

THE IMPACT OF THE 1986 TAX REFORM ACT
ON REAL ESTATE REHABILITATION SYNDICATIONS:
INVESTMENT OPPORTUNITY REMAINS

by

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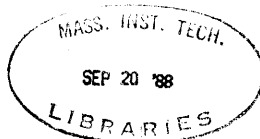
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ABSTRACT

For social and economic reasons, the restoration of historic and older buildings in the United States during the late seventies and early eighties proved to be very satisfying for developers and investors alike. Economic reasons were manifested through favorable tax policies which provided useful tax shelters for largely wealthy investors. The level of rehab activity during this time frame increased annually as it gained in popularity.

The Tax Reform Act (TRA), of 1986, while favoring historic renovation by retaining a minimally reduced tax credit, dealt rehab activity an inadvertent blow through new rules restricting the use of passive losses by real estate investors. This ruling has had a dramatic adverse effect on the real estate industry as a whole, and rehabilitation activity did not escape its across-the-board application. The limits on use of passive losses greatly restricts the investor market as an equity source and has served to slow the number of real estate syndications offered, including rehabilitations, substantially. Many in the real estate community believe that the TRA has spelled the end for rehabilitation activity.

The thesis looks at the likelihood of a continued decline in activity through an analysis of the TRA's impact on three historic rehabilitation syndications that were offered after 1986. Analyzed prospectuses include a publicly syndicated blind pool, a publicly syndicated single property, and a private single property offering. The analysis explores the changes in the deals' structures, investor markets, and real estate products that have occurred since the TRA was adopted, and determines their comparative value and potential success in today's marketplace.

Based upon the findings, it is apparent that rehabilitation syndications remain as valuable investment opportunities for eligible investors. The sponsors of the three deals have

actively changed their investment structure and targeted a different investor market in order to place them in a competitive position relative to other real estate syndications. More importantly, however, the tax credit continues to provide limited tax sheltering value for qualifying investors. The advantageous use of the tax credit places rehab syndications in a very strong market position and continued rehab activity is assured.

Thesis Supervisor: Lynne B. Sagalyn

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INTRODUCTION

For social and economic reasons, the restoration of historic and older buildings in the United States during the late seventies and early eighties proved to be very satisfying for developers and investors alike. Socially, the restored buildings were proud reminders of the past and preserved a portion of our heritage. Economically, the properties provided useful tax shelters and often proved to be profitable investments. The economic incentives to invest in these rehab projects was provided through favorable tax policies enacted during this time frame. The level of rehab activity increased annually as it gained in popularity.

Since 1986, renovation activity in these historic and older buildings has been severely impacted by recent changes in federal tax policy. The Tax Reform Act (TRA), of 1986, while favoring historic renovation by retaining a minimally reduced tax credit, dealt it an inadvertent blow. Rules restricting the use of passive losses by real estate investors were adopted which were intended to stop the flagrant use of tax sheltering by wealthy individuals. This ruling has had a dramatic adverse effect on the real estate industry as a whole, and rehabilitation activity did not escape its across-the-board application. The limits on use of passive losses

greatly restricts the investor market as an equity source and has served to slow the number of real estate syndications offered, including rehabilitations, substantially.

This thesis presents an analysis of the TRA's impact on three historic rehabilitation syndications that were offered after 1986. Analyzed prospectuses include a publicly syndicated blind-pool, a publicly syndicated single property, and a private single property offering. Each deal was selected as being representative of the three types of rehab syndications available in the market today. The analysis will explore the changes in the deals' structures, investor markets, and real estate products that have occurred since the TRA was adopted. The attempt is to determine the relative value of these syndications as real estate investments and their potential for success in today's marketplace.

It is important to study how the TRA has affected rehab investments, because, since the beginning when the TRA was initially introduced up to its passing in Congress, there has been nothing but controversy over whether rehabilitation activity will suffer or flourish. The majority of the real estate community predicted nothing but doom for future rehab projects.

For example, when the proposal was brought before Congress in 1985, Ian Spatz, at that time a tax expert at the National Trust for Historic Preservation stated:

"The Reagan tax proposal has stopped
[historic preservation work] cold in its

tracks.... It's like a cold, wet blanket....
The proposal would dismantle the tax incentives designed to encourage not only the restoration of architectural treasures but also the recycling of usable buildings. [1, p.10]

In 1986, just before passage of the bill, the general gloom that rehab activity would completely stop continued. For example, in the two to three years preceding the TRA's passage, there were 50 to 60 building restorations in Kansas City alone, all making use of the tax credit [2]. As of July, 1986, with the tax change looming, there were no tax credit projects planned for the City.

The TRA did retain a large part of the tax credit's availability, however, for eligible investors, although at a lower rate. It is important to focus on the relative significance of the credit as it relates to other real estate investment vehicles. Has the retention of the tax credit served to keep future rehabilitation activity from "stopping cold" by proving to still have value as an investment vehicle? Is there a silver lining to the cloud, and if there is, what form does it take?

Since a large portion of equity financing for rehabilitation projects came from syndications before the TRA, it is necessary to understand the effect it has had on the rehab syndication business. Greater comprehension of the products currently available on the market will lead to a better understanding of the future of rehabilitation activity; ie. how

they have changed and what is their relative value as investment vehicles. If this investment type can still attract investors, then there is belief that rehab activity will not die out altogether.

This thesis will attempt to prove that real estate rehabilitation syndications continue to hold some value for particular investors. The thesis will analyze the three rehabilitation syndications to determine whether they have actively changed the structure of their deals and targeted a different investor market in order to place them in a competitive position in the real estate marketplace.

PLAN OF THE THESIS

The thesis contains three more chapters; Chapter Two: a review of past tax policies and subsequent rehab activity, Chapter Three: the analysis, and Chapter Four: a critical look at the success or failure of these deals and speculation on future activity.

Chapter Two:

Initially Chapter Two will trace the tax policy changes that are specific to rehabilitation from 1978 up to the TRA. This section will focus on the nature of the incentives and how they affected the investor market and subsequent rehab activity. An in-depth discussion focusing on the TRA and its

changes relative to not only rehabilitation projects, but on the industry as a whole, follows. Initial figures on post-TRA rehab activity will be discussed. The chapter also presents a review of a "typical" rehab syndication; its structure; use of the tax benefits; the timing and value of the 1) cash flow, 2) tax benefits, and 3) residual; typical investor market; property type; and relative popularity before the TRA. This latter presentation serves as a benchmark for comparison when analyzing the deals in Chapter Three.

Finally, Chapter Two discusses probable changes that may occur in the structure, investor market, and real estate product because of the TRA and sets the stage for the analysis in the next chapter.

Chapter Three:

The deals analyzed in this chapter consist of a publicly offered blind-pool, a publicly offered single-property, and a private single-property syndication. The analysis will consider 1) how each deal is structured in terms of investment objectives, investor market, returns to the parties at each stage of the deal, timing of benefits, and comparative values of the deals components; 2) what type of investor market would be most attracted to these kind of investments; and 3) what real estate product type, if any, creates the best economic opportunity. The analysis will compare each deal with the probable changes outlined in the last section of Chapter Two.

Chapter Four:

This final chapter will assess the value of the deals in terms of their success potential in the marketplace. This Chapter will take each offering and discuss how the deal has responded to the changes brought about by the TRA and reflect on how that may or may not lead to its success. A reflection on the future of rehab syndications will follow with a focus on comparative value to other real estate investments and probable investor market. Finally, the proposed changes to federal tax policies will be addressed relative to its affect on future activity. Summary comments will focus on the potential level of future activity based on the analysis undertaken herein.

CHAPTER TWO

The purpose of this chapter is to characterize the main changes that have taken place with respect to the tax policies on rehabilitation of older and historic properties between 1976 and today. The changes in incentives will be examined as they relate to the investor market, especially in the field of syndications. Specifically, this chapter will examine the nature of the incentives offered and their attractiveness to investors, the effectiveness of the incentives on rehabilitation activity, the effect each change has had on the range of investor eligibility, and finally, how the latest change in rehab incentives (the 1986 Tax Reform Act), is likely to affect future investment in the area of rehab syndications.

Prior to the 1976 Tax Reform Act, federal tax policy held a favorable bias toward new construction over the renovation of older buildings. At that time, tax policies did not allow the investor in a rehab project to take advantage of substantial tax benefits that were currently available in new construction projects [1]. For instance, the investor in a rehab project could not apply the accelerated depreciation rate allowable to new construction for a building that had already been placed in service. Furthermore, the cost of demolishing an older building to make way for new construction could be

deducted in the year the expense occurred instead of capitalizing it. These economic incentives for investing in replacement rather than existing structures did little to steer investor appeal toward rehab projects. Simply put, it was often more lucrative to put a larger, more profitable building on a site than restore the existing structure. For the investor, there was no economic incentive to invest in rehabilitation projects; the tax policy was not favorable.

However, changing attitudes toward preserving older structures, coupled with a tax policy especially geared toward rehabilitation of older properties in 1976, provided rehab activity with a tremendous boost. Beginning in 1976 and going through numerous revisions up to 1981, tax policy relating to rehabilitation projects incorporated investor incentives that resulted in increasingly greater activity in the investment of rehabilitation projects.

THE NATURE OF REHABILITATION TAX INCENTIVES

The 1976 Tax Reform Act:

Initial rehab activity was spurred through the adoption of the 1976 Tax Reform Act which favored investment in these type of projects. The Act allowed for accelerated write-offs of rehabilitation costs through the application of a 60-month amortization schedule or, owners could elect to use the

depreciation method previously available only to new construction. In the latter case, depending on the project, a 150-or 200-percent-declining-balance depreciation schedule could be used [2]. In addition, a clear move toward favoring rehabilitation projects was made when the first year deductibility of demolition costs was disallowed and any new building that replaced a demolished historic structure was not eligible for accelerated depreciation [3]. In terms of providing favorable returns to the investor, the 1976 act served to bring rehabilitation projects to par with, or perhaps slightly better, than new construction projects.

