Transcript of Oct. 15, 2007, IRS Hearing on Proposed Rules (REG-114084-04) on Qualified Contracts for Low-Income Housing Credit

PANELISTS:
Christopher J. Wilson, senior counsel, IRS Office of Associate Chief Counsel (passthroughs and special industries);
Christopher Kelley, special counsel, IRS Office of Associate Chief Counsel (passthroughs and special industries);
Jack Malgeri, attorney, IRS Office of Associate Chief Counsel (passthroughs and special industries);
Sharon Kay, attorney-advisor, Treasury Office of Tax Policy

WITNESSES:
Richard S. Goldstein, Affordable Housing Tax Credit Coalition;
Miriam Colon, New York City Department of Housing Preservation and Development;
David Rammler, National Housing Law Project
Scott Kline, NHT/Enterprise Preservation Corp.

MR. KELLEY: While we're getting ready here, I just want to say good morning. We're going to get started with this hearing. It's a public hearing on the proposed Section 42 qualified contract provisions regulations that were issued on June 19th, 2007. On that date, the service published proposed regulations in the Federal Register and announced that a public hearing would be held today, October 15th, 2007, on those regulations.

Four people have requested the opportunity to speak this morning. Each speaker's going to have 10 minutes to speak, and there is a lighted indicator at the top of the podium. When three minutes are left, the light will turn from green to yellow, which indicates you have three minutes left to summarize your comments. And when the light turns red, the time will be up.

Let me go ahead and introduce our panel today. To my immediate left is Chris Wilson who is a senior counsel for Branch 5 of Passthroughs and Special Industries Division in the Office of Chief Counsel, Internal Revenue Service. To his left is Jack Malgeri, attorney-adviser in Branch 5 of the Office of Associate Chief Counsel, Passthroughs and Special Industries. And at the far left is Sharon Kay, an attorney-adviser in the Office of Tax Policy at Treasury. My name's Chris Kelley. I'm a special counsel to the associate chief counsel on passthroughs and special industries.

The first speaker we have on the agenda this morning is Mr. Richard Goldstein representing the Affordable Housing Tax Credit Coalition.

Mr. Goldstein.

MR. GOLDSTEIN: Good morning. My name is Richard Goldstein. I'm a partner with Nixon Peabody, a law firm here in Washington, D.C. And I'm here representing the Affordable Housing Tax Credit Coalition, which is a trade association based here in

Washington that represents most of the major participants in the low-income housing tax credit program and whose members are responsible for raising most of the equity capital that's invested in housing credit properties.

The coalition has been around since 1988, and I've been involved with the coalition since that time and was, in fact, involved with the legislation that led to the qualified contract provisions being inserted in the code back in 1989. So I, you know, part of my discussion today reflects some personal knowledge that I have as this process was unfolding almost 20 years ago.

The first thing I want to deal with is the question about whether the states have authority to impose more stringent requirements on the fair market value limit in the ... process and the pricing. And the answer is, in our view, absolutely not. The qualified contract provisions and the price, in particular, reflected congressional intent to try to balance interests, on the one hand to preserve affordable housing for as long as possible, for a longer period than the initial 15-year compliance period, but at the same time to continue to provide incentives for investors who were, at least at that time, concerned about being able to get a fair return on the capital that they invested. And Congress was concerned that had there been a straight 30-year extended-use period with no ability whatsoever to recoup investment after some period of time, that investment would be reduced or perhaps eliminated altogether. So there was a balancing of interests.

Had Congress intended a fair market value determination, it simply would have put that into the code. It didn't. It came up with a formula. The formula is perhaps not the clearest thing in the world. That, of course, becomes your job to try to interpret that. But nonetheless, had there been a fair market value determination being put in there it would have put it in there, and it didn't. The language that deals with more stringent requirements does not relate to the qualified contract price itself; it relates to the period of terminating the extended-use period in a different clause in Section 42(h)(6).

The next thing I want to deal with is the determination of the outstanding indebtedness. And I note that, in several instances, the service's proposed regulations would limit that indebtedness—first, to the qualified building costs; second, by discounting the debt in the event that the debt carries an interest rate below the applicable federal rate. In our view, there is no statutory authority whatsoever to do this. And in our view, the IRS really does not have authority to impose new concepts without any authority or legislative history.

