WRITTEN TESTIMONY OF THE STAFF OF THE JOINT COMMITTEE ON TAXATION REGARDING FEDERAL INCOME TAX ASPECTS OF PROPOSALS TO RESTRUCTURE CERTAIN FHA-INSURED MULTIFAMILY MORTGAGE PORTFOLIOS

FOR A HEARING
OF THE
SUBCOMMITTEE ON HOUSING
AND COMMUNITY OPPORTUNITY
OF THE HOUSE COMMITTEE
ON BANKING AND FINANCIAL SERVICES

SEPTEMBER 17, 1997

PRESENTED
BY
KENNETH J. KIES
CHIEF OF STAFF
JOINT COMMITTEE ON TAXATION
U.S. CONGRESS

SEPTEMBER 17, 1997
JCX-46-97

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I. INTRODUCTION

My name is Ken Kies. I am the Chief of Staff of the Joint Committee on Taxation. It is my pleasure to present the testimony of the Joint Committee at this hearing on the Federal income tax aspects of various proposals to restructure certain multifamily housing mortgages that are insured by the Federal Housing Association ("FHA").[1]

Under present law, the Department of Housing and Urban Development ("HUD") utilizes a number of subsidy programs to promote and retain adequate and affordable rental housing for low- and moderate- income individuals and families. As described in detail below, among these is a program wherein owners of multifamily housing projects are provided cash rent subsidies from HUD and mortgage insurance provided through the FHA. In many cases, the duration of the term of the rental payments (typically, 20 years) is shorter than the term of the mortgage (typically, 40 years), and the expiration of the rental subsidies may cause some project owners to default on their mortgages, potentially triggering the FHA guarantees. There have been several proposals to address this situation. These proposals generally would involve an up-front infusion of cash by HUD that is used to restructure the original project mortgage, with HUD then taking a second mortgage, generally at a below-market interest rate.

The principal Federal income tax issue presented by these restructuring proposals is whether the project owner would recognize income as a result of the mortgage restructuring. Income recognition may be required if (1) the up-front cash payment from HUD is treated as a taxable subsidy to the project owner or (2) the project owner is treated as having cancellation of indebtedness income under the transaction. Whether or not the project owner is treated as having cancellation of indebtedness income under the transaction depends upon a variety of factors, including the extent to which the second mortgage is recognized as a bona fide debt, and whether the stated principal amount of the debt is respected for tax purposes. These determinations often are based upon all the relevant facts and circumstances underlying the transaction. Because each HUD mortgage restructuring will involve a unique fact pattern, a blanket statement accurately describing the likely Federal income tax consequences for all project owners cannot be made. Rather, the following testimony describes the general Federal income tax aspects that must be considered in the typical proposed restructuring transaction. However, it is likely that if all project owners restructure their mortgages pursuant to any of the proposals, some of these taxpayers would incur increased tax liabilities as a result of the transactions.

Absent legislation or a Treasury announcement clarifying the Federal income tax

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[1] This document may be cited as follows: Joint Committee on Taxation, *Written Testimony of the Staff of the Joint Committee on Taxation Regarding Federal Income Tax Aspects of Proposals to Restructure Certain FHA-Insured Multifamily Mortgage Portfolios* (JCX-46-97), September 17, 1997.

treatment under any of the HUD restructuring proposals, it is likely that many project owners will not elect to restructure their FHA-insured mortgages before the expiration of their Section 8 contracts for fear of incurring immediate tax liabilities. Thus, the budgetary cost of providing tax relief legislation should be balanced with the budgetary savings that the restructuring proposals represent and with the program goal of maintaining the stock of low-income housing.

The analysis contained herein is based upon the application of the present-law provisions of the Internal Revenue Code of 1986 ("Code"), Treasury Department regulations issued pursuant to these provisions, relevant judicial decisions, and common law tax principles. The understanding of the staff of the Joint Committee on Taxation as to the operation of current and proposed HUD multifamily housing programs is based upon a review of materials provided by, and conversations with, the staff of the Subcommittee on Housing and Community Opportunity, Congressional Budget Office staff, HUD personnel, and representatives of interested parties.

