for good management. This requirement would establish a consistant, reasonable share of proceeds from any project sale to serve agency goals. Following this guideline, agencies should encourage transfer activity, provided that the new participants meet the agency's standards.

3. <u>To encourage resyndications of troubled projects, agencies should allow the original owner some benefit from the transfer.</u> Foreclosure is a clumsy threat that may work to pressure owners into resolving a problem, but carrying through a foreclosure proceeding does not lead to an economical end of project problems. The agency should also structure troubled property workouts to provide a long-term benefit to the managing general partner if the operating problems are resolved.

4. <u>Agencies should require the insertion of language in transfer documents to protect the security of their first mortgages.</u> These protections should include prohibitions against servicing secondary indebtedness from project income, except from surplus cash. The agency should also require clear remedies in the case of default on either the first or secondary financing. If the original general

partner was acceptable, including provisions to deed the property back to the sellers and avoid judicial foreclosure is a desirable option.

5. <u>Agencies should allow secondary financing in the sale of any project if its market value can justify the total indebtedness.</u> An independent appraisal should be required before any transfer request is approved. Setting ceilings on the level of secondary financing has bad effects; a ceiling that is too low would discourage the transfer of the more valuable and the older properties. A ceiling that is too high may distort the prices of transfers.

6. <u>Agency efforts to extend the subsidized operation of a property should coordinate the extension with reductions in the proportion of capital proceeds required for the Development Cost Escrow.</u> Long extension requirements on very marketable projects are self-defeating. Transfers will not occur so the agency will lose a chance to control a share of the proceeds. In states with mortgage prepayment options, the agency will have no leverage to prevent sales when the projects reach 20 years of age.

APPENDIX

The Economic Consequences of Secondary Financing

Example A: $15,000 First Mortgage; No Secondary Financing

Assumptions:

1st Mtg. Principal:	$15,000
Term:	40 Year Mtg.
Interest Rate:	10.0%
2nd Financing Principal:	0
Tax Brackets: 50% Marginal Bracket	
Net Operating Income: (before debt service)	$1528 per year

****

Year	Year end Taxable Basis	Deprec. Deduction	1st Mtg. Balance	Mortgage Payment	Int. Portion	2nd Loan Accrued Interest	2nd Loan Payments	Total Deduction	Tax Benefits 50% Brkt.	Net Oper. Income	Total Econ. Effect	NPV @15%
0	15,000											
1	13,050	1,950	15,000	(1,528)	(1,500)	0	0	3,450	1,725	1,528	1,725	1,500
2	11,250	1,800	14,972	(1,528)	(1,497)	0	0	3,297	1,649	1,528	1,649	1,247
3	9,750	1,500	14,941	(1,528)	(1,494)	0	0	2,994	1,497	1,528	1,497	984
4	8,400	1,350	14,907	(1,528)	(1,491)	0	0	2,841	1,420	1,528	1,420	812
5	7,200	1,200	14,870	(1,528)	(1,487)	0	0	2,687	1,344	1,528	1,344	668
6	6,150	1,050	14,829	(1,528)	(1,483)	0	0	2,533	1,266	1,528	1,266	548
7	5,250	900	14,784	(1,528)	(1,478)	0	0	2,378	1,189	1,528	1,189	447
8	4,500	750	14,734	(1,528)	(1,473)	0	0	2,223	1,112	1,528	1,112	363
9	3,750	750	14,680	(1,528)	(1,468)	0	0	2,218	1,109	1,528	1,109	315
10	3,000	750	14,620	(1,528)	(1,462)	0	0	2,212	1,106	1,528	1,106	273
11	2,400	600	14,554	(1,528)	(1,455)	0	0	2,055	1,028	1,528	1,028	221
12	1,800	600	14,481	(1,528)	(1,448)	0	0	2,048	1,024	1,528	1,024	191
13	1,200	600	14,401	(1,528)	(1,440)	0	0	2,040	1,020	1,528	1,020	166
14	600	600	14,313	(1,528)	(1,431)	0	0	2,031	1,016	1,528	1,016	144
15	0	600	14,217	(1,528)	(1,422)	0	0	2,022	1,011	1,528	1,011	124
Cumulative Total Years 1-15		15,000	14,323	(22,920)	(22,030)	0	0	37,030	18,515	22,920	18,515	8,003
Payment of 2nd Note (Prin.+Int) at end of Yr. 15							0					0
TOTAL		15,000	14,323	(22,920)	(22,030)	0	0	37,030	18,515	22,920	18,515	8,003