Contrast if you will Section 42(i)(7)(B)(1), which deals with the minimum purchase price under the right of first refusal. There the Congress explicitly did not include debt incurred in the prior five years prior to the exercise of the right of first refusal. It did not, and that was at the same time. That part of the code became law at the same time.

The next thing is on the adjusted investor equity. Similarly, the proposed regulations have language that would permit--that would reduce the amount that would be recognized to that which is invested in qualified building costs. Again, the language here in the code talks about it being recognized only to the extent of the adjusted basis, which we believe meant adjusted basis under Section 1012, which is different than what amounts to eligible basis or depreciable basis as would be put forth in the proposed regulations.

In the category of distributions which reduce the qualified contract price, we would urge you to look at what Florida has done in its own proposals. There, Florida basically says that it's the amount that would be reduced is cash that's remaining after the payment of expenses, debt service, and reserve payments. It does include expenses that are distributions to partners, including things like partnership administration fees or incentive management fees which, for this purpose, we think should be treated as if it were a distribution to a partner. Refinancing proceeds are a reduction. We think that's appropriate as well. We don't think it's appropriate to reduce amounts by payments of deferred development fee, provided that the fee is within limits imposed by the agency within their own guidelines. Deferred development fees are paid for services rendered, and we don't think, even if the services are rendered by an affiliate of the general partner, that that should be a reduction in the distributions.

A major concern that we have really has to do with process. Defining a bona fide contract is a very difficult thing. There isn't a definition that we can really find anywhere that is going to be terribly helpful. What we're concerned with here in the context of a bona fide contract is either the buyer or the seller acting unreasonably, the buyer presenting a contract that has clearly unreasonable terms or a seller getting a perfectly reasonable contract and refusing to act on it because it didn't want to do what would normally be reasonable in the context of these business transactions.

And in light of that, we think it is important that there be some sort of dispute resolution that would be imposed upon the parties in the event that the parties cannot come to an agreement. We suggested binding arbitration under rules similar to the American Arbitration Association. You know, that would be fine as a model. There could be other models adopted. But we do think that the parties will be forced to be reasonable if they know at the back that they're going to have to face an arbitrator who would rule against them under those circumstances.

Also on the process, I know some commentators have suggested that the states' responsibility ends at the point where the contract is presented. And we disagree with that. We think that Congress intended that this is a bona fide contract to acquire, within a reasonable period after the contract is entered into, the property. If the Congress intended only that a presentation of a contract be the end of the process, it would make no sense. The idea was a real contract, a bona fide contract gets presented, and then there be a closing on that. In the event that the buyer walks away, in our view, the state should not continue to have additional bites at the apple here.

The language is clear. It has a right to present A, which we interpret to be literally A, one qualified contract. If the buyer defaults without seller defaults, if the buyer defaults, the state should not have an opportunity to go back to the process and back to the process. It's their responsibility to bring a buyer to the table who can close and perform on the contract.

Similarly, you know, there may be situations where sellers are going to be unreasonable as well. And we, you know, we are not looking for sellers to have the opportunity to act unreasonably and then claim that the contract wasn't a bona fide contract or that they should be released from the extended provisions under those circumstances. And that's why we think some procedure like a binding arbitration procedure will make parties act more reasonably under those circumstances.

The last thing I just want to mention is in the context of what would be required by the state. We understand that there's a certain amount of documentation that's going to be needed in order to assess what the qualified contract price ought to be and to interest buyers in actually purchasing these properties. We think that the due diligence requests need to be reasonable. States have come up with various proposals. We've seen what Florida looks at. We've seen what North Carolina looks at. We think those are reasonable. But we also are concerned that states would come up with potentially unreasonable requests that really can't be met and that would potentially frustrate the process.

So with that, I have a minute left if you have questions or I can--whatever.

MR. KELLEY: Any questions from the panel?

MR. MALGERI: I'd like to--Mr. Goldstein, what are your views on our determination of land?

MR.GOLDSTEIN: Interesting. I think you should ignore it. One of the commentators, who's the National Council of State Housing Agencies, made the point, which I think is a good one, that the--to the extent that land is paid for in the beginning of the process, it will be reflected already in the debt and/or equity that's paid, and that that--and those two elements are part of the qualified contract price.

