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January 16, 1979

The Honorable William Proxmire
Chairman, Committee on Banking
Housing and Urban Affairs SEN00700
United States Senate

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Dear Mr. Chairman:

AGC00358

The Program Analysis Division of the General Accounting Office is currently performing a study of alternative financing mechanisms for subsidized housing production. The alternatives being analyzed include the more traditional FHA insurance programs, state housing finance agencies, the section 11b program and others which utilize private ownership. All of these methods necessarily include the use of section 8 subsidies since the bulk of housing assistance is now channeled through this program. We have, therefore, looked in some detail at the policies and procedures governing section 8 and have, during the course of our investigation, observed what appears to be a serious and very costly problem in the way this program is administered. This problem could immensely reduce the effectiveness and increase the costs of housing assistance by allowing private investors who own and operate section 8 housing to sell their projects or convert them to condominiums in as little as 5 years. This would likely result in the displacement of low and moderate income tenants and is in marked contrast to the much longer service which can be expected from a program such as conventional public housing which should serve subsidized tenants for at least 40 years at much lower costs.

We believe this will happen because (1) the Housing Assistance Payments (HAP) agreement which HUD executes with each developer allows cancellation or renewal of the HAP contract, at the option of the owner, after 5 years (or multiples of 5 years) and because (2) there will be strong economic incentives for many owners to dispose of their investments long before the end of the 20 years which has been generally anticipated. We discussed this matter with the Department. They are aware of the problem and are working on its solution.

In the past, FHA multifamily insurance programs have been implemented using a regulatory agreement giving the Department of Housing and Urban Development control for 20 years over the

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project owner's ability to sell or refinance the property. A similar regulatory agreement is executed for insured section 8 projects. However, the regulations for section 221(d)(4), which is the major insurance program being used in conjunction with section 8, exempt project owners from restrictions limiting their ability to sell. Even without this exemption we believe it is unlikely that HUD would restrict a project owner's ability to sell or increase rents if the subsidy payments were stopped at the owner's option.

For uninsured projects such as those developed through state housing finance agencies, there is no regulatory agreement between the developer and HUD and the terms of the HAP contract also allow owners to withdraw at the end of any 5 year renewal period. Those states which have agreements controlling ownership generally make such terms dependent upon prepayment of the mortgage debt. We have reviewed the section 8 legislation, regulations and applicable contracts and are concerned that project owners under any financing method have the legal right to dispose of section 8 properties at the end of any of the 5 year renewal periods specified in the HAP contracts.

We had originally anticipated including this finding in our overall report to the Congress on multifamily financing alternatives, which will be issued early in 1979, but with the large volume of section 8 starts which are approved each week using the current regulations and HAP agreements, we concluded that the matter should be brought to your attention as soon as possible. If only 10 percent of the units which are approved by HUD during any single week fail to serve subsidized tenants for the full 20 years, the eventual additional cost of providing housing to these subsidized households could run into many millions of dollars. During a year the cost implications run into the hundreds of millions of dollars.

FINANCIAL CONSEQUENCES

The seriousness of the problem arises because the government goes to some considerable effort and expense to get new subsidized housing produced and because there are rather large front-end Tandem and tax subsidies expended to make this production economically feasible and financially attractive to investors. If projects are refinanced or sold after 5 or 10 years rather than held for the 20 years originally anticipated, then these front-end costs and the Department's energies and administrative expenses are largely lost along with the availability of the housing to low and moderate income tenants. The net effect is to greatly increase the per unit cost of providing this housing during the first 5 years and then to make it necessary to start replacement units at higher inflated costs at a later time.

The enclosed table (see table 1) gives a rough approximation of the additional cost needed to provide 20 years of housing services when a newly constructed unit is sold after 5 or 10 years rather than being held for the full 20 years. These calculations were done ignoring increases in operating costs which would be the same in each case and are, therefore, not meant to be actual cost estimates. They do, however, give an approximation of the large incremental per unit costs which would be incurred if multifamily real estate prices and construction costs increase by only about 5 percent per year. The cost for section 8 units financed using state housing finance agencies or other tax exempt financing would also be much higher with early sales. Table 2 shows the potentially huge cost increases which would result if the current procedures were adopted indefinitely.