Following is a discussion of the background on multifamily housing assistance (Part II), a description of housing restructuring proposals (Part III), the Federal income tax aspects of these proposals (Part IV), and a brief economic analysis (Part V).

II. BACKGROUND

Multifamily Section 8 Housing Assistance

The Department of Housing and Urban Development ("HUD") has employed a number of subsidy mechanisms, contained in the United States Housing Act of 1937 as amended, to promote and retain adequate and affordable rental housing for low- and moderate-income individuals and families. The subsidies are either provided to: (1) owners of particular apartment units (project-based subsidies) or (2) low-income individuals or families (tenant-based subsidies). The subsidies are either direct (e.g., monthly cash rental payments) or indirect (e.g., mortgage insurance provided through the Federal Housing Association ("FHA")).

For the type of multifamily housing projects that are addressed under the most recent HUD proposal (a proposal HUD calls "portfolio re-engineering"), HUD has previously combined two different subsidies. These subsidies are (1) mortgage insurance and (2) project-based Section 8 cash rental payments (by reference to Section 8 of the United States Housing Act of 1937).

The first subsidy mechanism is mortgage insurance provided through the FHA. Typically, a mortgage was created upon the development of a project, which had an amortization schedule that assumed 40 years of Section 8 cash rental payments. The mortgage insurance also typically had a duration of 40 years, and provided that HUD, through FHA, would pay principal and accrued interest on the mortgage in the event that the mortgagor fails to meet payment obligations. For most projects for which it originally was provided, HUD continues to carry this mortgage insurance. In some cases a default has occurred and HUD now directly holds the mortgage.

The second subsidy mechanism was Section 8 monthly cash rental payments. These can be described as supplements to the stream of rental income from a housing project which, when combined with the rents paid by tenants, generally equal payments on the mortgage on the project. The duration of these payments varied from 15 to 40 years, with a typical duration of 20 years. While these rental payments were entitled "fair market rents" or "fair market rents for new construction," they often represented amounts in excess of the rent that would have been negotiated between a willing landlord and a willing tenant. The amount of rent that would have been negotiated between a willing landlord and a willing tenant is often referred to as "street rent." While the cash rental payment for each project was separately negotiated, it is now commonly believed to have initially exceeded "street rent" for many of these low-income projects. The automatic inflator formula in these contracts designed to take into account inflation often maintained or exacerbated these excessive payments in the years after the project was placed in service. As a result, many of these projects continue to receive rent payments of 150 percent or more of their street rent.

While there is some variety as to the structure of these deals, the typical formulation was as follows. A developer of a low-income project (low-income tenants were then classified as

persons with 80 percent or less of area median income) would negotiate with HUD a package of subsidies to be provided to the low-income project. The developer would then create a single-asset partnership, interests in which would be issued to investors. The costs of development, including developer's fees, would be passed on to the partnership. The developer generally would act as the general partner in this single-asset partnership. The developer, who typically would retain a one to five percent interests in the partnership, would then solicit limited partners for the remaining 95 to 99 percent interests in the partnership. All debt undertaken by the partnership was nonrecourse, meaning that the partners' liability was limited to their equity investment in the partnership. Generally, the equity investment was very small and the assets of the partnership were very highly leveraged. This structure also served to maximize the favorable tax aspects associated with these tax shelters. The limitation of these tax benefits, principally through the passive loss rules of the Tax Reform Act of 1986, may have reduced the attractiveness of such investments and limited the availability of new capital for these types of deals.

The partnership usually would finance the project (including development costs) through a private mortgage secured by the low-income project building. The mortgage could involve taxable or tax-exempt debt. The tax-exempt debt structure generally involved privately marketed tax-exempt bonds. Whether the debt was taxable or tax-exempt, a private third party would grant the partnership a loan secured solely by the low-income project property. The private third-party would either hold the mortgage or in turn sell interests in the mortgage to other investors. The type of the private third-party investors could be affected by the nature of the debt. For example, taxable persons would be more likely to invest in tax-exempt debt than tax-exempt entities such as pension funds. The private third-party investors contracted with an unrelated vendor to service the mortgage (collect principle, interest, and escrow accounts) for a fee.