I think the witness from New York will make a point, and we agree with this, that if the land is donated, and then has a fair market value 15 or 16 years later that obviously is higher than the donated value, that the seller should not be able to take advantage of the fact that they got the land for free and now they've got a huge fair market value, particularly in a place like New York City. So I think the land calculation really ought to be just left out of the equation.

MS. KAY: What do you think about--and you may not have seen it, but another commentator said that they did not believe we had authority to include land in the debt of equity because the statute refers to the qualified contract price as being for the acquisition of the building, and that everywhere else in Section 42, wherever it refers to building, it never includes land. And so that they said we did not have authority to include land in this instance either.

MR. GOLDSTEIN: Whether you have authority, I'm not sure. But I agree that it doesn't make sense to include land because it's already inherently part of the price, that is two parts of the equation already. If someone has paid for the land, they've either done so with the debt, or they've done so with equity. And those are two elements in the price already. If the land comes for free, then it hasn't been paid for. I don't think you ought to be giving people the opportunity to, sort of, capitalize on the land value that has now been inflated over whatever the donated price was.

MR. WILSON: And even if it's a long-term lease, do you think that that accurately reflects the land? In other words, you just ...

MR. GOLDSTEIN: There are a number of transactions where there are long-term leases, HOPE VI transactions in particular. And those are usually 60--yeah, we require that those be very long-term, at least 65 years, or very often 99 years, in order to take the position that they're for federal income tax purposes, the partnership, the owner is the owner of ...

MR. WILSON: And so you're paying for the land in the contract itself, on the lease terms? In other words, does it accurately reflect the value of the land--those long-term leases? In other words, you ...

MR. GOLDSTEIN: It doesn't ...

MR. WILSON: ... comparable to, like a sale?

MR. GOLDSTEIN: When you're first entering into the transaction?

MR. WILSON: Right. Right.

MR. GOLDSTEIN: Typically, it depends on the transaction. Very often the ground lease has a dollar payment--a dollar per year or some nominal amount, so if the land were to be sold free and clear it would clearly be worth more than a dollar. So it doesn't--no, the answer is it does not accurately reflect the value of the land at that time, typically, that is.

There may be situations where the lease does have a fair market value component. I have seen transactions where it's a commercial party that's actually leasing the land under a long-term ground lease, and that's just the business arrangements between the buyer and the seller, effectively. And there it may actually reflect more of a fair market value determination, but, again, I don't think that ought to be part of the equation.

MR. WILSON: OK.

MS. KAY: If you had to, sort of, translate to a layman who doesn't do these deals and looks at the words “adjusted investor equity,” and kind of thinks, I don't know what that means. What number do you think Congress was trying to get to--just the end number for the qualified contract?

MR. GOLDSTEIN: That portion of it is basically what the investor has agreed to invest as capital, equity capital, at the project level. And then take that number and inflate it by the annual CPI.

MS. KAY: I meant the entire qualified contract amount, including everything--the debt, the equity, the capital contributions. What number do you think they were trying to target?

MR. GOLDSTEIN: I don't know if I can define that, Sharon, in a number as much as a concept. And that was to say, OK, you've put your money in, and we're going to let you get a fair return on your equity. The debt should be whatever it is at the time so, you know, you repay that, so clearly whoever buys the property has to be responsible for helping you pay off the debt. You've gotten--and you'll get a return based on the CPI, as sort of a generally recognized inflating factor that will increase the equity amount.

And then we're going to reduce the amount of money that you've been able to put in your pocket, which is the "cash distributions" part of it. And we think that's a fair return. I think that's sort of, you know, as layman-like as I can get in terms of, sort of, defining what the Congress had in mind. But I think it was just basically to say to the investors: OK, we're going to let you have a fair return on your money. You know, you've put your money in, and you want the ability to get that out after 15 years. So I think that was as close as they could get.

MR. KELLY: Anybody else? OK, thank you.

MR. GOLDSTEIN: Thank you. I appreciate the opportunity.

MR. KELLEY: Our next speaker is Ms. Miriam Colon, representing the New York City Department of Housing Preservation and Development.