****

Example B: $18,000 First Mortgage; No Secondary Financing

Assumptions:

1st Mtg. Principal:	$18,000
Term:	40 Year Mtg.
Interest Rate:	10.0%
2nd Financing Principal:	0
Tax Brackets: 50% Marginal Bracket	
Net Operating Income: (before debt service)	$1528 per year

****

Year	Year end Taxable Basis	Deprec. Deduction	1st Mtg. Balance	Mortgage Payment	Int. Portion	2nd Loan Accrued Interest	2nd Loan Payments	Total Deduction	Tax Benefits 50% Brkt.	Net Oper. Income	Total Econ. Effect	NPV @15%
0	18,000											
1	15,660	2,340	18,000	(1,834)	(1,800)	0	0	4,140	2,070	1,528	1,764	1,534
2	13,500	2,160	17,966	(1,834)	(1,797)	0	0	3,957	1,978	1,528	1,672	1,264
3	11,700	1,800	17,929	(1,834)	(1,793)	0	0	3,593	1,796	1,528	1,490	980
4	10,080	1,620	17,887	(1,834)	(1,789)	0	0	3,409	1,704	1,528	1,398	800
5	8,640	1,440	17,842	(1,834)	(1,784)	0	0	3,224	1,612	1,528	1,306	649
6	7,380	1,260	17,792	(1,834)	(1,779)	0	0	3,039	1,520	1,528	1,214	525
7	6,300	1,080	17,738	(1,834)	(1,774)	0	0	2,854	1,427	1,528	1,121	421
8	5,400	900	17,677	(1,834)	(1,768)	0	0	2,668	1,334	1,528	1,028	336
9	4,500	900	17,611	(1,834)	(1,761)	0	0	2,661	1,331	1,528	1,025	291
10	3,600	900	17,538	(1,834)	(1,754)	0	0	2,654	1,327	1,528	1,021	252
11	2,880	720	17,458	(1,834)	(1,746)	0	0	2,466	1,233	1,528	927	199
12	2,160	720	17,370	(1,834)	(1,737)	0	0	2,457	1,228	1,528	922	172
13	1,440	720	17,273	(1,834)	(1,727)	0	0	2,447	1,224	1,528	918	149
14	720	720	17,166	(1,834)	(1,717)	0	0	2,437	1,218	1,528	912	129
15	0	720	17,049	(1,834)	(1,705)	0	0	2,425	1,212	1,528	906	111
Cumulative Total Years 1-15		18,000	17,178	(27,510)	(26,430)	0	0	44,430	22,215	22,920	17,625	7,814
Payment of 2nd Note (Prin.+Int) at end of Yr. 15							0					0
TOTAL		18,000	17,178	(27,510)	(26,430)	0	0	44,430	22,215	22,920	17,625	7,814

****

Example C: $15,000 First Mortgage; $3000 Secondary Financing

Assumptions:

1st Mtg. Principal:	$15,000
Term:	40 Year Mtg.
Interest Rate:	10.0%
2nd Financing Principal:	$3000
Term:	15 Years
Interest Rate:	10%

(Principle and Interest Accrue Until
Note Comes Payable in Year 15)

Tax Brackets: 50% Marginal Bracket

Net Operating Income: $1528 per year
(before debt service)