The crux of the problem is that, with the expiration of many of the Section 8 cash rental subsidies, HUD now wants to bring these projects into line with true market rents (i.e., street rents). However because without additional capital contributions by the partners or other cash infusion, the debt service of the 40-year mortgages cannot be met without continuing the non-economic rental payments, the problem to be addressed by HUD and Congress is how to bring the rental payments down to "street rent" levels and reduce FHA and HUD liability under the mortgage insurance program. A description of proposed solutions follows below.

III. DESCRIPTION OF MORTGAGE RESTRUCTURING PROPOSALS

The Portfolio Re-engineering Proposal

The portfolio re-engineering proposal is intended to place the affected low-income projects in a true market position and to reduce HUD's financial responsibilities under both the Section 8 cash rent payment agreements and the potential mortgage insurance liability (the "Proposal"). The affected projects are only those which: (1) have Section 8 cash rental payments in excess of street rent and, (2) have a mortgage in excess of the amount which can be supported if the amount of cash rental payments is reduced to street rent levels. Under the Proposal, HUD, the project owners, and the mortgage holder must agree to all three elements of the restructuring.

The three elements are as follows. First, the cash rental payments would be reduced to an amount intended to reflect street rents (the ability to determine actual street rents could vary from project to project). Second, the mortgage holder would accept a cash payment from HUD to reduce the outstanding mortgage (with a level principal and interest schedule) to an amount which can be supported under the new financing structure (the "First Mortgage"). Third, HUD would hold a subordinated second mortgage at or below a market rate of interest with a back-loaded principal and interest repayment schedule (the "Second Mortgage").[2]

Alternative Proposals

There are two related alternatives to the basic mortgage restructuring proposal described above. Under the first alternative, where HUD currently holds the mortgage pursuant to the lender previously filing a mortgage insurance claim after a nonpayment by the project owners (he "First Alternative"), the restructuring would involve HUD bifurcating the debt into first and second mortgages. Presumably, the first mortgage would then be sold to a unrelated third party.

Under the second alternative, where the current lender will not continue to be party to the transaction (the "Second Alternative"), HUD would fully satisfy the outstanding mortgage currently held by a current lender and replace it with first and second mortgages. This alternative is contemplated in cases where the current holder of the mortgage refuses to accept the proposal or HUD has some reason to want to eliminate this party from the restructuring. Again, the new first mortgage would presumably be transferred to an unrelated third party and HUD would retain the second mortgage.

In all cases, the cash rental payment would be reduced to "street rent" levels, an unrelated third party would hold a first mortgage which could reasonably be supported by the project for the its term, and HUD would hold a second mortgage which would be satisfied at the end of the cash rental payment contract/first mortgage from the proceeds of the sale of the project.

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[2] A version of this proposal can be found in H.R. 2447, as introduced by Mr. Lazio.

IV. FEDERAL INCOME TAX ASPECTS RESTRUCTURING PROPOSALS

Tax Issues of Mortgage Restructuring, in General

Because HUD is a tax-exempt government entity, the major tax issues of the refinancing are those facing the owners of the various properties covered.

Under section 61 of the Code, the gross income of a taxable individual or entity includes "all income from whatever source derived." Specifically included in gross income is income from cancellation of indebtedness ("COD") (sec. 61(a)(12)). Government subsidies provided to a taxable individual or entity are also included in gross income for unless excluded pursuant to a specific exception.

Section 7872 of the Code addresses the tax treatment of certain below-market loans and generally imputes taxable payments on such loans to account for the difference between the interest actually paid and interest at the Applicable Federal Rate (generally the rate at which the Federal government borrows money for the term of the instrument in question).

Owners possibly will be required to recognize taxable income in the year of the refinancing either as a result of (1) the treatment of the refinancing terms as a taxable subsidy or COD or (2) an imputed payment on the Second Mortgage under the below-market loan rules of section 7872.

The issues of taxation as a result of the terms of the refinancing is different for the three different scenarios. Under the First Alternative, the owner (under the appropriate facts and circumstances) likely will recognize COD income in the amount of the difference between the principal amount of the Second Mortgage and a lower imputed principal amount determined by treating a portion of future payments on the Second Mortgage as payments of interest at the long-term Applicable Federal Rate (currently 6.45 percent). Under each of the Proposal and the First and Second Alternatives, there is also a issue that an amount up to the total principal amount of the Second Mortgage will be treated as taxable COD or subsidy income to the owner.