MS. COLON: Good morning, my name is Miriam Colon. I'm the assistant commissioner for the Division of Housing Incentives at the New York City Department of Housing Preservation and Development, HPD. Joining me is Chris Allred, over there. He's the director of the Tax Credit and Compliance Unit. He may be helping me answer some of your questions.

The New York City Department of Housing Preservation and Development appreciates the opportunity to comment in response to the proposed rulemaking on the qualified contract provisions. HPD is the nation's largest municipal housing development agency, and our mission is to promote quality housing in viable neighborhoods for New Yorkers.

As part of our responsibility, HPD directly allocates approximately $12.5 million in 9 percent credits each year. Since 1998, HPD has allocated $180 million in competitive credits, generating 1 billion [dollars] in private equity contributions. This has created more than 28,000 units of quality affordable housing. In the past 14 years, HPD has also processed applications for more than 120 million [dollars] in as-of-right credits for 180 tax-exempt bond finance projects, creating almost 17,000 affordable units.

We are concerned Section 1.42-18(b)(3), as it applies to projects built on land acquired for below-marked prices, will increase the cost of the qualified contract, and thereby would make it more difficult to maintain affordability in these properties. Such an increase would be inconsistent, in our view, with the goal of the extended long-term commitment provided by the code to continue the use of the low-income portion of the building as low-income housing.

For a building that has received an allocation of tax credits, the proposed section requires a fair market value of the land underlying the building be included in the calculation of the qualified contract price. However, for tax credit projects in New York City, the city has often provided to the development at below-market price land, and often at a nominal price as a form of direct subsidy to create low-income housing.

Let me briefly present to you two examples, one new construction, one rehabilitation. Both are 4 percent credits in northern Manhattan. In the new construction project, the city sold the lots for one dollar each--I believe there were 12 lots. Appraised value at the time was 1.16 million [dollars], so, therefore, the city provided the land at virtually a subsidy of $1.16 million.

The rehabilitation example, the city sold the land and the building for $300,000. Appraised value at the time was $2.6 million. In this case, the city provided a $2.6 million subsidy for land and building. These are not insignificant amounts, and without the subsidies, the projects would have been financially infeasible at the time. Including the fair market value of the land would significantly increase the qualified contract price and would make it so much more difficult to maintain affordability.

And increasing the qualified contract price that does not reflect the actual amount contributed by the developer, the investor, would make it more difficult to find an entity that is committed to preserving affordability for the project, which are typically the not-for-profits, while still being able to pay the qualified contract price, acquire the property, and continue to operate as low-income housing.

In addition, if a not-for-profit were unable to pay the qualified contract price at that inflated value, the city could be required to provide additional subsidy to the not-for-profit to preserve the affordability of housing. Not recognizing the city's initial subsidy would have the effect of forcing, basically, the city to provide a second subsidy for the same land.

As it is the intent of the code to ensure a fair price is arrived at in the computation of the qualified price and it is also the intent of the long-term commitment--extended long-term commitment—to maintain low-income housing, we are of the opinion that the regulation should only include the actual value contributed by the investor in acquiring the land, not the fair market value.

Finally, although not part of our written submission, we would like to express our support for four other aspects raised by others. First, the code considers a qualified contract price to be only the building and not the underlying land. Therefore, it's not clear the value of the land should be considered at all in determining the qualified contract price.

Second, the agencies should be allowed to have some administrative discretion in handling qualified contract requests.

Third, under no circumstances should the qualified contract price exceed fair market value, and also recognizing that appraising tax credit properties is complex, as many of the properties have a multitude of restrictions that must be considered when determining the value.

Conversations with our agency appraisers suggest determining an accurate consensus price for any given property would be really difficult. Some guidance in establishing standards for appraisals would be really welcome.

Thank you so much for the opportunity to share our concerns. We will gladly answer any questions that you may have.

MR. KELLEY: Any questions?

MR. WILSON: What did you have in mind? You said more flexibility for administrative determinations of a qualified contract. Did you have anything in mind specifically?

MS. COLON: Well, I think, in terms of documentation, particularly in terms of documentation, I'm pretty sure that others would address these. But also, in terms of the timing, at what point is the request for qualified contract, the clock starts there. But I would say mostly, in my mind, it's in terms of the documentation to establish a fair price.