The 1978 Tax Act:

A 1978 law provided even greater incentive for building rehabilitation with the use of applying an investment tax credit against rehab costs. A 10% investment tax credit was available to owners who were rehabbing commercial and industrial buildings more than 20 years old and which had not been rehabbed within the last 20 years [4]. This tax credit, when coupled with the depreciation deduction, was a clear shot in the arm for rehab projects. The beauty of the tax credit was that it provided a dollar-for-dollar reduction in an owner or investor's tax liability. Instead of a deduction, which only reduces taxable income in line with the taxpayer's marginal bracket, the credit allowed a straight reduction in the amount of taxes paid by the amount of the credit. For example, in 1978 a taxpayer in the 30% bracket earning an income of

\$80,000 had a tax liability of \$24,000. If the taxpayer was allowed a 10% deduction of \$8,000 ($\$80,000 * .10$), it reduced the taxable income to \$72,000, resulting in a tax liability of \$21,600; a \$2,400 or 10% reduction. With the tax credit, however, the taxpayer received an \$8,000 dollar-for-dollar reduction from \$24,000, or, a final tax payment of \$16,000; a full 33.3% savings. This reduction in an investor's tax liability was a clear benefit over the economic value of investing in new construction.

The 1981 Economic Recovery Tax Act (ERTA):

The adoption of ERTA in 1981, further increased the tax benefits available to rehab properties. ERTA contained special targeted legislation that expanded on the 1978 law and provided even greater economic incentive for the rehabilitation of older buildings. The percentage of credit allowed was increased and varied with property type. The tax credits were three tiered with a 25% credit for historic buildings (In order to qualify, projects must be of historic or architectural significance, or in an historic district), a 20% credit for nonresidential buildings more than 40 years old, and a 15% credit for those non-residential buildings more than 30 years old. These credits were applied against rehabilitation costs and used to reduce an owner or investor's tax liability on a dollar-for-dollar basis.

By increasing the amount of available credit and the eligibility of buildings it was clear that rehabilitation ac-

tivity was given full support by the federal government. The government also allowed an accelerated straight-line depreciation of 15 years on the entire adjusted basis of the building. The shorter depreciable time period allowed for greater write-offs early on when the expense of a rehab building exceeded its income. The increase in benefits and accelerated depreciation provided greater incentive to search for buildings that would qualify. Previously buildings older than 20 years were eligible for a 10% credit. Now, depending on the age of the building, the level of credit varied but provided greater benefits than what was previously allowed. Rehabilitation activity boomed and the investor base broadened, as discussed in more detail below. Specifically, with the 25% tax credit, it was clear that preferential treatment was given to designated historic structures, which included all residential rehab activity. Designated historic buildings and residential property proved to have the greatest economic incentive for rehabilitation and consequently spurred the greatest activity.

Cutbacks:

There were technical corrections to ERTA in 1982 and 1983 which varied its provisions only slightly. The most important cutback was that only half of the 25% credit amount for historic properties could be included in the depreciable basis. Previously, ERTA did not require any basis reduction for the amount of the credit. This 1982 cutback remained beneficial,

however, when compared to a 100% reduction for all other properties [5].

Another cutback was the lengthening of a property's depreciable life to 19 years. This change was negligible in its impact when compared to the value of the credit, however, because the credit could still be used in its full amount the first year a rehabilitated building was placed in service. This dollar-for-dollar reduction of tax liability in the first year made it an extremely desirable tax shelter mechanism for many real estate investors, many of which used syndications as their investment vehicle. In addition, syndication sponsors received greater benefits because the tax credits structure allowed them to collect higher fees upfront rather than over time as was typical with syndications that sold taxable income losses [6].

REHABILITATION ACTIVITY 1977 - 1985

In spite of the 1982 and 1983 cutbacks, the rehabilitation activity that occurred over the 1976 to 1985 time frame increased commensurately with each additional tax change and benefit expansion. The trend of rehab activity that followed these favorable additions to the tax code is illustrated in Table 2.1 below.

TABLE 2.1

TOTAL REHABILITATION ACTIVITY 1977 - 1985
 MEASURED IN REAL DOLLARS
 Base Year - 1977

.....

DOLLARS INVESTED		
<u>YEAR</u>	<u>(000,000's)</u>	<u>% CHANGE</u>
1977-78	\$140	
1979	\$270	93.0%
1980	\$273	1.1%
1981	\$531	94.5%
1982	\$757	42.6%
1983	\$1,417	87.2%
1984	\$1,334	-5.9%
1985	\$1,462	9.6%

.....

Source: Betsy Chittenden. "Tax Incentives for Rehabilitating Historic Buildings, Fiscal Year 1987 Analysis". National Trust for Historic Preservation. Washington, D.C. 1987.

The increased interest in rehabilitation activity can be seen from the growth of dollars invested after the 1978 Tax Act. In 1979, there was a 93% increase in the amount of inflation-adjusted dollars spent on rehab activity. In 1983, the effects of ERTA seemed apparent as investment soared to \$1.4 billion in real dollars, an increase of 87.2%. This increase in activity reveals that even the 1982 and 1983 cut-backs did little to curtail rehabilitation activity, although, in real dollar terms, investment levels were almost constant for the succeeding two years. There was plenty of economic incentive remaining that made it extremely profitable for

owners and investors alike to participate in rehab projects; specifically, the tax credit.

The benefits of the tax credit cannot be understated. In particular, the 25% credit for historically certified buildings understandably claimed the largest number of annual projects. Clearly a 25% credit was economically more valuable than the lower percentage credits. As can be seen in Table 2.2 below, activity in historic rehab projects far out-paced non-certified projects in every year from 1977 through 1985.

TABLE 2.2
APPROVED
HISTORIC VERSUS NON-HISTORIC REHAB PROJECTS 1977 - 1985

.....

<u>YEAR</u>	<u>HISTORIC</u>	<u>NON-HISTORIC</u>	<u>TOTAL</u>
1977-78	420	9	429
1979	686	17	703
1980	920	8	928
1981	1,281	55	1,336
1982	1,977	115	2,092
1983	2,528	222	2,750
1984	3,007	177	3,184
1985	3,006	271	3,277

.....

Source: Betsy Chittenden. "Tax Incentives for Rehabilitating Historic Buildings, Fiscal Year 1987 Analysis". National Trust for Historic Preservation. Washington, D.C. 1987.

Contrary to what one might associate with historic rehabilitation projects, housing constituted a large share of that

activity. Although housing was not eligible for the 15% and 20% credits it was given preferential treatment at the 25% level. With that incentive in place, housing rehabilitation accounted for 45% to 57% of all rehab projects undertaken annually between 1982 and 1985 [7]. It is clear that rehab activity was taking place in the areas where the greatest amount of tax shelter benefit was derived.

In general, the incentives provided through the tax code attracted investors to rehabilitation because the tax benefits were decidedly more favorable than those for conventional real estate investments. The dollar-for-dollar reduction, as explained previously, lowered the taxpayers tax liability, not their taxable income. The accelerated depreciation benefited the taxpayer by allowing the taxpayer to shelter a higher rate ordinary income during the depreciation phase and paying a lower rate capital gains upon disposition. This reduction, when coupled with the accelerated depreciation afforded huge tax savings to the investor. Finally, the 25% credit for certified historic properties gave the maximum tax credit benefit available to the investor.

1986 TAX REFORM ACT

When a new tax reform bill was introduced into Congress during 1985 and passed in 1986, the continued existence of

these benefits were threatened. A large part of the bill restructured many key areas of the tax code such as income taxes, capital gains, and real estate depreciation. Income tax rates were lowered from a maximum of 50% to two brackets of 28% and 15% for personal income, and 34% for corporate income. In addition, for the first several years there is a surcharge of 33% on specific income brackets. This is an important point and its relevance to this study will be discussed in greater detail in Chapter Four. With these lower rates, it makes investments aimed at reducing tax liability less attractive. Real estate depreciation has been lengthened to 27.5 years for residential and 31.5 years for commercial real estate resulting in lower amounts of depreciation taken in any one year. Finally, capital gains is now taxed as ordinary income and thus raises the maximum tax of 20% to 28%. These changes have had a strong impact on real estate in general, and many tax shelters that were once used widely are no longer available.

Tax Policy Changes Relating to Rehabilitation Projects:

The rehabilitation tax credit, thanks to a successful lobbying effort, was not eliminated during the 1986 Tax Reform Act (TRA). However, rehabilitation activity is not exempt from many of the general changes discussed above. In addition, there have been some very significant modifications in

policy which related specifically to the rehabilitation of real estate.

The first change is the reduction in credit from 25% to 20% for historic rehabilitation projects and a 10% credit for non-residential, income-producing properties built before 1936. The reduction in credit for historic rehab projects is a minor change, however, non-residential structures were not so fortunate. The singular 10% credit is greatly reduced from the 20% credit for non-residential buildings more than 40 years old and the 15% credit for those non-residential buildings more than 30 years old. Plus buildings must now be at least 50 years old or older. The economic incentive in investing in non-historic buildings is less and eliminates a large pool of available structures which previously qualified.

The second change requires that the depreciable basis be reduced by the full amount of the credit. This places rehab projects in the same category with new construction in their determination of the depreciable basis.