<u>INVESTOR PERSPECTIVE</u>

With the current appreciation in real estate values, the shrinking supply of moderate priced rentals, and a housing shortage predicted through the 1980s, we can reasonably expect that many owners will opt to sell their properties during the first 20 years if there is no prohibition against such sale. Although recapture and capital gains taxes have long been considered a factor in making continued ownership of subsidized housing attractive to investors for at least 15 years, such considerations were generally based on the assumption that the value of subsidized properties would not appreciate. There is ample reason to doubt this assumption. HUD is already involved in a number of lawsuits where property owners have prepaid mortgages and attempted to evict subsidized tenants in spite of the older and clearly more binding regulatory agreements. These projects are generally well located and have appreciated to the point where the owners expect to make significant profit by selling or converting.

Sketchy data on section 8 project locations indicate that many of the new projects are in areas which are experiencing above average real estate appreciation. We have calculated the tax impacts and expected profits for owners of multifamily subsidized projects which appreciate at a rather moderate 5 percent per year. Even after recapture and capital gains taxes are paid, passive investors in relatively low marginal tax brackets (50 percent) could expect impressive yearly rates of return of about 28 percent and 32 percent if multifamily properties were sold after 5 or 10 years respectively (see table 3). Although these properties would continue to provide good returns after 10 years, the bulk of the tax shelter is exhausted in the first

10 years. And tax shelter is the primary motivation for investment in subsidized multifamily projects. Higher appreciation rates which are bound to occur in some areas and higher investor tax brackets, which are the norm, would result in even greater incentive to dispose of such investments. This combination of factors makes it very likely that some portion of section 8 owners will choose to sell when HAP contracts come up for renewal.

THE DEPARTMENT'S VIEWS

We met with HUD officials to get their views on this problem and they made a number of points regarding our findings. Most importantly they agreed with us that the possibility of early project sales does exist, and they said they were taking steps to correct the situation. They said that our interest in the problem might buttress their efforts to solve it. The Department is proposing changes, as part of a major rewrite in the section 8 regulations, which would require owners of insured projects to continue with the subsidy payments for the full term of the original HAP contract. This would generally mean 20 years and would probably assure continued ownership. We have not reviewed the proposed changes to ascertain their likely impact because the new regulations are not yet available. HUD also said they would be looking at ways to control the ownership of non-insured projects such as those financed by state housing finance agencies. Until such changes can be made, they felt it might be possible to have sponsors voluntarily sign waivers having the same effect as the proposed regulation changes although they admitted this might meet with some legal or practical drawbacks.

These steps are aimed at accomplishing needed changes, but there are some difficulties. First, the regulation change which HUD is proposing applies only to FHA insured projects which account for roughly 30 percent of all section 8 starts to date. The proposed change is also imbedded in a general revision of the section 8 new construction and substantial rehabilitation regulations which are now under preparation by HUD. After completion these proposed changes must undergo departmental review, congressional approval and finally be published in the Federal Register for public comment. During the course of this process, the needed language could be deleted or changed if HUD were to decide that the ability to sell prior to 20 years was a desirable incentive to investors. This seemed to be a minority view of those HUD officials present. The change might also be deleted if when the regulations are published, the public comment is highly unfavorable. Developers could well be expected to oppose such changes since control of ownership would reduce their flexibility. This particular production incentive seems unnecessary since past insurance programs with less attractive subsidy mechanisms have shown that HUD could achieve impressive multifamily production while retaining control over ownership for at least 20 years.

The second problem is that the changes needed to control housing ownership (or subsidized tenancy) for non-insured projects will likely take much longer than for insured projects since no concrete measures have as yet been formulated and these measures may involve the cooperation of state housing finance agencies and local public housing authorities.