MR. MALGERI: Is there anything, as far as examples, that you think we need to clarify concerning administrative discretion? You gave some examples. Is there anything else that would have been helpful?

MS. COLON: Well, we have just barely started dealing with qualified contracts. And I know that other states have started the processes. I can't remember, but some states are asking for 15 years' worth of documentation for cash flow. Some others are just requesting a year's worth or for a limited amount of time. So we have not started reviewing those, but we would like to have the discretion to fully evaluate and not be restricted to one or two years, for example.

MS. KAY: One more question. When you said--I think you said in your sort of list of things that your preference would be to not even include land at all in the qualified contract amount. Is that correct?

MS. COLON: Well, as was expressed earlier, it is not clear that the value of the land should be included. And I think some of the others commenting, the position has been that it is, you know, that the land comes with the building and it is inherent also, if there's a loan, basically you have been paying for the land as well.

MS. KAY: Oh, that's what I wanted to clarify. So you think it should be in the outstanding debt and in the equity, just not separate from those?

MS. COLON: Well, I don't know. To me it's still unclear whether the portion of the land that is--the things that you cannot--in my mind, you cannot divide the low-income portion from the market portion. So we would like to--it is not clear for us that it should be included. I mean, other people that have been looking at this more closely may have a better handle of what, if any, should be included. But definitely our message here: do not include the ones that we have been subsidizing this many years.

Thank you.

MR. KELLEY: Thank you very much.

Our next speaker is Mr. David Rammler, representing the National Housing Law Project.

MR. RAMMLER: Good morning. I am David Rammler, and I do represent the National Housing Law Project. We are a national nonprofit charitable organization which acts as an advocate and resource for low-income and affordable-housing entities across the country, including legal services programs which work on the ground with the individual projects and support groups and coalitions of attorneys and paralegals who work in this field, such as the National Housing Justice Network.

We submitted comments on a number of points. First, I'd like to say that we do appreciate the provision in B-3 that says that the valuation of the for-profit section must take into account the existing and continuing requirements contained in the commitment for the building.

We think that's very important, because we, of course, support the long-term preservation of these properties as affordable housing, and we think that's a consideration which should mitigate the cost to any nonprofit or preservation purchaser. And we think it's a fair valuation and does reflect the actual market condition.

Secondly,--and this has been touched on by a couple of the speakers--the uniformed standards for appraisal methodology and qualifications. These are complicated and fairly specific kind of developments, and they require people who understand the nuances of valuation far better than I do, for instance. But I think Mr. Goldstein, who's been in this business for many years and, as he said, was part of the development of this process, spoke well to that question, and we would support that proposition.

We'd also support their suggestion that in the case of a conflict, the objecting party could hire their own appraisal and there be some mechanism for making the adjustment between the two if they differ. We did, in our comments, refer to the Low-Income Housing Preservation and Residential Homeowners Act of 1990, codified at 12 USC 4101, which has a similar mechanism for resolving conflicts between competing appraisers.

The valuation of the land we spoke of, too, and I think we were one of the parties who commented that the statute 42H(6)(f) and 42C(1) used the word “building.” And I think Mr. Goldstein spoke quite properly about that, that these transactions include the cost of the building, the many times donated land and many times leased land, and we would support the position of both Mr. Goldstein and Ms. Colon on that question: that the land should not be included in the valuation.

The final point I want to address, and I guess these are going to be fairly brief remarks, but the fair market valuation question. We do not believe that the low-income portion of the property should be evaluated beyond or appraised beyond fair market value.

It puts preservation purchasers at a disadvantage if we strictly impose the perhaps well-reasoned and compromised description of the three or four elements which go in--it depends on how you break them down, but the several elements that go into the appraisal of the low-income portion, if that appraisal comes out to be significantly above fair market, and a nonprofit or preservation purchaser would then have to pay a premium in order to maintain the property as affordable for that portion of the units.

The owner could then turn around, having rejected this, from the market perspective, inflated value and sell it at fair market value to any nonpreservation purchaser or any other entity which wants to come in and then develop the land to its highest possible economic use, which was not the intention of Congress when they passed this statute, although, unlike Mr. Goldstein, I wasn't there. I would defer to his wisdom on this question.