These first two changes can be considered minor, however, the greatest impact on rehab activity comes from the "passive loss" and "passive credit" rules. Before the TRA, income from any source was treated equally and losses or credits from one type of investment could be used to offset income from any investment source. Under the new law, income and losses from investment sources are treated quite differently. A taxpayer's income is effectively divided into three categories:

active, passive, and portfolio. Portfolio income can be characterized as monies received through interest and/or dividends. Passive income is derived from businesses in which the taxpayer is not involved in the activity on a regular, continuous, and substantial basis. Active income on the other hand is defined as income derived from salaries, wages, and other businesses in which an individual materially participates.

Income from limited partnerships are categorized as passive, as well as income from real estate, regardless of the taxpayers level of participation. Under the TRA, taxpayers are no longer allowed to offset losses from one income type against another income type. Only passive losses may be used to offset passive income, active losses against active income, etc.

Passive Loss Limitation Rule:

This singular offset against similar income type has served to greatly restrict the investor pool. Under the new law, only those taxpayers with passive income may invest in real estate to take advantage of any available passive losses and credits. There is an exception to this rule, however, which allows for a limited amount of active income to be offset by passive losses or credits.

The TRA now allows investors with incomes less than \$200,000 to offset the tax liability on \$25,000 of active income. This provision means that in 1987, using the top tax

bracket of 38.5%, an individual may shelter a total of \$9,625. In later years this amount is reduced to \$7,000 when the top rate is reduced to 28%. Any amount over this limit is carried forward into future years.

The use of credits is more severely limited for investors earning between \$200,000 and \$250,000 and is totally unusable for anyone earning over \$250,000. For investors who actively participate in a project (ie. general partners) their use of credits is even more restricted. Active participants may only apply the credits against active income if they earn less than \$100,000. The use of credits is phased out between \$100,000 and \$150,000 and is eliminated altogether above \$150,000. The only entity which may offset active income with passive income freely are C corporations. Any C corporation that is exempt from active income limitations may use credits against any corporate income; passive or active.

By allowing the small-scale investor some tax relief, but denying the wealthier individual investor any benefit at all, the passive loss limitation rule has served to decrease the investor pool from pre-1986 levels. In addition, the \$7,000 annual deduction limit lessens the attractiveness of the rehabilitation credit benefit. No longer can the investor take the full amount of the credit's dollar-for-dollar reduction in tax liability in the first year the property is placed in service. Only a maximum of \$7,000 can be taken in any one year with the remaining carried over into future years. Given the

time value of money, any carry over credit is worth less than the year it was distributed. A final drawback is that investors do not receive the tax credit in that year if they already have \$25,000 in deductible losses from passive income.

THE EFFECTS OF THE TRA ON HISTORIC REHABILITATION ACTIVITY

The impact of the TRA on historic rehab activity is too recent to be fully documented, however, initial figures show declining activity for 1986 and 1987. Figured in inflation-adjusted dollars, investment in rehabilitation activity dropped dramatically 36% in 1986 from its high in 1985. [See Table 2.3.]

Another way to see this precipitous decline is to look at certification activity because certification is necessary before investors can use the 25% credit. Beginning in May 1986, the monthly rate of new project applications to the National Trust for Historic Preservation dropped approximately 47% from previous levels [8]. On an annual basis, applications continued to drop in number for 1986 and 1987, the first declines since the Trust started tabulating the figures.

TABLE 2.3

TOTAL REHABILITATION ACTIVITY 1977 - 1987
 MEASURED IN REAL DOLLARS
 Base Year - 1977

.....

DOLLARS INVESTED		
<u>YEAR</u>	<u>(000,000's)</u>	<u>% CHANGE</u>
1977-78	\$140	
1979	\$270	93.0%
1980	\$273	1.1%
1981	\$531	94.5%
1982	\$757	42.6%
1983	\$1,417	87.2%
1984	\$1,334	-5.9%
1985	\$1,462	9.6%
1986	\$930	-36.0%
1987	\$585	-37.0%

.....

Source: Betsy Chittenden. "Tax Incentives for Rehabilitating Historic Buildings, Fiscal Year 1987 Analysis". National Trust for Historic Preservation. Washington, D.C. 1987.

TABLE 2.4

APPROVED
HISTORIC VERSUS NON-HISTORIC REHAB PROJECTS 1977 - 1987

.....

<u>YEAR</u>	<u>HISTORIC</u>	<u>NON-HISTORIC</u>	<u>TOTAL</u>	<u>%CHANGE</u>
1977-78	420	9	429	
1979	686	17	703	63%
1980	920	8	928	32%
1981	1,281	55	1,336	44%
1982	1,977	115	2,092	56%
1983	2,528	222	2,750	31%
1984	3,007	177	3,184	15%
1985	3,006	271	3,277	3%
1986	2,574	188	2,762	-15%
1987	1,641	84	1,725	-37%

.....

Source: Betsy Chittenden. "Tax Incentives for Rehabilitating Historic Buildings, Fiscal Year 1987 Analysis". National Trust for Historic Preservation. Washington, D.C. 1987.

This downward trend does not indicate that rehabilitation projects will die out, however, because the rehab credit is currently the only tax shelter benefit available to the real estate investor today. Specifically, it is interesting to note that although the total number of rehabilitation projects has declined in the past two years, the amount of historic rehab activity has remained considerably higher than non-historic projects. The popularity of this activity is because federal tax policy has continued to give historic rehabs preferential treatment over non-historic projects. This preferential treatment is significant because even though the value of the historic rehab benefit has been reduced, it remains as the

largest single source of tax benefit available to real estate investors.

What do all these changes mean with respect to the raising of equity for future rehabilitation projects? More specifically, how has the syndication business, through which a large share of rehab activity was financed, had to adjust to these changes? What has been the impact of the TRA upon the real estate rehabilitation syndication business?

SYNDICATION OF REHABILITATION PROJECTS

Pre-1986 Syndications:

Deal Structure: Before 1986, rehabilitation projects were largely dependent on the tax benefits to help lure private investors into raising capital. The equity portion of most rehab projects had been financed largely through limited partnerships and syndications where the investor could take advantage of the pass-through of passive losses to offset any passive or active income earned in any one year [9]. In 1985 the National Trust for Historic Preservation noted that 62% of the approved projects were financed through equity syndications [10]. Projected investor returns ranged from 20% to 24% with a large share of the value derived from the tax credit and use of passive losses. The tax credit represented a substantial benefit up front followed by annual use of passive

losses. Cash flow usually did not figure prominently in the value of the deal. The emphasis was on tax sheltering income.

The majority of these deals were privately offered and thus had less than 35 investors. Under the old laws, syndications were largely private to avoid the Securities and Exchange Commission (SEC) filing costs. In order to avoid these costs, private deals could have an unlimited number of "accredited" investors (investors who had a net worth over \$1 million or a yearly income for the past two years over \$200,000) but only 35 "non-accredited" investors (investors with incomes who do not meet the above criteria, generally lower). Average unit cost for these deals ranged from \$75,000 to \$100,000; clearly affordable for the more wealthy investor.

Investor Market: In 1982-83, IRS tax returns revealed that investors earning between \$100,000 and \$250,000 of adjusted incomes claimed an average tax credit of \$16,000 [11]. An average tax credit of \$30,000 was claimed by individuals earning over \$250,000. Fully 43% of the dollars invested in rehab syndications during this time period came from individuals with incomes greater than \$200,000 and yet they represented only 13.1% of the investor pool [12].

For the most part, this income group invested in the larger dollar projects, ie. those with project costs greater than \$500,000. Projects costing more than \$500,000 have represented one-fifth of all tax credits, yet they involve 85% of all dollars invested in rehab projects [13]. During this

time corporations were only small players, contributing only 17.5% to rehab projects. Clearly the market was for the wealthier investor who could afford high unit costs and subsequently high tax benefits.

The 25% investment credit was the most popular tax benefit offered with no limit on the dollar-for-dollar return in the first year. After the first year, deals provided substantial tax losses allowed through favorable depreciation schedules. The majority of these losses were usually passed through to the limited partners as added incentive to invest. The main attraction was that benefits were realized in the early years of the investment and appreciation on sale after the five year tax credit recapture period was over. Tax sheltering was the name of the game.

Real Estate Product: Investments in particular rehab projects were weighted heavily in favor of the smaller dollar-sized projects. Table 2.5 illustrates the percentage breakdown. These figures suggest these smaller deals were more popular because they could be offered privately to a small number of investors in order to obtain the necessary equity. On the other hand, it could be that many of the projects involved small structures that called for small dollar amounts.

TABLE 2.5
 REHABILITATION PROJECT PROFILE BY DOLLAR VALUE
 1982 - 1986
 PERCENT BREAKDOWN

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<u>Project Value</u>	<u>Percent of Projects</u>
Under \$100,000	48.0%
\$100,000-\$499,999	32.7%
\$500,000-\$999,999	7.5%
\$1,000,000-\$1,999,999	5.2%
\$2,000,000-\$4,999,999	4.2%
\$5,000,000 and over	2.4%

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Source: Donovan D. Rypkema and Ian D. Spatz. "The Tax Reform Act's Passive Activity Rules. Urban Land. October, 1987.

The risks associated with rehab projects were ones similar to conventional real estate syndications. Every rehab project ran the risk of construction delays, failing to acquire the requisite number of investors, rising construction and finance costs, a downturn in the market, and specifically to rehabs: extra costs often associated with meeting federal historic preservation standards and denial of historic certification. The risks seemed minor or were compensated by higher returns as seen by the benefits potential investors could enjoy. Increased investment activity over time indicates the attractiveness of this type of investment vehicle.