****

Year	Year end Taxable Basis	Deprec. Deduction	1st Mtg. Balance	Mortgage Payment	Int. Portion	2nd Loan Accrued Interest	2nd Loan Payments	Total Deduction	Tax Benefits 50% Brkt.	Net Oper. Income	Total Econ. Effect	NPV @15%
0	18,000											
1	15,660	2,340	15,000	(1,528)	(1,500)	300	0	4,140	2,070	1,528	2,070	1,800
2	13,500	2,160	14,972	(1,528)	(1,497)	300	0	3,957	1,979	1,528	1,979	1,496
3	11,700	1,800	14,941	(1,528)	(1,494)	300	0	3,594	1,797	1,528	1,797	1,182
4	10,080	1,620	14,907	(1,528)	(1,491)	300	0	3,411	1,705	1,528	1,705	975
5	8,640	1,440	14,870	(1,528)	(1,487)	300	0	3,227	1,614	1,528	1,614	802
6	7,380	1,260	14,829	(1,528)	(1,483)	300	0	3,043	1,521	1,528	1,521	658
7	6,300	1,080	14,784	(1,528)	(1,478)	300	0	2,858	1,429	1,528	1,429	537
8	5,400	900	14,734	(1,528)	(1,473)	300	0	2,673	1,337	1,528	1,337	437
9	4,500	900	14,680	(1,528)	(1,468)	300	0	2,668	1,334	1,528	1,334	379
10	3,600	900	14,620	(1,528)	(1,462)	300	0	2,662	1,331	1,528	1,331	329
11	2,880	720	14,554	(1,528)	(1,455)	300	0	2,475	1,238	1,528	1,238	266
12	2,160	720	14,481	(1,528)	(1,448)	300	0	2,468	1,234	1,528	1,234	231
13	1,440	720	14,401	(1,528)	(1,440)	300	0	2,460	1,230	1,528	1,230	200
14	720	720	14,313	(1,528)	(1,431)	300	0	2,451	1,226	1,528	1,226	173
15	0	720	14,217	(1,528)	(1,422)	300	0	2,442	1,221	1,528	1,221	150
Cumulative Total Years 1-15		18,000	14,323	(22,920)	(22,030)	4,500	0	44,530	22,265	22,920	22,265	9,615
Payment of 2nd Note (Prin.+Int) at end of Yr. 15							(7,500)				(7,500)	(922)
TOTAL		18,000	14,323	(22,920)	(22,030)	4,500	(7,500)	44,530	22,265	22,920	14,765	8,693

****

NOTES

1. Smith, David A. "The Resyndication Opportunity." Real Estate Review. (Spring 1983). (Forthcoming).
   Massachusetts Continuing Legal Education, Inc. Real Estate Resyndications: The New Game in Town. (1983).

2. Congressional Budget Office. "Tax Expenditures: Budget Control Options and Five-Year BudgetProjections for Fiscal Years 1983-1987." Congress of the United States. (November 1982).

3. Smith, David A. Subsidized Housing as a Tax Shelter. Robert Stanger and Co. (1982).

4. Smith, David A. "The Resyndication Opportunity." p.12-15.

5. Zoubeck, Paul H. Memorandum: "Survey of State Housing Policies Regarding Financially Troubled Uninsured 236 Projects." (April 21, 1981).

6. Glenon, John. General Counsel, Illinois Housing Development Authority. Interview. (February 23, 1983).
   Frawley, Brian. Massachusetts Housing Finance Agency. Interview. (January 19, 1983 and March 18, 1983).
   Pennings, Richard. General Counsel, Michigan State Housing Development Agency. Interview. (April 1, 1983 -and February 2, 1983).
   Purcell, William. Senior Vice-President, New York Mortgage Loan Enforcement Corporation. Interview. (March 11, 1983).