Another point which several HUD officials made was that though they saw the potential difficulty which we were pointing out, they also felt it was unlikely that many developers would actually want to sell. The reasons for this were that 1) the subsidy mechanism which allows periodic adjustments for inflation in operating costs, and 2) the high percentage of section 8 projects which are for the elderly and, therefore, relatively easy to manage, would provide incentive for investors to hold their projects. Although we believe that some developers will no doubt maintain the section 8 subsidies for a long period of time, the real issue is whether they should be allowed to opt out after only a few years when it is unnecessary and costly to allow it to happen. Nevertheless we believe that the economic incentives alone (such as profit taking and the need to renew tax shelters) will cause many project owners to take advantage of the opportunity to sell if it is available.

Since it may be some time before this serious and potentially costly problem can be corrected, during which hundreds of additional projects may be approved, we felt we should bring the matter to your attention as quickly as possible. Should you have any questions regarding this problem or our analysis, my staff would be glad to meet with you and discuss the matter in greater detail. Mr. Joseph Delfico or Mr. William Gainer of the Program Analysis Division can be reached on 275-3581. We are also reporting on this matter to the Chairmen of the Senate and House Committees on Appropriations, the House Committee on Banking, Finance and Urban Affairs, and the House Committee on Government Operations.

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Sincerely yours,

Comptroller General
of the United States

Enclosure

TABLE 1

Yearly Undiscounted Life Cycle
Cost To Operate An FHA Insured
Unit For 20 Years

	Sale After Twenty Years a/	Sale After Five Years b/	Sale After Ten Years c/
Direct Subsidy d/	$3,254	$3,873	$4,195
Indirect Subsidy			
Tandem Expense e/	212	482	558
Federal Taxes Lost Due to Depreciation f/	345	666	806
Tax Revenue When Unit is Sold g/	(556)	(770)	(998)
Total Per Unit Per Year Cost	$3,255	$4,251	$4,561

a/ Assumes a $30,000 unit is sold after 20 years.

b/ Assumes a $30,000 unit is sold after 5 years and is replaced by a new unit which is in turn sold after 15 years.

c/ Assumes a $30,000 unit is sold after 10 years and is replaced by a new unit which is in turn sold after 10 years.

d/ Assumes an initial total development cost per unit of $30,000 which increases by 5 percent per year, 90 percent mortgage loans, equal operating expenses, and a tenant income of $5,000 per year.

e/ Tandem expense is based upon a 7.5 percent mortgage being sold when the market interest rate is 10 percent.

f/ Assumes a 50 percent marginal tax bracket investor.

g/ This represents tax revenue due to recapture of excess depreciation and capital gains.

TABLE 2

Yearly Undiscounted Life Cycle Cost to Operate An FHA Insured Unit For 20 Years

	Sale After Twenty Years a/	Sale Every Five Years b/
Direct Subsidy c/	$3,254	$4,739
Indirect Subsidy		
Tandem Expense d/	212	1,270
Federal Taxes Lost Due to Depreciation e/	345	1,389
Tax Revenue When Unit is Sold f/	(556)	(1,493)
Total Per Unit Per Year Cost	$3,255	$5,905

a/ Assumes a $30,000 unit is sold after 20 years.

b/ Assumes a $30,000 unit is sold and replaced every 5 years.

c/ Assumes an initial total development cost of $30,000 per unit which increases by 5 percent per year, 90 percent mortgage loans, equal operating expenses, and a tenant income of $5,000 per year.

d/ Tandem expense is based upon a 7.5 percent mortgage being sold when the market interest rate is 10 percent.

e/ Assumes a 50 percent marginal tax bracket investor.

f/ This represents tax revenue due to recapture of excess depreciation and capital gains.

TABLE 3

Rate Of Return For Profit Motivated Passive Investor a/

	Sale After 5 Years	Sale After 10 Years
Per Unit Investment b/	$4,050	$4,050
Total Tax Savings	5,093	7,365
Taxes on Sale d/	4,991	4,191
Cash Realized	7,976	18,613
Rate of Return c/	28.54%	32%

a/ Taxpayer is assumed to be in the 50 percent marginal tax bracket. Higher tax bracket investors which are the norm would realize even higher returns.

b/ Based upon a total per unit development cost of $30,000.

c/ Assumes only a moderate multifamily appreciation rate of 5 percent.

d/ This represents taxes due to recapture of excess depreciation and capital gains.