Past rehabilitation syndication was definitely a tax sheltering vehicle for many wealthy investors. These pre-1986

deal characteristics will serve as a benchmark for comparison during the analysis of the post-1986 deals in Chapter Three.

THE TRA AND PROBABLE CHANGES IN REHABILITATION SYNDICATIONS

As discussed earlier, the passing of the 1986 TRA has resulted in many of the benefits used to attract investors being cutback or eliminated. Credit amounts have been reduced, the marginal tax rates have been reduced, depreciable life has been increased, and the full reduction of the depreciable basis by the amount of the credit is now being required. In addition the investor pool has been reduced to C corporations, those earning passive income, or investors who earn active income of less than \$250,000.

What do all these changes mean with respect to the syndication of rehab properties? In order to fully realize the effect the TRA will have on syndications it is necessary to outline the probable avenues of change with respect to the real estate product, the investor market and the structure of offerings.

Syndications will more than likely be affected enough to warrant a deal restructuring. The overall return from a rehab investment can be expected to decline because of two reasons. One, the tax credit is less and the use of tax losses is not

as valuable as they once were. Second, as the size of an investor's contribution rises above the level that allows the investor to claim the entire tax credit in the first year of eligibility it will be carried over into future years and diminish the overall return. The \$7,000 limit on credit use clearly discourages large equity contributions. The use of the credit is no longer as beneficial to a greater pool of investors as it once was. Syndicators will have to examine ways to maximize the existing tax credit in a fashion attractive enough to lure this smaller pool of investors to them.

In addition, the timing of benefits are no longer as attractive. Now that the first year credit amount has been reduced and tax losses realized in the investment's early years are virtually eliminated, different methods of utilizing these losses will have to be examined.

Alternative ways of keeping syndication fees at previous levels will have to be examined as well. Before 1986, most syndication fees were obtained during the unit-selling phase where high equity contributions resulted in high fees (usually charged at 8% of the total contribution). Now that the investor market is not as wealthy and lower unit purchases are likely, the syndicator must look for other methods to receive fees similar to previous levels; i.e. the broad pool of small-scale investors.

Finally, with respect to deal restructuring, a change in the level of public versus private offerings should be dis-

cussed. Since eligible investors are no longer as wealthy as previous ones, the unit sizes are apt to be less expensive; i.e. \$5,000 to \$10,000 [14]. This means that more investors will be required for a similar size deal than pre-1986 deals which needed fewer investors.

Investor Market: Probable changes in the investor market must also be examined. It is clear that the investor pool is greatly reduced. Syndicators will have to attract a market that has not previously played a large role in rehab development, especially the smaller scale investor and C corporations.

Real Estate Product: What type of real estate product will be offered to this relatively new pool of investors? There is a large selection of intermediate projects (those ranging between \$500,000 and \$5 million), whose existences are threatened because they are too large to be private, but too small to justify SEC filing costs. Before 1986, these projects represented 37.5% of all rehab projects, [15]. Now syndicators must look to other project sizes that will take full advantage of the tax benefits available.

Since the tax benefits are greatly reduced and the use of passive losses virtually eliminated, will syndicators look to a particular rehab product that will produce a greater value than another? Changes in property performance will be reviewed due to the inability to use tax losses in the early years against other income. A shift toward more economically

sound projects, i.e. those experiencing positive cash flow immediately after the tax credit is exhausted, will be explored as a means to utilize some of the tax losses.

CHAPTER THREE

The following chapter presents an analysis of three historic rehabilitation syndications that were offered after the 1986 TRA. The intent is to explore the changes in each deal structure that have been brought about by the TRA. This thesis will attempt to prove that syndicators, while operating under the TRA's constraints, have actively taken steps to 1) re-structure their deals to maximize benefits to all parties, 2) attract a selected investor market, and 3) stress project performance over tax sheltering benefits.

Analyzed prospectuses include a publicly syndicated blind-pool, a publicly syndicated single property, and a private single property offering. Each deal was selected as being representative of the three types of rehab syndications available in the market today. Because both of the single property deals were underway during 1986, both qualified for a 25% credit, 19-year depreciation, and a 50%-basis reduction under the TRA's grandfather rules. They were still subject to the passive-loss rules however. As a result, the structure of the deals has changed with respect to the treatment of tax benefits under the new law. The objective was to obtain deals that pertained solely to income-producing property and offered the historic rehab tax credit as its only tax benefit.

The analysis will look at how each deal is structured in terms of investment objectives, investor market, returns to the parties at each stage of the deal, timing and value of benefits, fee payments, track records of the syndicators, and new investment risks that have appeared because of the TRA's restructuring influence. The analysis will compare each deal with the probable changes outlined in the last section of Chapter Two. This chapter will attempt to answer the questions regarding how the 1986 TRA has affected the use of the historic tax credit in terms of the investment structure, the investor market, and the real estate product and reflect on the value of these investment vehicles.

"HISTORIC PRESERVATION PROPERTIES 1988"

Investment Description:

The first deal to be analyzed, Historic Preservation Properties 1988 (HPP), is a publicly offered \$30-million-blind-pool consisting of 30,000 limited partnership units with an option to raise an additional \$30 million. Each unit costs \$1,000 with a minimum purchase requirement of \$5,000. The subscription period runs for a little more than 10 months from February 24, 1988 through December 31, 1988. The Partnership, issued in February 1988, plans to invest in a diversified real estate portfolio which is expected to qualify for the Rehabil-

itation Tax Credit (RTC). The investment, when fully closed, will be in properties that are, or expected to be, eligible for designation as Certified Historic Properties or, were built prior to 1936. Diversification in the properties will be geographic and by type, ie. residential, office, and commercial projects. The Partnership plans to invest in five to eight properties with no more than \$15 million or 35% of the offering's gross proceeds in any one property. As of the date of the prospectus, there were no properties designated for this pool. A Boston-based syndication firm, Boston Bay Capital, (the General Partner and Dealer), intends to acquire some properties during 1988 and the remainder during the next two years.

This is the second blind-pool public partnership offered by Boston Bay Capital. The first was offered in the summer of 1987. Between 1979 and 1986, Boston Bay Capital dealt exclusively in privately placed syndications. During that time, the Sponsor placed over \$100 million of interests in over 60 historic rehabilitation and restoration partnerships. The firm concentrated on raising capital from a small number of wealthy investors who were willing to invest over \$100,000 each. Since 1986, the firm has abandoned private placements and moved exclusively to the area of public syndications.

Analysis:

Investment Objective:

The objectives of the Historic Preservation Properties 1988 Limited Partnership, as outlined on page one of the Prospectus, are as follows:

1. To preserve and protect the Partnership's capital
2. To generate rehabilitation tax credits
3. To provide potential appreciation in value of Partnership properties
4. To provide cash distributions following completion of rehabilitation and initial lease-up which will be sheltered from tax during the early years of the Partnership's operations

Objectives #1 and #2 remain fairly consistent with pre-1986 investment objectives. With regard to objective #1, the partnership expects to place most of its investment with joint ventures with property developers. This strategy is not new to the syndication business; it is geared to provide the partnership with control and preferential returns. HPP does not require that controlling interest be in the form of ownership of more than 50% of the joint venture's capital or profits. Instead, HPP's control may include the right to make or veto certain management decisions concerning the sale, lease, refinancing or expansion of properties, termination of contractors or management agents, or placing certain limitations on the rights of other parties in the joint venture.

With reference to objective #2, all historic rehab deals were structured to take advantage of the tax credit. This

particular investment expects to generate two years of RTC for the investor.

Objective #3 is different because prior to 1986, appreciation in properties, albeit important, was not as important as generating tax losses in order to shelter an investor's income. In fact, HPP's emphasis on property appreciation over the generation of tax losses implies movement in the direction of investing in more properties that are anticipated to have strong economic performance, ie. a positive cash flow in the early years.

Objective #4 confirms this theory of investing in more economically productive properties by taking rehab tax credits in the first two years followed by the distribution to investors of positive cash flow beginning in 1990. HPP's selection criteria includes an emphasis on acquiring historically designated properties, therefore qualifying for the 20% credit. There is no mention of any other tax sheltering mechanisms available nor is there mention of specific performance criteria for each property. If the General Partners were intent on acquiring economically sound properties, it would be expected that there would be specifics on what they were looking for in terms of performance potential, ie: strength of real estate market, potential project absorption, likely rents, etc.

As a potential investor there is some concern with not knowing the specific criteria used to select properties. The

prospectus is very general and generic. There is a question on whether the syndicator is really interested in what occurs in later years. The structure of this blind-pool, which will be discussed in more detail later, allows for a large amount of the syndicator's profit to be made at subscription.

Investor market:

Through its structure, this syndication is clearly oriented to the small-scale investor, ie. those earning less than \$200,000. An example is the small unit sizes of the offering: \$1,000 per unit with a minimum purchase of five units. If individuals earning \$200,000 purchased 5 units, it would represent only 2.5% of their income.

The marketing brochure for the offering makes a direct pitch to the smaller investor with the following:

"It's no secret that the investors with income ranging from \$30,000 to \$200,000 per year have paid the majority of Federal income taxes over the past decade.

Now, under the new tax law, these individuals generally can utilize Rehabilitation Tax Credits to shelter up to \$25,000 of all income." (page 3)

Clearly the investment is pitched toward that income group that is most likely to fully benefit from the RTC. What does the deal offer to make it attractive enough to acquire the necessary number of investors? If each investor purchased the minimum number of units, then the offering would need at least 6,000 subscribers. What does the deal have to offer to appeal to that number of investors?