7. New York State Mortgage Loan Enforcement and Administration Corporation. Memorandum from Kenneth G. Lore to Michael Butler, President: "Tax Treatment of Installment Sales of Real Property." October 14, 1981

8. Zoubeck.

9. Michigan State Housing Development Authority. "Policy for Sale or Other Changes in Ownership of Project Subject to MSHDA Mortgages." (March 3, 1983).

10. Frawley, Brian.

11. Betnun. p. 116-119.

12. Betnun. p. 117.

13. Betnun. p. 118

14. Meyers, Don. Director, HUD-held Properties Division, HUD. Washington, D.C. Interview. (February 10, 1983).

15. HUD. Memorandum: "Policy for Projects with HUD-Held Mortgages." (June 18, 1982). p. 6.

16. HUD. Memorandum: "Policy for Projects with HUD-Held Mortgages." p.6,10.

17. HUD. Regulations: "Management and Disposition of Multifamily Housing Projects." (24 CFR Part 290).

18. Purcell, William. Senior Vice-President, New York Mortgage Loan Enforcement Corporation. Interview. (March 11, 1983).

19. Illinois Housing Development Authority. "Policy on Transfers of Ownership." (January 1983).
Massachusetts Housing Finance Agency. Memorandum: "Resyndication: Chestnut Park,1 Merrimac Plaza." Prepared by Robert L. Evans. (December 16, 1981).
Michigan State Housing Development Authority. "Policy for Sale or Other Changes in Ownership of Project Subject to MSHDA Mortgages." (March 3, 1983).

20. HUD. Memorandum: "Review of Transfer of Physical Assets Proposals." (December 6, 1982).
Michigan State Housing Development Authority.

21. HUD. Memorandum: "Review of Transfer of Physical Assets Proposals."

22. Minnesota Housing Finance Agency. "Assumption Policy, Multi-family Developments." (July 22, 1982).

23. Michigan State Housing Development Authority.

24. HUD. Memorandum: "Headquarters Review of Transfer of Physical Assets Proposals." (November 10, 1981).

25. Bell, Jimmy K. Deputy Director, Office of Multifamily Occupancy and Management, HUD. Washington, D.C. Interview. (February 10, 1983).

26. Bell.

27. New Jersey Housing Finance Agency. "Board Packet." (January 20, 1983).

28. Housing and Development Reporter. (December 1982).

29. Miller, Stan. Senior Vice-President, Director of Appraisals, Real Estate Research Corporation, Miamim Office. Interview. (March 18, 1983).
Kirk, David S. and Smith, David A. "Appraising Subsidized Housing." (1983) (Unpublished).

30. Smith, David A. "The Resyndication Opportunity." Real Estate Review. (Spring 1983). (Forthcoming).

31. Housing Opportunities Commission of Montgomery County. "Purchase Offering for Hewitt Gardens North." Maryland. (APril 6, 1982).

BIBLIOGRAPHY

A. Periodicals and Books

Betnun, Nathan. Housing Finance Agencies: A Comparison Between States and HUD. Praeger Books. (1976).

___. "Section 236 Projects and the New Tax Rollover." Real Estate Review (Spring 1973): 55-64.

Blew, Joseph Miller and Stevenson, Howard H. "How to Understand a Subsidized Housing Syndication." Real Estate Review (Summer 1978).

Boston Financial Technology Group, Inc. "Offering Memorandum, Springfield Chestnut Associates." (April 15, 1982).

Boston Urban Observatory. Subsidized Multi-family Rental Housing in the Boston Metropolitan Area: Analysis and Prognosis

Brealey, Richard and Myers, Stewart. Principles of Corporate Finance. McGraw Hill Book Company, 1981.

Brueggeman, William. "Tax Reform, Tax Incentives, and Investment Returns on Rental Housing." In House Committee on Banking, Finance and Urban Affairs, Federal Tax Policy and Urban Development: Hearings Before the Subcommittee on the City . (95th Congress, First Session).