But the clear intent of the whole structure is to provide a rational and reasonable opportunity to convert the property from the original owner-developer into ownership by an entity which will preserve the affordable units. And so I think that there's a logic here which sort of overshadows the entire structure, that you shouldn't require the preservation purchaser to pay this premium, so that if there comes a point where the appraisal on the applicable fraction exceeds the fair market value, we believe that the agency should have the discretion to mitigate that, and we would hope cap it at fair market value.

Thank you.

MR. KELLEY: Thank you very much.

Any questions from the panel?

MR. RAMMLER: Any questions? Yes.

MS. KAY: Just to pick on the land one more time, because I'm still not quite understanding. When you said that, you know, we shouldn't be including the land ...

MR. RAMMLER: Yes.

MS. KAY: ... because of the statute, because the statute is referencing building, I took that to mean even in no part of the formula whatsoever should land be included, even under debt or under the equity analysis either.

MR. RAMMLER: Well, it is in debt and equity, so --

MS. KAY: But it's not. If you interpret the statute to say the statute is supposed to be getting to a qualified contract amount on the low-income portion of the building and the non-low-income portion of the building, then it, by definition, cannot include land if the interpretation of that building means it doesn't include land. So that's where I guess maybe I'm getting a little confused was from that comment and was passing my confusion along to other commentators. (Laughs.)

MR. RAMMLER: Well, the structure says the investors get a reasonable return. If you include the provisions which you've set forth in your proposed--what is it--B-2--C-2--the investors get a fair return.

MS. KAY: But not on the land, because we said it's only--the definition we came up with, I think, was only the costs that go into the depreciable basis.

MR. RAMMLER: Well, outstanding indebtedness, adjusted investor equity, other capital contributions with distributable cash deducted. If the investors have paid for the land in that structure, then they get reimbursed within that structure. So it's a double dip, if you will, to add it on top, because the structure --

MS. KAY: Our definition doesn't allow you to include land currently.

MR. RAMMLER: I understand. But what I'm saying is that--excuse me --

MS. KAY: In any of those. So it wouldn't be a double dip, I guess, is what I was saying, under the current structure.

MR. RAMMLER: Well, it would be payment to --

MS. KAY: We'd have to revise it.

MR. RAMMLER: It would be cash out of the qualified contract to, in this case, at this point, the sellers, the owners, which they didn't contribute to the original development, because they're getting what they contributed to the original development out of the three initial categories of allocable price.

MS. KAY: OK.

MR. KELLEY: Any other questions?

MR. RAMMLER: Thank you.

MR. KELLEY: Thank you.

And our next and final speaker is Mr. Scott Kline, representing the National Housing Trust and Enterprise Preservation Corporation.

MR. KLINE: Good morning. My name is Scott Kline. I'm the vice president of the National Housing Trust. Thank you for the opportunity to speak with you this morning.

The National Housing Trust, established in 1986, is a national nonprofit, and our mission is the safeguarding and preservation of affordable housing. The trust is the only national nonprofit in the country with public policy, lending, and actual development experience under one roof. I spend much of my time working on transactional work, so I'm probably one of the few people in here that's not an attorney.

The context in which this discussion is taking place is that we have a severe affordable housing crisis in this country. Taken from the state of the nation's housing 2006 report prepared by the Joint Center for Housing Studies of Harvard University, one in three households now spends more than 30 percent of their income towards housing and the industry standard is 30 percent. Further, one in seven spends more than 50 percent of their income on housing.

Also in the report, between 1993 and 2003 the number of units renting for less than $400 fell by 13 percent, which is a loss of $1.2 million or--I'm sorry--1.2 million units or 110,000 units a year. In fact, for every new low-cost unit created a year, two are lost due to demolition, abandonment, or a conversion to more expensive housing. This growing shortage of affordable housing forces millions of families to make difficult choices among the most basic needs: housing, food, clothing, or medical care.

With respect to the qualified contract formula, I'd like to first speak to the topic of value. The proposed regulations provide that the fair market valuation of the non-low-income portion of the building must reflect the restrictions on the use of the low-income portion of the building. There are sound policy and economic reasons to adopt this view. From a purely commonsense economic perspective, the true value of any property is obviously affected by any and all legal constraints limiting the income available to the property. The value of the property must take this into consideration.