Investor/Partnership Fees, Use of Proceeds, and Returns:

The General Partner (or related entity), receives 23% of the funds invested up-front in the form of an 8% commission, a Historic Consulting fee, and miscellaneous reimbursement expenses. A remaining 77% of the investment, or \$23,100,000 is available for property acquisition. It is interesting to note that the Historic Consulting fee (in place of most syndications' Real Estate Consulting fee), is so named because the General Partners may use that portion of the fee directly attributable to rehabilitation costs in the computation of the RTC available. By increasing rehab costs, it increases the amount of rehab tax credit allocated to each partner.

During the course of normal operations, the Limited Partners are allocated 99% of the taxable income and losses. The General Partner receives the other 1%. These tax losses allocated to the Limited Partners are almost useless, however, if the Limited Partner does not have any passive income. Any tax losses made available the Limited Partner may be used to the extent of offsetting any cash flow derived from the projects. But, if there is passive income, the TRA requires that investors must apply the tax credit to their passive income first before taking advantage of any other losses. Therefore, it is important that the properties do not have any positive cash flow until the credit is exhausted. Under the TRA's new rules, the only investor who may fully benefit from a large

amount of tax losses would be a C corporation, or an investor who has a large amount of passive income.

The Limited Partners receive 99% of the annual cash flow after the General Partner has been reimbursed for administration expenses (limited to the lesser of actual costs or 90% of the cost of an outside firm), and beginning in 1994, a 4% incentive management fee. The management fee is payable to the General Partner before distributions are made. It is difficult to determine the dollar value of the management fee, however, it holds little value as incentive for the General Partner to remain in the deal. This should be of concern to potential investors.

Upon sale or refinancing, the deal first returns any proceeds to the Limited Partners in an amount equal to their capital contribution after it has been adjusted for any previously taken sale or refinancing already received.

Second, HPP offers the Limited Partners preferred returns equal to the greater of a 1) cumulative, non-compounded annual return based on their average capital contribution after the tax credit has been taken, or 2) a cumulative, non-compounded annual return calculated from their adjusted capital contribution. As state in the Prospectus, the former return ranges from 8.5% to 6.75% and the latter return is equal to a range between 6% and 4%; both depending on the subscription date. The calculations for each annual return are computed quarterly based on distributions. Neither return is guaranteed and the

above figures are based on anticipated cash flows, sales, and refinancing proceeds. These return rates are projected to be competitive with other investment alternatives but actual yields will be dependent on actual property performance. As with any blind-pool offering, the potential investor is placing a lot of faith in the expertise of the Sponsor.

Some Limited Partners are also offered Early Investor Incentive Annual Percentage Return to be realized upon sale or refinancing. This return accrues to those limited partners who purchased units early in the subscription period as a bonus. Table 3.1 outlines the early returns and total preferred returns offered to Limited Partners at various stages of subscription.

TABLE 3.1
 EARLY INVESTOR INCENTIVE RETURNS
 AND
 TOTAL INVESTOR RETURNS ON ADJUSTED CAPITAL CONTRIBUTION
 AND AFTER-CREDIT CAPITAL CONTRIBUTION
 ON SALE OR REFINANCING

.....

<u>Date (1988)</u>	<u>Early</u>	<u>Total Adjusted</u>	<u>Total After-Credit</u>
Prior to 3/31	2.00%	8.00%	10.50%
4/1 - 4/30	1.75%	7.75%	10.25%
5/1 - 5/31	1.50%	7.50%	10.00%
6/1 - 6/30	1.25%	7.25%	9.75%
7/1 - 7/31	1.00%	7.00%	9.50%
8/1 - 8/31	.75%	6.75%	9.25%
9/1 - 9/30	.50%	6.50%	9.00%
10/1 - 10/31	.25%	6.25%	9.75%

.....

The returns accrue but do not compound, and are payable at the end of the investment's five-to-ten year holding period. The holding period begins when a property's rehabilitation is complete and place in service.

Finally, any excess sale or refinancing proceeds are distributed 85% to the Limited Partners and 15% to the General Partners after the payment of a 3% brokerage commission (if the General acts as broker) or 50% of the standard brokerage commission for any sale.

The projected amount of Early Investor Incentive returns are not guaranteed either. If there is a shortfall, the amount allocated to the General Partner is payable to those qualifying for Early returns and the General's share is reduced proportionately. If the shortfall is greater than the amount previously allocated to the General Partner, returns are reduced in .25% increments until each Limited Partner receives their commensurate proportion. Nothing is stated however about what will happen when there is no money available for payment of Early returns.

Risks:

The risks associated with an historic rehab blind-pool are many and raises questions as to value of the deal. There are always risks associated with blind-pools, but those specific to HPP are:

1. There is no basis for assuming the investor returns. The prospectus does not indicate what property criteria or assumptions the General Partners used when determining returns. For the less-than-savvy or ill-advised investor, the determination of potential earnings would be extremely difficult. Great faith must be placed in the Sponsor's expertise.
2. There is no tax credit benefit if the property is not placed in service the year the investor subscribes. If the benefit is delayed a year, their present value is lower.
3. Some of the properties HPP plans to invest in may not be historic rehabs and therefore will not receive any credit.
4. There is no specification of the RTC amount available for the Limited Partnership's use.
5. Until the proper properties are located and acquired, the Partnership may use temporary investments such as certificates of deposits and public investment companies which produce no tax benefit whatsoever and, in general, lower returns than real estate.

These risks are not mitigated in the investment structure. The Incentive Management fee is too small to provide the General Partner with enough incentive to stay in the deal. For those who failed to subscribe early, the lower returns are not high enough to warrant the risks. For example, investors who purchase units in October would qualify for an 8.75% return on their capital after deducting for the tax credit, or a 6.24% return on their average adjusted capital contribution. Assuming the after-credit return is more likely (given that the General Partner would have to invest in at least one rehab property during the life of the investment), if the Early Incentive Return was not available upon disposition investors

would earn 6.75% on their money after the credit deduction. If property performance was strong, the yield may be higher than the return, but if performance is low the yield could be substantially lower.

Summary:

It is difficult to assess the value of this deal in terms of identifying the stages where the investor derives the greatest benefit. Clearly the tax credit is of benefit to the small-scale investor, but the timing of the credit is uncertain. It depends on when the Partnership places a property into an operational stage, and also, the amount of that credit is unknown. The investor is being asked invest dollars up front for properties that have yet to be selected and to receive a return on these properties with no guarantees.

There are several possible outcomes with this type of deal structure. One, the credit may not be available the year the Limited Partner invests because the property(s) have not been completed on time, or, have not been acquired. On the other hand, if the properties are acquired at different times, then the credits from one property can serve to shelter the cash flow from another property that has already exhausted its credits. One problem may exist, however, with this latter scenario. If the tax credit must be applied against any passive losses first, a slower-than-anticipated acquisition period may throw off projected returns when the tax credit cannot

be used against active income until all passive losses have been exhausted.

The effects of the TRA on blind-pool syndications will limit the amount of tax credit offered and virtually eliminate the use of tax losses in any one year for the small-scale investor. This limit will result in lower returns than what could have been previously experienced before 1986 for a similar deal. (This differential will be illustrated more fully in the following deals.) The analysis above shows that these lower returns are no bargains considering the inherent risks.

Other than the tax credit, the pool carries the same benefits and risks as a conventional blind-pool, ie. unknown properties and unknown cash flow. It seems that another major effect the TRA has had is to steer more syndicators toward the blind-pool structure. A Boston-based syndicator, who requested to remain anonymous, reported that many syndicators are turning to blind-pools in order to keep their fees high. Before 1986, syndicators did not need as many investors as they do now for the same dollar-size deal. By offering a blind-pool, the syndicator avoids the risk of carrying a large single property during a subscription period. In fact, before TRA, Boston Bay Capital dealt exclusively in privately placed syndications. Since 1986, HPP is their second public offering of any kind; another indication of the product changing to meet the market.

In conclusion, this deal holds many of the characteristics described in Chapter Two. The marketing and unit sizes encourage small equity investors, ie. the less than \$200,000 income individual. When valuing the deal's overall return it is not clear that this investment vehicle is an attractive one when there are so many unknowns, risks and little incentive for the General Partner to stay in the deal.

The next deal, The Pennsylvanian, is slightly different than HPP, but has also made clear changes in its structure and investor market because of the TRA.

"THE PENNSYLVANIAN"

Investment Description:

The Pennsylvanian is a \$25,550,000 single property offering 25,550 limited partnership units of \$1,000 per unit with a \$5,000 minimum purchase. The property, the former Union Train Station, is located in Pittsburgh, Pennsylvania. The Partnership plans to fund the rehabilitation of the station into 242 luxury unit apartments and approximately 50,000 square feet of commercial and retail space. The apartments will be converted to condominiums once the 5 year tax credit recapture period is over. The property has been grandfathered to take the 25%

rehab credit, the 19 year depreciation and the 50% basis reduction because it was underway during 1986. However, it still falls under the new passive-loss limitation rules. The prospectus was issued on July 31, 1987, with an extension and supplemental issue on June 6, 1988 by Historic Landmarks for Living, a Philadelphia based firm (the General Partner, Dealer Manager, Developer, and Contractor).

The General Partner has been involved in historic rehabilitation for the past ten years. Prior to 1986, Historic Landmarks For Living sponsored 31 private limited partnerships. Due directly to the TRA, this partnership had to go public. This move is explained on page three of their Supplemental Prospectus:

"The continuing financial strength of the Sponsor is ultimately dependent upon the ability of the Sponsor to successfully syndicate, joint venture, convert and sell or otherwise finance or refinance its existing and future development projects. In the past, the Sponsor had generated revenues primarily from development fees funded through privately-offered limited partnership syndications. However, the Tax Reform Act of 1986 imposed substantial limitations on the tax benefits available in such syndications and on the class of investors who could benefit from them...As a result, the Sponsor found it necessary to restructure its programs and promote them through public offerings to a broader class of investors with lower income levels."