Congressional Budget Office, "Real Estate Tax Shelter Subsidies and Direct Subsidy Alternatives." Congress of the United States. (May 1977).

___. "Tax Expenditures: Budget Control Options and Five-Year Budget Projections for Fiscal Years 1983-1987." Congress of the United States. (November 1982).

Housing Opportunities Commission of Montgomery County. "Purchase Offering for Hewitt Gardens North." Maryland. (April 16, 1982).

Illinois Housing Development Agency. "Mortgage Loan Program: Changes in Ownership of Developments Subject to an Illinois Housing Development Authority Mortgage." (January 1983).

Kuehn, Robert H. Jr. "Analysis of Existing and Proposed Tax Regulations Related to Real Estate Development and Investment." Housing in the Seventies, Working Papers Volume 2. (Hereinafter, Housing in the Seventies) U.S. Dept of Housing and Urban Development, Housing Policy Staff. (1974).

Massachusetts Continuing Legal Education, Inc. Real Estate Resyndications: The New Game in Town. (1983).

Massachusetts Housing Finance Agency. Memorandum: "Portfolio Capital Needs Analysis." Prepared by Lavergne Randolph, Jr. (September 4, 1981).

___. Memorandum: "Resyndication: Chestnut Park, Merrimac Plaza." Prepared by Robert L. Evans. (December 16, 1981).

Michigan State Housing Development Authority. "Policy for Sale or Other Changes in Ownership of Project Subject to MSHDA Mortgages." (March 3, 1983).

Minnesota Housing Finance Agency. "Assumption Policy, Multi-family Developments." (July 22, 1982).

Morris, Peter. State Housing Finance Agencies. Praeger Books. (1977).

National Housing Law Project. The Subsidized Housing Handbook: How to Provide, Preserve, and Manage Housing for Lower-Income People. (1982).

New Jersey Housing Finance Agency. "Sale of Projects Owned by Non-profit Corporations to limited Dividend Partnerships: Draft." (March 22, 1983).

New York State Mortgage Loan Enforcement and Administration Corporation. 1981 Business Report. (1981).

___. Memorandum re: "Potential Impact of Accelerated Cost Recovery Provisions of the Economic Recovery Tax Act of 1981 on UDC Workout Programs." (November 11, 1981).

___. Memorandum re: "UDC Calculation of Potential Tax to Investors on Foreclosure of a Project." (November 11, 1981).

Pennings, Richard. "State Agencies Look at Sales and Resyndications." Michigan State Housing Development Agency. (October 1982).

Smith, David A. "The Resyndication Opportunity." Real Estate Review. (Spring 1983). (Forthcoming).

___. Subsidized Housing as a Tax Shelter. Robert Stanger and Co. (1982).

Surrey, Stanley. "Tax Incentives for Housing." Housing in the Seventies. 982-998.

Touche Ross Co. "Study on Tax Considerations in Multifamily Housing Investments." for U.S. Dept. of Housing and Urban Development. (1973).

U.S. Department of Housing and Urban Development. "National Report on the Transfer of Physical Assets in the Sale of Multifamily Projects." Prepared by Donald Kirkendall, Assistant Inspector General. Audit Case No. 82-TS-113-0013. (August 24, 1982).

___. "Survey of Troubled Multifamily Housing Projects." (1977).

____. Memorandum: "Headquarters Review of Transfer of Physical Assets Proposals." (November 10, 1981).

____. Memorandum: "Amendment to Headquarters Review of Transfer of Physical Assets Proposals." (February 4, 1982).

____. Memorandum: "Review of Transfer of Physical Assets Proposals and Amendment of Processing Instructions." (March 26, 1982).

____. Application and Related Forms for Transfer of Physical Assets.

____. Memorandum: "Standards and Controls for the Processing of Multifamily Transfers of Physical Assets." (September 2, 1982).