Even if taxable COD or subsidy income does not result from the refinancing, there is an issue under all scenarios that the owner will recognize taxable income in the year of the refinancing as a result of treatment of the Second Mortgage as a below-market loan subject to the rules of section 7872. The amount of such income would be equal to the difference between the principal amount of the Second Mortgage and the imputed principal amount which results from discounting at the long-term Applicable Federal Rate. Unlike the issue of taxable COD or subsidy income, the issues of income recognition to the owner under the below-market loan rules of section 7872 is roughly the same under all three scenarios.

Cancellation of Indebtedness or Subsidy Income

Under each of the scenarios, there is a possibility that the owner will be required to

recognize income in the taxable year of the refinancing as a result of its terms.

First alternative

These issues are clearest under the First Alternative. Because under the First Alternative HUD is already the holder of the First Mortgage on the property, the issuance of the Second Mortgage to HUD in exchange for a reduction in the payments required under the First Mortgage could be viewed as a "debt-for-debt" exchange between the owner and HUD. In such an exchange, section 108(e)(10) of the Code provides that a borrower recognizes COD income in an amount equal to the difference between the amount of the original indebtedness and the "issue price" of the new indebtedness. The issue price of the First Mortgage as a result of the refinancing will be its new reduced principal amount (Treas. reg. sec. 1.1273-2(d)). Due to the low interest rate of the Second Mortgage, its issue price will be an imputed amount lower than its principal amount, which will be determined by a calculation that discounts all payments to be made on the Second Mortgage at the long-term Applicable Federal Rate (sec. 1274(b)). Thus, under the First Alternative, section 108(e)(10) will require that an owner realize COD income in the amount of the difference between the principal amount of the Second Mortgage and its lower issue price under this calculation.

In the First Alternative, it is possible that structuring the First and Second Mortgages as a single debt instrument held by HUD will reduce the amount of COD income realized by the owner. If treatment as a single instrument is respected, the combined instrument would result in COD income under the above analysis only if the total of the interest payable on the First and Second Mortgages was below the long-term Applicable Federal Rate for the combined instrument. The staff of the Joint Committee has been unable to locate any authority as to whether combining the First and Second Mortgages into a single instrument would be respected for purposes of the COD calculation. However, the original issue discount rules provide a helpful analogy.[3] In any event, for owners whose COD income would be reduced by treating the First and Second Mortgage as a single instrument, there seems little downside to structuring the First Alternative in this manner.[4]

Depending on the situation of the individual owner, all or a portion of any COD income realized may be excluded from recognition under the rules of section 108 of the Code in exchange for a reduction of favorable tax attributes. One of these rules allows exclusion of COD income arising from "qualified real property business indebtedness" in the case of taxpayers

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[3] Under the original issue discount rules, all debt instruments issued in the same transaction or related transactions are treated as a single debt instrument (Treas. reg. 1.1275-2(c)).

[4] Even if the First and Second Mortgages are not structured as a single instrument, an owner may be entitled to claim such treatment as a reporting position based on the analogy of the original issue discount rules.

other than C corporations (sec. 108(a)(1)(D)). This exception has the effect that an individual owner of a project, or an individual investor in a partnership that owns a project, could be able to exclude an amount of COD income equal to his or her total basis in the project and other depreciable real estate investments, whether held directly or in partnership form.[5]

All Scenarios

Under the Proposal and the First and Second Alternatives, there is a possibility that the owner will be required to recognize taxable COD or subsidy income in an amount up to the entire principal amount of the Second Mortgage. This could occur as a result of application of one of several tax doctrines that prevent financial transactions from having the tax consequences that would normally follow from their form (as opposed to their substance).