Here is a clear change to a public offering which is directly related to the effects of the TRA. Because of these changes, the General Partner suffered delays in closing a number of partnerships, including the Pennsylvanian. The delay has caused the General Partner to undertake additional borrow-

ings to carry the cost of the project while acquiring the requisite number of subscribers.

Analysis:

Investment Objective:

The objectives of the Pennsylvanian, as outlined on page one of the prospectus are as follows:

1. To preserve and protect the Partnership's capital.
2. To realize the potential appreciation in the value of the property.
3. To provide distributable cash from operations beginning in 1990, which may not constitute currently taxable income.
4. To generate tax benefits including the Investment Tax Credit.

Of note is objective #3 where the Pennsylvanian places an emphasis not only on the RTC, but on the economic benefits of the property as well. The prospectus forecasts that the RTC will be distributed in the first two years with the investor receiving a positive cash flow thereafter. This is similar to HPP where the value of the property is seen not only in the generation of tax benefits, but in the production of positive cash flow and property appreciation.

Investor Market:

In addition to structuring a deal that depends on an economically sound product, the General Partner has also geared the deal toward the small-scale investor. This deal would not have gone public, nor targeted the less-than-\$200,000-investor if the TRA had not passed in its final form. The initial

Partnership offered 25,440 units for \$1,000 each, with a minimum purchase of 5 units. In the Supplemental Prospectus, issued once the requisite number of subscribers were not acquired in time, the Partnership introduced volume discounts as incentive for investors to purchase 21 units or more. If an investor earning \$200,000 purchased 21 units, it would represent 10.5% of his/her income. A purchase of the minimum number of units would represent 2.5% of an individual's \$200,000 income. If each investor purchased the minimum number of units, the deal would require 5,110 investors.

Before 1986, a deal of this dollar-size would not need as many investors but because of the passive loss limitation rules the number of small-scale investors needed for these deals has increased. This will often lengthen the subscription period; evidenced here with the delay in closing the Pennsylvanian. The volume discount offer is a move to sell more units and hasten the closing process. The question arises, with the passive-loss limitation rules, will wealthier individuals be lured by the volume discount and invest in this deal?

Due directly to the TRA, the Pennsylvanian had to restructure the deal to appeal to those investors most likely to take advantage of the RTC: the small-scale investor. It is unknown whether they will acquire the requisite number of investors and avoid greater infusion of their own funds by June 30, 1988, the end of the subscription period. What benefits does

the deal offer in order to attract desperately needed investors; how is it structured?

Investor/Partnership Fees, Use of Proceeds, and Returns:

The General Partner receives a large amount of the investment up front in the form of fees. As developer, they receive a development fee of \$3,835,380 or 15% of the total investment. Other fees include 8% selling commission, 2.8% reimbursement for organizational expenses and administration costs, and a .85% loan fee. Thus the total amount of investment available for the property is slightly more than 74.2%. Not included in the above is an 11.8% contractor fee (based on construction costs). The latter fee represents a reduced amount from the original offering because the contractor had agreed to take a reduction in fees if there were cost overruns. Construction costs ran \$1 million higher than anticipated so the contractor took an equal amount off the fee.

Cash flow from operations is distributed 100% to the Limited Partners after the General Partner has been paid a 5% management fee for the residential units and a 6% fee for the commercial property.

During the course of normal operations, the Limited Partners are allocated 99% of taxable income and losses available each year. Once again, similar to HPP, these losses are essentially useless for those investors without passive income.

Upon the sale or refinancing, 100% of the proceeds will be distributed to the Limited Partners equal to the sum of:

- 1) a Legislative Preferred Return; a return that serves to compensate the investor for their inability to use tax losses,
- 2) a preferred return equal to 8% per annum on the amount of the Limited Partners' capital contribution, less the tax credit,
- 3) an Investment Credit Reduction which is the amount of the tax credit that may be lost if historic certification is not obtained, and,
- 4) the Limited Partner's capital contribution, which has been adjusted for the amount of sale and refinancing proceeds previously distributed.

In addition, an Incentive Preferred Return is available to investors who subscribe between July 31, 1987 and October 15, 1987. The return will be equal to 2% per annum of the Limited Partner's capital contribution less any tax credit previously taken. If any investors subscribes within 90 days after October 15, they are entitled to a 1% return on the same amount. This increases the Preferred Return to 10% and 9% depending on subscription. The Incentive Preferred Return is not available, however, until the above distributions are made.

Any excess sale or refinancing proceeds are allocated 75% to the Limited Partners, 12.5% to the Limited Partners who qualify for the Incentive Preferred Return, 10% to the General

Partner, and 2.5% to the Special Limited Partner until qualifying Limited Partners have received their Incentive Preferred Return. (The Special Limited Partner is an affiliate of the Buncher Company, an un-related third party who sold their joint venture interest in the property to Historic Landmarks for Living.)

Thereafter, proceeds will be distributed 75% to the Limited Partner, 20% to the General Partner, and 5% to the Special Limited Partner.

The allocations of this deal are similar to HPP with the exception of the Legislative Preferred Return and the Investment Credit Reduction. Compensation for unusable tax losses and credit is an excellent strategy to attract investors but there is nothing backing this offer. If investors subscribe after the Incentive Return qualifying date, however their return is only 8%. Given the delays in the closing, there is speculation that a large share of investors do not qualify for this additional 2% return.

Because there were delays in closing the deal, the General Partner had to borrow additional funds to carry the ongoing construction costs, purchase a little more than \$9 million worth of units to meet the December 31 Interim Closing date, and extend the closing to June 30, 1988. Assuming each investor purchases the minimum number of units, the General Partner bought 1,022 units of \$5,000 each on December 31, leaving another 1,802 investors needed by June 30, 1988.

These 1,802 investors will not qualify for the Incentive Preferred Return.

The supplemental prospectus provides an estimated 9 year pro forma based on an annual 8% appreciation rate on the value of the condominiums at sale for a Limited Partner with a minimum investment of \$5,000. Distributions to the Limited Partner were based on a 2% Incentive Preferred Return and an 8% Preferred Return. Each Limited Partner will receive two years of the RTC, projected to be worth \$1,808, and their pro rata share of 100% of the cash flow beginning in 1990. The tax credit distribution remains a direct dollar-for-dollar reduction even though a \$5,000 investor has not purchased enough units to qualify for the full \$7,000 limit. Investors would have to buy 20 units, or \$20,000 to receive the full \$7,000 annual allowed amount.

By using the numbers provided in the prospectus, an IRR of 16.04% was calculated. (Clearly the IRR's will be lower for those who do not qualify for the Incentive Preferred Return. Unfortunately, the actual difference is difficult to calculate with the numbers provided.) This yield is better than other risk-free investments but it would have been even higher if the passive-loss limitation rule was not in effect.

Calculations were made to compare this estimated return with a return based on pre-TRA rulings. Table 3.2 illustrates a full 4.75% drop in return for the individual investor.

TABLE 3.2

ESTIMATED INDIVIDUAL INVESTOR IRR'S
BEFORE AND AFTER 1986

.....

<u>Time</u>	<u>IRR</u>
Before 1986	20.79%
After 1986	16.04%

.....

In addition, given the assumptions provided for a C corporation with the purchase of 10 units, an IRR of 21.62% was calculated. There is speculation that the 10 unit purchase is used because the passive-loss limitations do not apply and corporations can buy larger shares. Without having corporations subject to the passive-loss limitation rule there is clearly a better return than the one estimated for the small-scale investor.

It should be noted and stressed that these returns were based on the assumptions provided in the prospectus. Evaluation of these assumptions show that in many instances they are totally unrealistic. For instance, an average construction interest rate of 9% is used. Construction rates at this time average one point over prime, and prime today is 9.50%. Another example is the very aggressive 7% annual rental increase given that the project that will have on-going construction for 5 years. Returns will certainly be lower if more conser-

vative assumptions were applied; the 16.04% IRR calculated herein should not be heavily relied upon.

Nevertheless, there is no doubt that the passive loss limitation rule has served to lower returns to the individual investor. This ruling has also had a large effect on the timing and value of income sources. Based on the prospectus's assumptions and assuming the same deal structure, Table 3.3 segments the percentage share of deal's cash flow, residual, and tax benefits value as they relate to the small-scale investor's overall return before and after the TRA. The tax benefits before the TRA include the tax credit and the use of passive losses. The tax benefits after the TRA illustrate the value of the tax credit only.

TABLE 3.3

VALUE SEGMENTATION OF RETURNS
FOR THE INDIVIDUAL INVESTOR
BEFORE AND AFTER THE TRA

.....

<u>Time</u>	<u>Percent Share</u>		
	<u>Cash Flow</u>	<u>Residual</u>	<u>Tax Benefits</u>
Before	10.46%	53.14%	36.40%
After	12.82%	65.12%	22.05%

.....

Clearly the tax benefit comprised a larger share of the investment's value before the 1986 TRA, but the tax credit

alone still holds almost one-quarter of the value today. After the TRA, a majority of the lost value is now to be realized in the residual. The value of the cash flow has changed little and does not support the argument that the value of positive cash flow is what will lure investors into rehabilitation syndications. Instead, this deal depends heavily on a strong performance in their condominium sales. This is where over 65% of the investment's value is being derived.

What is even more interesting is timing of the residual value. As discussed in Chapter Two, prior to 1986 the timing of benefits involved a large tax write-off up front with a heavy dependence on losses during the life of the investment with less emphasis on appreciation value at sale. Here, the deal projects a staggered sale of condominiums between 1993 and 1996. The timing of sales is based on when the units were placed in service versus when their recapture period is over. This spread of sales out over the investment's holding period is similar in character to a cash flow stream, instead of receiving the full residual amount at the end of the deal.