____. Memorandum: "Review of Transfer of Physical Assets Proposals." (December 6, 1982).

____. Memorandum: "Policy for Projects with HUD-Held Mortgages." (June 18, 1982).

____. Regulations: "Transfer from Non-Profit to Profit-Motivated Ownership for Multifamily Housing Projects with HUD-Held Mortgages." (24 CFR Part 265) (August 14, 1980).

____. Regulations: "Management and Disposition of Multifamily Housing Projects." (24 CFR Part 290).

____. Memorandum: "Policy for Repairs on HUD-Owned Multifamily Projects." (November 3, 1981).

____. Memorandum: "Marketing HUD-Owned Projects and Projects Covered by HUD-Held Mortgages." (May 7, 1982).

____. Memorandum: "HUD-Owned Multifamily Projects -- Sales, Marketing, and Tracking." (June 16, 1983).

<u>Personal Interviews</u>

Bell, Jimmy K. Deputy Director, Office of Multifamily Occupancy and Management, HUD. (February 10, 1983).

Carey, Jim. Director of Operations, Massachusetts Housing Finance Agency. (January 19, 1983).

Clancey, Pat. Executive Director, Greater Boston Community Development. (April 3, 1983).

Frawley, Brian. Massachusetts Housing Finance Agency. (January 19, 1983 and March 18, 1983).

Kumer, Harold. HUD-Held Properties Division, HUD. (February 10, 1983).

Keene, David. Director of Federal Programs, New York Mortgage Loan Enforcement Corporation. (March 11, 1983).

Langlois, Laurie. Chief, Loan Management Branch, Boston Area HUD Office. (January 19, 1983).

Mcloof, George. Northeast Regional Consultant, HUD. (March 7, 1983).

Mills, Carol. National Corporation for Housing Partnerships. (February 11, 1983).

Myers, Don. Director, HUD-Held Properties Division, HUD. (February 10, 1983).

Purcell, William. Senior Vice-President, New York Mortgage Loan Enforcement Corporation. (March 11, 1983).

Smith, David. Vice-President, Boston Financial Technology Group, Inc. (February 2, 1983 and April 5, 1983).

Telephone Interviews

Armstrong, Tish. Director of Portfolio Management, New York Housing Finance Agency. (March 25, 1983).

Bonaparte, Otto. General Counsel, Connecticut Housing Finance Agency. (March 9, 1983).

DeWitt, Bob. Winthrop Financial Corp. Boston, Mass. (March 5, 1983).

Doherty, John. Legal Counsel, Massachusetts Housing Finance Agency. (March 21, 1983).

Finch, Wes. The Finch Group. Boston, Mass. (April 7, 1983).

Firehock, Robert. General Counsel, California Housing Finance Agency. (March 25, 1983).

Glenon, John. General Counsel, Illinois Housing Development Authority. (February 23, 1983).

Hillman, Marvin. Director, HUD-Owned Property Division, HUD. Washington, D.C. (March 8, 1983).

Johnson, Michael. Regional Vice-President, Security Pacific, Inc. Fairfax, Virginia. (March 2, 1983).

Kirby, Tom. Analyst, Real Estate Research Corporation, Houston Office. (March 30, 1983).

McKellar, Judd. General Counsel's Office, Virginia Housing Authority. (March 8, 1983).

Miller, Stan. Senior Vice-President, Director of Appraisals, Real Estate Research Corporation. Miami Office. (March 18, 1983).

Monico, Tom. Real Property Services, Inc. Chicago Office. (March 8, 1983).

Pennings, Richard. General Counsel, Michigan State Housing Development Agency. (February 2, 1983 and April 1, 1983).

Quince, Kevin. Syndication Officer, New Jersey Housing Finance Agency. (April 4, 1984).

Radelet, Tim. Legal Counsel, Wisconsin Housing Finance Agency. (March 9, 1983).

Rosette, Bruce. Oakdale/NDS. Santa Monica, California. (March 23, 1983).