Debt v. equity.--The most likely challenge would probably assert that the terms of the Second Mortgage do not justify treatment as a debt instrument for tax purposes, but rather as some sort of equity interest in the property.[6] The determination of whether an investment

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[5] Qualified real property business indebtedness is indebtedness that (1) is incurred or assumed in connection with real property used to a trade or business, (2) is secured by that real property, and (3) with respect to which the taxpayer has made an election under this provision. Indebtedness incurred or assumed on or after January 1, 1993, is not qualified real property business indebtedness unless it is either (1) debt incurred to refinance qualified real property business debt incurred or assumed before that date (but only to the extent the amount of such debt does not exceed the amount of debt being refinanced) or (2) certain acquisition indebtedness (sec. 108(c)(3)).

The amount excluded under the provision with respect to the discharge of any qualified real property business indebtedness may not exceed the excess of (1) the outstanding principal amount of such debt (immediately before the discharge), over (2) the fair market value (immediately before the discharge) of the business real property which is security for the debt, reduced by the principal amount of any similar indebtedness to which it is subject (sec. 108(c)(2)(A)). The amount excluded is subject to an overall limitation which is generally equal to the aggregate adjusted bases of the taxpayer's depreciable real property immediately before the discharge (sec. 108(c)(2)(B)). Because of this overall limitation, it unlikely that the project owners subject to the HUD restructuring proposals will be able to avail themselves of the qualified business real property exception to COD recognition. It is understood that most of the real property subject to the HUD restructuring proposals were placed in service several years ago and thus have a zero or low adjusted basis. However, to the extent the project owners own other qualified real property, they may be able to use the exception.

[6] Analytically, the equity interest would be in a constructive joint venture or partnership that owns the property. For properties that are actually owned by partnerships or joint ventures, the equity interest would be in that entity.

constitutes debt or equity for tax purposes is generally made on the basis of factors which have been articulated in a long line of court cases. These factors generally reflect terms that would be required by an unrelated debtor making a commercial loan on arm's length terms. One recent case provides the following list of debt/equity factors that have been used by the courts:

1. names given to certificates evidencing the indebtedness;
2. presence or absence of a fixed maturity date;
3. source of payments;
4. right to enforce payments;
5. participation in management as a result of the advances;
6. subordination to other creditors;
7. intent of the parties to credit a debt;
8. ratio of purported debt to equity;
9. ability of debtor to otherwise obtain credit from outside sources;
10. use to which the advances were put;
11. failure to debtor to repay; and
12. issue involved in making advances.[7]

The Second Mortgage in this scenario may be viewed as lacking several of the indicia of debt established by the case law due to the special nature of the refinancing. The refinancing is motivated by housing policy concerns of reducing the debt to a level which can be serviced by projected rents. These are not concerns that would motivate a commercial lender. As a result, the terms of the Second Mortgage lack some of the case law indicia of debt, including the lack of adequate security and the lack of required payments on the indebtedness (until sale or refinancing) in the absence of the adequate cash flow. Although somewhat less important, the non-market rate of interest also is a factor against characterization of the Second Mortgage as debt. However, the Second Mortgage also possesses a number of the indicia of debt under the case law, including the form of the certificates, the intent of the parties to create debt, the fixed maturity date, the unrelated nature of the parties, HUD's lack of a management relationship or interest in upside profit beyond the principal amount of the Second Mortgage, and other provisions found in standard commercial loan documents. Thus, if the Second Mortgage is challenged on the basis that it constitutes a type of equity rather than debt, it is not possible to predict with certainty how a court would resolve this issue.[8]

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[7] Dairies Corp. v. Commissioner, 74 T.C. 476 (1980). See also Plumb, "The Federal Income Tax Significance of Corporate Debt," 26 Tax L. Rev. 369 (1971).

[8] As an alternative, it is worth considering structuring the Second Mortgage in the form of an equity interest. This would prevent challenge under the debt/equity case law and would also reduce the likelihood that the owner has COD income under the First Alternative. However, this variation would still be subject to challenge on the basis that the equity rights granted by the owner are not equal in value to the cash infusion by HUD, with the result that the difference must be treated as taxable income to the owner. Thus, under the equity variation, it would be

In the First and Second Alternatives, HUD becomes the holder of both the First and Second Mortgages. In these Alternatives, the issue of reclassification of the Second Mortgage as equity should be reduced somewhat if the First and Second Mortgages are combined into a single debt instrument. Because the First Mortgage possesses nearly all of the indicia of debt established by the case law, the First Mortgage terms may be sufficient to protect a combined First and Second Mortgage from reclassification as equity.