Risks:

There are many risks associated with this deal, but the heavy dependence on value at sale is a causes the greatest concern. Over 65% of the deal's value is dependent on sale, and estimating sale prices five years into the future is practically a shot in the dark. In addition, these estimated sales prices are based on unrealistic projections. In fact,

the supplemental prospectus admits that the project has been adversely affected by unforeseen rising costs. The cost of construction was greater than anticipated and the Developer had to reduce his fees, as agreed to in the development contract. In addition, the delay in obtaining enough subscribers has caused the Partnership to borrow more money to keep the project afloat.

The second risk is intertwined with the delay. If the Partnership does not meet the requisite number of subscribers, then the entire investment is in trouble because the carrying costs will continue to require further infusions of money. Unfortunately there is no indication of the Partnership's status to date.

Summary:

It is interesting to reflect on the Partnership going public. In the search for a single property public investment for this analysis, many syndicators commented that there were no longer such offerings available. The reason is the risk associated with undertaking such a large project and not acquiring the necessary number of investors in time. Like the Pennsylvanian, the sponsor runs the risk of a low response and rising costs due to delays. Only the Pennsylvanian and an offering for low income elderly housing (which paired the historic tax credit with low income credits), were found. At least with a blind-pool the money is held in another, more

liquid investment and is readily available when the appropriate property is acquired. However, other risks associated with the blind-pool make investments in known products more attractive.

Since the Pennsylvanian was already under rehabilitation when the TRA was passed, it is slightly unfair to analyze the TRA's effect on changes in project type. However, value segmentation revealed that it might have been more of a tax driven deal if offered before 1986 even though the majority of value is derived at sale. If the property was originally being structured as a tax deal it raises questions on the ability to change a tax sheltering investment into an economic one. Only TRA rulings have changed, not the building's performance.

The prospectus is making a strong pitch for investing in a property that will have a strong performance later years. The offering contains over 16 pages describing their forecast assumptions, residential and commercial uses, floor plans, the property and its location, the competition, the type of development being done to the property, and the selling schedule of the residential units once they are converted to condominiums. This level of property detail was rarely seen in a pre-1986 offering.

A strong push toward selling the economics of the deal to investors may be an indicator of a post-1986 trend, or it may be because the project is behind schedule and investors are

needed in a hurry. The Pennsylvanian is a victim of circumstance that is trying to sell a deal that will keep the project afloat while attempting to make it attractive enough for the right type of investor. Time will tell whether this strategy is going to work.

The TRA has also affected the deal's investor market. The deal is offered in easily affordable units and, as mentioned above, the supplemental prospectus confess restructuring their deal to attract this target market. In addition, pro formas using projections for C corporations indicate marketing to this investor type.

Finally, the deal has introduced two incentives which serve to attract the small-scale investor. Both benefits, the Legislative Preferred Return and the Investment Credit Reduction are compensation for the investor if either the tax credit or tax losses cannot be used. The positive aspects of these incentives, coupled with the projected yield of 16.04% result in an excellent return to the investor if everything progresses as planned. There are a lot of "ifs", however, and it is unlikely that the 16.04% IRR is truly obtainable.

"PRIVATE OFFERING"

Investment Description:

This deal is a privately offered single-property limited partnership and, similar to the Pennsylvanian, has been grandfathered under the old credit deduction of 25%. The use of tax credits by the investor, however, are subject to the passive loss rules and the deal is structured accordingly. The property, a two story, 24,200 square foot office building is located in a major mid-western city. The building is forecasted to provide two years of tax credits and positive cash flow thereafter. The offering calls for 121 units of \$25,290 each (\$23,827 if purchased in one lump sum instead of installments; a 9.42% discount), for a total of \$3,060,090. Installments are due annually beginning on February 1, 1989 through 1992. Installment amounts include interest of \$1,463 per unit at a rate of approximately 5% per annum on the deferred amounts. The prospectus was issued on May 16, 1988 by the Sponsor (the financial adviser and Special Limited Partner), and by the Broker (a Class B Limited Partner). The developer of the property, a local firm, is the General Partner. The sponsor of this project, requested that the name of this deal and the parties involved remain anonymous.

The General Partner has renovated several other buildings in the Project's proximity, including a privately owned hotel.

The General Partner's business was formed in 1980 for the purpose of developing, marketing, and syndicating retail and commercial office properties.

The Sponsor, a small New England firm, was formed in 1981 to provide financial consulting services with respect to tax advantaged investments. The firm's emphasis is on historic renovation and multi-family housing investments. The Sponsor also acts as the Investor Service Agent. In this capacity the Sponsor monitors its investments and provides informational services to their investors.

Analysis:

Investment Objective:

Unlike the previous two deals, this offering does not have a written list of investment objectives. Instead, the intent of the Partnership is to acquire, renovate, construct, own, and operate the building. There are, however, 17 pages which outline the market area, the property, the property's current leasing activity and their lease structures, and a brief summary of their market analysis. The full market analysis is included in their appendix. Judging from these indicators, the prospectus seems to stress the economic benefits of the property over the tax credit. The Partnership is more concerned with the long term performance of the property; the tax credit is treated as a small side benefit.

Investor Market:

This deal is interesting in terms of the investor market. Since the deal is a private offering, the Partnership can have only 35 non-accredited investors. The Partnership must market to these investors by providing smaller units and the generation of tax credits. The Partnership must also pitch the Project the larger accredited investor because only 35 of the 121 units can be purchased by non-accredited investors. The deal will have to accomplish this task by stressing positive cash flow and, if applicable, the generation of tax losses. There is no differentiation between the benefits and returns distributed to the accredited and non-accredited investor during any phase of allocation. The only difference lies in each investors abilities to use the benefits to their advantage.

As discussed above, the Partnership has structured unit purchases on a 5 year installment method. Although the installment method is not new in syndications, it does not require a large sum of money for the small-scale investor at the onset. For investors earning \$200,000, the first installment of \$7,000 represents only 3.2% of their income as opposed to 12.6% for an up-front single unit purchase.

Investor/Partnership Fees, Use of Proceeds, and Returns:

There are less up-front fees associated with this investment than in the previous two deals. The Developer receives a 10.45% development fee, and the Sponsor is paid 8.8% of the proceeds for services such as historic consulting, investment

arrangement, and partnership reorganization. This leaves 80.69% of the proceeds available for the property. The General Partner and the Sponsor, however, receive more fees in the course of property operations through performance incentives.

After an Incentive Management fee of 5% (up to a maximum amount), is paid to the General Partner and a \$5,000 Investor Service fee is paid to the Sponsor, annual cash flow will be distributed pro rata to the Limited and General Partners in an amount equal to an annual 8.5% return on their capital contribution. If there are any proceeds remaining after distribution to all the partners, the General Partner is paid an additional 20% Incentive Management fee. The balance, if any, is distributed 97% to the Limited Partners with the remainder divided equally among the other three partners.

During the course of normal operations, the Limited Partner will receive 97% of the taxable income, losses, and credits available. The remaining 3% will be distributed equally among the General Partner, the Sponsor, and the Broker.

Upon sale or refinancing and after all debts and prior items repaid, 85.53% of the proceeds are distributed to the Limited Partners, 1.31% plus a 24% disposition fee to the General Partner, and 6.58% each to the Broker and Sponsor as partners.

The Project's projected pro forma forecasts an investor earning less than \$200,000 will derive \$7,000 of tax credit

benefit the first year and \$440 dollars the second year. This amount equals the first installment purchase price and results in a direct dollar-for-dollar reduction. Thereafter, the investor will receive positive cash flow, as projected, in the later years. The assumptions used in projecting the pro forma are much more conservative than those used in the Pennsylvanian. For example, the sponsors estimate a 10.25% construction loan and a 5% annual rent increase. Seventy percent of the project has been pre-leased and all leases are triple net.

Using these assumptions, a projected IRR's of 15.23% for the installment method and 12.60% for the lump sum payment was calculated. What is interesting here is that these returns would not have been much higher if offered before the TRA; as Table 3.4 indicates.

TABLE 3.4
ESTIMATED INDIVIDUAL INVESTOR IRR'S
BEFORE AND AFTER 1986

<u>Time</u>	IRR's	
	Lump Sum	Installment
Before 1986	13.53%	16.64%
After 1986	12.60%	15.23%

This small difference in yield between before and after the TRA questions whether this deal was ever a tax deal. It appears that the property's strong performance over time is what drives the deal; not tax sheltering. Estimated IRR's for corporations show a 19.27% for the installment purchase and 15.60% for the lump sum alternative. When compared to the small-scale investor, the corporation's higher IRR is directly related to their ability to use passive losses.

Proof of the deal's reliance on economic performance is seen in Table 3.5. This table, assuming the same investment structure, presents the value segmentation for the project's cash flow, refinancing, residual, and tax benefits as it relates to the overall return for a small-scale investor before and after the TRA.

TABLE 3.5

VALUE SEGMENTATION OF RETURNS
FOR THE INDIVIDUAL INVESTOR
BEFORE AND AFTER THE TRA

Time	Percent Share			
	Cash Flow	Refinancing	Residual	Tax Benefits
Before	19.53%	22.49%	32.64%	25.34%
After	20.34%	23.42%	34.00%	22.25%

There is little change between the value of each component relative to the deal between pre-1986 and after. This suggests that the deal was structured with impending passage of the TRA in mind. The value of the tax benefit remains almost the same, with the singular use of the tax credit reducing the benefit's value only slightly. This shows the importance of the tax credit in the early years of the investment. The largest value is placed on sale, but this is relatively low compared when compared to the Pennsylvanian's projected 62% share. The cash flow benefit is the smallest component where benefit is derived.