When it comes to fair market valuation of the non-low-income portion of the building, the proposed regulations recognize this and we think that makes sense. But the proposed regulations also provide that the fair market value of the non-low-income portion of the buildings should include the fair market value of all land. The statute makes no reference to land, as several have said, and with respect to the qualified contract, it only talks about buildings. And following along what others have said, we think it's beyond the authority of the service to include land value in the qualified contract valuations.

I have much here about—even if one were to conclude that it does--it should at a minimum be broken out into the affordable piece and the non-affordable piece and the valuation should take into account the affordability restrictions. I think because all of the speakers thus far have agreed that land shouldn't even be included at all, I'm just--I'm going to skip over those comments, but I wanted you to know that we had thought about it and feel that, even if it was in there, there is still a flaw in the formula in that it should be broken up.

Also on the topic of value, the appraisal process itself requires much attention. There must be appraisal qualifications specified for those professionals who will be involved in opining the value of these properties, in doing so consistent with the qualified contract formula. Additionally, there must be precise guidelines on the methodology and approaches that the appraisers are to use in providing appraisals for purposes of the qualified contract. Valuation of real estate is as much an art as it is a science. The complexities of affordable housing make the valuation process even more volatile.

I've been working in the arena of affordable housing from a development perspective for almost 22 years. And in my experience, it's not uncommon at all for two different appraisers to conclude values of the same property that are anywhere from 30 to 50 percent different.

This past year, right here in Washington, I worked on a property, as an example. In this particular instance, we were helping a tenant association acquire their building and convert it into a cooperative. The bank ordered the appraisal and the appraiser came up with an “as is” market value of $2.6 million. That seemed low to us, based on work that we had been doing in this market. So we reviewed the appraisal and questioned some of the methodology employed--under the circumstances and given the purpose of the appraisal--and the appraiser agreed with us. He revised the methodology and came back with a value of $3.9 million--just about a 50 percent increase. And this wasn't two appraisers looking at the same property. This was the same appraiser looking at one property, but using a different methodology. And this property didn't have any, as of yet, affordability restrictions on it to complicate the valuation process.

There are many appraisal considerations: How is the building to be allocated among the low-income and non-low-income; what variables go into determining fair market value; what are appropriate comparables; how is the impact of the low-income portion on the non-low-income portion to be calculated; what's the right cap rate? Should we consider replacement reserve contributions that are required in the loan documents and partnership documents or should it be based on a new capital needs assessment looking at the next 15 years? And how will disagreements among the buyer, the seller, and the agency regarding conclusions of the appraisals be settled?

These represent just a few in a myriad of factors that go into the appraisal process. And without specific prescription on how they're to be handled, the process will be suspect. It will be carried out differently among different appraisers in different credit agencies. So for the process to work, it's critical that the appraisers themselves are qualified and that they have solid instructions to follow.

My last comment with respect to valuation and the qualified contract formula is that it should be capped at the fair market value. Not capping the formula would be bad public policy and ignoring fair market value as a cap doesn't make economic sense. Under a scenario in which an owner were going to end the low-income use restrictions, the subsequent sale of the property isn't going to yield a price that's greater than the fair market value. Fair market value is the best that the owner can get. Why would a qualified contract purchaser pay more for the property than it's worth? How would a qualified contract purchaser pay more for a property than it's worth? The purpose of this program is to provide long-term affordable housing. It would be poor policy to promote overpaying for an asset so that the asset can be used for its intended public purpose.

And back to the question of how a purchase price in excess of fair market value could be supported: It is most likely that the only way a qualified contract purchaser could be able to overpay for a property would be to draw upon public dollars, such as local or state, home, CDBG, or trust fund dollars. It would of course be inappropriate to use public resources to pay more for a property than it's worth. And it would be inappropriate that the goal of the extended commitment initially anticipated by the program require a second subsidy.

I spoke initially of the serious affordable housing crisis in the country. The service should, where reasonable and feasible, adopt regulations that encourage preservation of this unique housing resource. Requiring payment in excess of fair market value to do so is neither reasonable nor feasible.