Other doctrines.--It is possible, although less likely, that the Second Mortgage could be successfully challenged on the basis of other tax doctrines which can be used to modify the tax consequences ordinarily flowing from the "form" of a transaction. For example, it is possible that the refinancing could be challenged on the basis that it is a "sham transaction"[9] or that it serves only a tax avoidance purpose rather than a non-tax economic purpose.[10] Because the impetus for the refinancing came from documented housing policy concerns, and the rights granted to HUD under the Second Mortgage are significant, a successful challenge of the Second Mortgage under such doctrines seems less likely than on the basis that it is in substance equity. Possible challenges under doctrines other than debt/equity would be reduced if the Second Mortgage were required by the enabling legislation.

Tax consequences.--Regardless of the particular doctrine utilized, if the form of the Second Mortgage as a valid debt relationship between the owner and HUD is successfully challenged, the owner will be treated as recognizing income in the year of the refinancing due to the reduction in the First Mortgage resulting from the new cash infusion provided by HUD. This income could be characterized either as COD income or as a taxable subsidy. The amount of such taxable income should be the principal amount of the Second Mortgage, reduced to account for the value of HUD's rights to cash flow and sale or refinancing proceeds under the terms of the Second Mortgage. If the income recognized by the owner were characterized as COD income, the statutory exceptions to the recognition of such income discussed above would be available.

Imputed Income Based on Interest Rate of Second Mortgage

Even if no taxable COD or subsidy income is realized by the property owner under the above analysis, there is still a issue as to whether the owner will be required to recognize taxable income in the year of the refinancing as a result of the treatment of the Second Mortgage as a

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advisable for the owner to grant significant rights to HUD in addition to those in the Second Mortgage--such as participation in an increase in rents or the profits from sale of the property--in order to increase the total value of the equity.

[9] See, Knetch v. U.S., 364 U.S. 361 (1960)

[10] ACM Partnership v. Commissioner, T.C. Memo 1997-115 (1997).

below-market loan subject to the imputed interest rules of section 7872.[11]

One type of loan that is subject to the provision is a "tax-avoidance loan" (sec. 7872(c)(1)(D)). Another type of loan that qualifies is a loan with a "significant effect" on the tax liability of the lender or the borrower (sec. 7872(c)(1)(E)). There is a possibility that the Second Mortgage will be treated as one of these types of loans subject to the imputed income rules of section 7872. If the Second Mortgage is so treated, the owner would recognize taxable income in an amount equal to the excess of the principal amount of the Second Mortgage over an imputed principal amount determined by discounting all payments to be made on the Second Mortgage at the long-term Applicable Federal Rate (sec. 7872(b)(1)).[12]

There is a possibility that the Second Mortgage will be excepted from section 7872 under a Treasury regulation which covers "loans subsidized by the Federal . . . government (or any agency or instrumentality thereof), and which are made available under a program of general application to the public" (Temp. Treas. reg. sec. 1.7872-5T(b)(5)). However, there is a issue that the HUD refinancing program will not qualify under this regulation on the basis that it is not a program of "general application," but only an offer made to certain owners. Moreover, the regulations provide that the exception for government-subsidized loans is not available if the taxpayer structures a loan to qualify for this exception and "one of the principal purposes of so structuring the transaction is the avoidance of Federal tax" (Temp. Treas. reg. sec. 1.7872-5T(a)(2)). There is a significant issue as to whether the Second Mortgage will fail to qualify for the exception for government-subsidized loans on this basis. Even if this occurred, additional arguments would be available against treating the Second Mortgage as subject to the imputed income rules of section 7872. The issue of application of section 7872 to the Second Mortgage would be reduced if the execution of a Second Mortgage is required by the enabling legislation.

Conclusion

As the discussion above indicates, there are a variety of factors that must be analyzed in order to determine whether or not a project owner would recognize taxable income upon the restructuring of its FHA-insured multifamily mortgage. However, it is clear that if all project owners restructure their mortgages under any of the proposals, it is likely that some of these taxpayers will recognize taxable income as a result of the transaction. The possibility of such

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[11] If the Second Mortgage is not respected as a valid debt instrument under the above analysis, there would be no imputed income under these rules because they apply only to debt instruments.

[12] Under section 7872, the Second Mortgage would be treated as an bearing original issue discount, with the result that the owner would be entitled to deductions over the term of the Second Mortgage representing accrual at the long-term Applicable Federal Rate. However, because the owner would have income in the year of the refinancing and deductions only over the term of the Second Mortgage, there would be a timing "mismatch" to the owner.

recognition likely will inhibit many project owners from electing to restructure their mortgages under a proposal.

V. ECONOMIC ANALYSIS

According to the Congressional Budget Office, approximately 850,000 rental housing units receive project-based Section 8 rent subsidies and have mortgages insured by the FHA. The Section 8-assisted rental payments exceed market value (as determined by the rent received by comparable unassisted units) for about 58 percent, or almost 500,000, of these units. These units receive Section 8 rent subsidies pursuant to contracts that ranged originally from 15 to 40 years, with a typical rent subsidy contract lasting 20 years. The FHA-insured mortgage typically lasts about 40 years. Most of the Section 8 contracts are scheduled to expire by 2003, while the mortgage insurance obligations will continue another 20 years.

Under present law, the Section 8 rent subsidy contracts may not be renewed at more than 120 percent of the fair market rent. At these rent levels, it is anticipated that many of these projects default on their mortgages, which would result in large losses to the FHA insurance fund, and probable displacement of a large number of the low income tenants. HUD anticipates that many of those owners who anticipate default will fail to maintain their properties during the years immediately preceding the default, thus causing a decline in value of the properties FHA would eventually be forced to acquire. The staff of the Joint Committee on Taxation understands that the Congressional Budget Office estimates that losses to the FHA insurance fund would total approximately $7.6 billion over the 1998 - 2010 period. The cost in terms of eventually restoring the housing stock lost to the disinvestment in the protracted foreclosure process is likely to be much higher.

These mortgage restructuring proposals are designed to reduce the cost of unexpired Section 8 contracts, to reduce losses to the FHA insurance fund, and to reduce losses in the supply of low-income housing, by providing an incentive for investors to restructure their mortgages, rather than default on them. A successful restructuring of the mortgage would limit the FHA/HUD exposure to the amount in the second mortgage, and ensure that the affected units continue to be maintained and to be made available to low-income tenants. However, if the restructuring is deemed by the Internal Revenue Service to trigger taxable income, the resulting income tax liability is likely to make the restructuring deal unattractive to many of the affected investors.

In particular, very few investors whose Section 8 contracts expire after the year the restructuring program would sunset are likely agree to restructure their mortgages early. It would be preferable to most investors to default on the mortgage at the time the contract lapses, and claim capital gains treatment on the default, rather than to take the restructured amount into income in the earlier time frame contemplated by the proposal as ordinary income. Thus, to the extent that this restructuring mechanism is expected to trigger taxable income at the time of the restructuring, it is likely to attract fewer investors, and result in little savings to the Section 8 program or the FHA insurance fund.

If this legislation were amended in such a way as to ensure that the restructuring mechanism would not trigger taxable income for the investors, it is likely that a larger percentage

of the investors would take advantage of the restructuring proposal, resulting in a greater savings to the Section 8 program and FHA insurance fund, and in the preservation of more units of housing for low-income tenants. The cost savings would be partially offset in the latter part of the budget period with a loss of Federal income tax receipts. Alternatively, the amount of money provided by HUD in the restructuring of the mortgages could be increased to compensate investors for their tax loss.

Any tax legislation that provides that investors will not recognize taxable income as result of the restructuring proposal will decrease Federal budget receipts. The staff of the Joint Committee on Taxation cannot, at this time, determine the magnitude of the revenue loss because such amount will be dependent upon the drafting specifications of the tax proposal. In addition, the Joint Committee staff would need to consult with the staff of the Congressional Budget Office in order to determine the extent to which such tax legislation, coupled with the underlying housing legislation, would entice investors to restructure their mortgages.