Finally, we'd like to recognize the provisions in the proposed regulations that limit outstanding indebtedness in the valuation formula to qualified building costs. We support this provision and commend the service for furthering the intent of the qualified contract process. The service was also thoughtful in drafting the provision that outstanding indebtedness, with an interest below the applicable federal rate, be discounted using present value calculation to obtain an imputed principle amount. This debt was provided to the property for the purpose of providing affordable housing. Its valuation and use thereof should recognize this public policy purpose. And the treatment of these funds should not contradict their intended purpose.

In closing, the qualified contract price formula has to balance a lot of things. It needs to provide a price that's reasonable for qualified purchasers to pay in order to retain the long-term preservation of this affordable housing and also provide investors with a fair rate of return. And our comments support that goal and we hope you will find them helpful and employ them in development of the final regulations.

Thank you.

MR. KELLEY: Thank you, Mr. Kline.

Any questions from the panel?

MR. MALGERI: Yes.

Mr. Kline, you mentioned that we should not have included land in the regulation. Would you then suggest that we revise the approach that we take presently for the low-income portions based on an eligible basis approach? Would you suggest that we revise that calculation to include specifically debt, the finances, land or are you asserting that we should--land should be completely excluded? In other words, would we revise the regulation to specify the debt-equity, include what was the original financing for land, or should we stick with, you know, the eligible basis approach that we presently, you know, have in the regulation?

MR. KLINE: I think if I understand, I guess my answer is that--and because I'm a transactional person, I think in formulas. And so when I look at the formula, it shows the fair market value of the non-income portion and then it reads, “plus 100 percent of the fair market value of the land.” So from a formula standpoint of view, I would take that out--“100 percent of the fair market value of the land.” So I think what that leads to, in answer to your question, is that it--I think what that does is take land out altogether.

MR. MALGERI: OK.

MS. KAY: I think one of the questions we had when we originally--looking at this question about whether or not we had statutory authority to include land in the formula anywhere--was whether or not you could have a bona fide contract if it didn't include land somewhere. And I think that's where our question--one of the questions we raised in the preamble was, in fact, you know, how often does it happen that someone would be selling low-income properties without the underlying land? And so would that be considered a bona fide contract if it didn't include land in the price somewhere?

MR. KLINE: Right. Not something I can address as a non-attorney person, so--but I understand what you're saying.

MR. WILSON: You recommended that--uniform standards for appraisals, et cetera. Can you--you know--obviously, we're not in the business of appraising, and it's like trying to find--to find a “reasonable man” standard--you know, there's obviously a lot of nuances. Do you know any objective standards that are out there that would probably suit? In other words, in other areas of negotiations, et cetera, in maybe the commercial world of--in other words, is there something we could point to and say, these are good standards, too?

MR. KLINE: I think there are some minimum qualifications that could be utilized, but this is so specialized and the contract formula is so unique, I think that the appraiser should be certified in making sure that they understand what the intent here is and they understand what the qualified contract formula is.

MR. WILSON: But that implies a certification process so they made this--they meet this type of standard.

MR. KLINE: There isn't one out there for this.

MR. WILSON: Right. Right. And so --

MR. KLINE: To answer your question, there isn't one yet. And for other programs, for example, the U.S. Department of Housing and Urban Development had a preservation program many years ago called LIPRA, and they developed their own appraisal standards for that program.

MR. WILSON: OK.

MR. KELLEY: Anything further?

Thank you very much.

MR. KLINE: Thank you.

MR. GOLDSTEIN: Mr. Kelley, would it be appropriate for me to clarify something I said?

MR. KELLEY: Certainly.

MR. GOLDSTEIN: Thank you.

I want to go back to this issue on the land. I said before you ought to be excluding the value of the land, but that assumed that you did not limit either the adjusted investor equity or the outstanding indebtedness provisions to qualified building costs.

MR. KELLEY: Yeah.

MR. GOLDSTEIN: So it's, you know, basically I think, as I said, the land costs ought to be included by virtually they're being inherent in the costs that were paid for from one of those sources. But we don't think you have the authority to impose that limitation. There's nothing in the statute, there's nothing in the legislative history that says you get to make that determination. That was not part of the formula and there's no suggestion that there was in this context.

MR. KELLEY: OK.

OK, thanks.

I think that's it for the speakers that were scheduled to speak today. Does anyone else here have anything in way of comments they'd like to add?

If not, then I'll thank everyone for coming and that will conclude our hearing. Thanks.