A small area of concern is the dependence on refinancing in 1992 to provide almost one-quarter of the deal's value. There is a question whether the deal will be able to refinance the project at the rate they would like to obtain: 10.25% with a 30 year amortization. There is no guarantee that the date or rate of the refinancing will occur as projected. This concern must be put in context however when both the cash flow and residual projections may not occur as estimated either.

This deal is very different from the previous two deals with its fairly equal dependence on all of the components to derive total value. The Pennsylvanian relied heavily upon sale, and HPP does not even offer a clue regarding what constitutes value in their projects.

Another difference is that the up-front fees are less, but the General Partner and the Sponsor derive substantial annual

and disposition fees. In terms of the tax benefits, the deal offers each investor the annual maximum amount for a one unit investment and carries the excess credit (\$404), into the following year. The Pennsylvanian on the other hand, offers very little in the way of an annual tax credit (\$1,808) for a single unit purchase, and it is unclear exactly how much credit HPP will generate. The difference in this deal is that the tax benefit comprises an almost equal share of the deal's total value. Even before the TRA, if the deal were offered in the same manner, the value of all components would be fairly equal.

The timing of the benefits will change slightly. The timing of the tax benefits is the only thing that has been affected by the TRA. Instead of being offered annually, tax benefits are only realized in the first two years in the form of the tax credit.

Risks:

The risks associated with this deal lie in the purchase of the units. There is a question on whether the deal is attractive enough for accredited investors. Is the deal worthwhile for those earning over \$200,000? The wealthier investors will be unable to qualify for any tax credit, unless they are a C corporation, therefore some other benefit will have to attract them to this Project. Possible accredited investors may also include those with passive income or those who see benefit in the potential positive cash flow and appreciation on sale.

Will the deal obtain enough accredited investors to keep the offering from having to go public? In addition, will a non-accredited investor find the installment pay-in attractive even though there are interest payments? Is the lump sum payment too large an amount for a non-accredited investor? To date, the offer is still on the market and there was no information pertaining to the current level of subscribers.

Summary:

When comparing the characteristics of this deal to the discussion of probable changes brought about by the TRA, the deal falls into many of the categories. The installment method allows the small-scale investor to purchase affordable units. The question is whether the large equity contributors will find the deal attractive enough without the tax credit benefit, or, if appropriate, the tax losses as well. The projected overall return is not low and it would not be much higher if every investor could benefit from the tax credit and passive losses, as evidenced by the C corporation's and pre-1986 return estimates.

The up-front fees payable to the General Partner and the Sponsor are lower than in the previous two deals, but they take out more than the other deals during the operational and disposition phases. This indicates that the General Partner has greater incentive to stay in the deal.

The income produced by the property supports the speculation that rehab projects have to be more economically sound than previously, but pre-1986 return estimates suggest that this was never a tax sheltering deal. It seems this deal was structured with the probable effects of the 1986 TRA in mind.

CONCLUSION

In summary, the characteristics of the three deals analyzed herein represent responses to changes brought about by the TRA. These changes have affected the investment structure, the investor market, and to some extent, product type. In some cases, significant impacts have been felt on returns, the timing of benefits, and the value of those benefits as they relate to the overall return.

The structure of each deal continues to offer the tax credit as a benefit although the amount of annual dollar for dollar reduction is limited due to the passive loss limitation rule. In both the Pennsylvanian and the private deal, however, the tax credit comprises almost one-quarter of the investment's value; proof that the tax credit, albeit limited, can still be an important component of any deal.

On the other hand, the use of tax losses as a tax sheltering mechanism is greatly reduced. In some cases, instead of the deal stressing these tax sheltering benefits as it's main attraction, a greater emphasis is placed on other components;

i.e. the Pennsylvanian's increasing reliance on the residual. The private deal has mitigated the impact of lost benefits by structuring the deal to provide fairly equal value among all of its components.

Since the small-scale investor's use of losses is limited to the passive income derived from the deal to offset the deal's positive cash flow, lower returns than what would have previously been experienced before 1986 have resulted. Comparisons of yields with C corporations and a hypothetical pre-1986 IRR reveal that the ability to take full advantage of the tax credit and losses available results in a higher overall yield.

The passive loss limitation rule has also affected the timing of benefits. Instead of huge tax credit savings in the early years followed by annual use of passive losses, the tax credit is taken in the first year and any excess it is taken in the second year. After the credit is exhausted, the generation of positive cash flow is anticipated to compensate the small-scale investor for the inability to fully use tax losses. Finally, the appreciation on sale holds more value as a benefit than before, especially in the Pennsylvanian.

Another change in the investment structure is the switch from private to public deals. Both sponsors of HPP and the Pennsylvanian had never offered public deals until after the TRA. Now both parties work exclusively in this area. The Pennsylvanian openly notes this change in their supplemental

prospectus and comments that the TRA has affected their projects. Their switch to a public offering was necessitated because of the deal's large dollar-size and the need for more small-scale investors. HPP on the other hand, made a conscious decision to move to a blind-pool structure. There is some speculation that this move was made in order to keep their fees high.

Finally, interesting twists are seen in the Pennsylvanian's offerings. First, the Pennsylvanian's Legislative Preferred Return and the Investment Credit reduction offers a benefit to investors who cannot use tax losses or, if historic qualifications are not met, the historic tax credit. The former benefit is a clear response to the passive loss limitation rule. The latter benefit mitigates the investor risk of not having the project pass historic certification. This may sound good in theory, but in reality there is nothing behind either offer and compensation may never be received.

In terms of the TRA changing the investor market, it is clear that all three deals pitch their offerings to the small-scale investor. As previously noted, HPP's marketing brochure makes a clear appeal to this investor type. The Pennsylvanian's supplemental prospectus also aims for this market area. In addition, all three prospectuses are selling unit sizes that are smaller than would have been normally offered in similar deals before 1986. The General Partners of Historic Landmarks for Living, the sponsors of the Pennsylvanian

comment that before 1986 they were selling \$100,000 units. Now they are selling \$5,000 units.

A less obvious pitch is also being made to corporations in the Pennsylvanian and in the private offering. Both deals include pro forma projections for the investor and for C corporations. IRR's calculated for this analysis reveal greater value for the corporate investor. The TRA has allowed corporations, and investors with passive income, the ability to benefit more fully from these type of investments.

Finally, these three deals offer little clue to the TRA's affect on the real estate product. Both the Pennsylvanian and the private offering were underway when the TRA went into effect. HPP is the only clear response to the change by moving away from private deals and offering a blind-pool product. In addition, HPP places investment emphasis on projects that qualify for the 20% credit. It is likely that historic projects will continue to be more popular than the 10% credit.

A major question remains about the ability to take a tax shelter deal, like the Pennsylvanian and sell it as an economically viable product by simply changing the deal structure and marketing it to a different pool of investors. For example, pre-1986 value segmentation for the Pennsylvanian showed a fairly value heavy dependence on the tax benefits, second only to sale. Post-1986 analysis revealed a switch to an increased emphasis on sale values, with very little change in the cash flow. The investor is not buying much but the tax

credit and projected sales. In contrast, the private deal offers almost equal benefit in the value of all its components.

Nonetheless, these three deals are post TRA pioneers. Currently, there are very few rehab deals on the market. Many syndicators are taking a "wait and see" attitude, and others are still trying to fully understand the law. There is no doubt that the value of these deals are lessened because of the passive loss limitation rules and other changes brought about by the TRA. Some deals, like the Pennsylvanian and the private offering have been forced to change, and others, like HPP, are breaking new ground for its sponsors. Future activity is dependent on the ability of sponsors to make these deals attractive enough to the small-scale and corporate investors.

CHAPTER FOUR

The analysis in Chapter Three proves that the sponsors of these rehabilitation syndication projects have structured their deals to meet the changes imposed by the TRA. The tax credit's per unit-of-investment is smaller, the timing and nature of benefits is altered, and the total return has declined from pre-TRA deals. As observed by these deal structures and marketing techniques, sponsors have changed their focus to target a pool of less wealthy investors, C corporations, and investors with large amounts of passive income. Projected returns based on these offerings range between 12% to 15% for the individual investor and 16% to 19% for those investors who can take advantage of passives losses. How successful sponsors will be is still uncertain because no deal has reached the final selling stage.

Initial analysis reveals lower return levels to the individual investor than before the TRA. The use of the tax credit, however, (although limited in its use), remains as the only benefit for reducing tax liability for small-scale investors. The one exception is that they can take advantage of passive losses to the extent they offset the project's cash flow.

As shown in Chapter Three, tax benefits are greater for the C corporation. Corporate investors have full use of the

tax credit in the first year and can offset any income, active or passive, with annual tax losses. This increases their overall return significantly; more than the small-scale investor.

A final question remains whether these deals have been successful in responding to the changes in federal tax policy. Do these deals still hold value for the investor; particularly the small-scale one? This question is what Chapter Four intends to explore.

DEAL CHANGES - SUCCESSFUL OR NOT?

The first major change to be evaluated is the shift from a largely privately syndicated market to public offerings; single property and blind-pools. This shift was seen in the Pennsylvanian going public, and the sponsors of HPP undertaking a blind-pool offering; a first for them.

Blind-pools:

There are many risks inherent in a blind-pool offering. The risks largely pertain to "unknowns". For instance, there is no selection criteria relating to property performance. Investors have no clue about what kind of properties they are buying. Second, the tax benefit may not be usable in the first year of subscription. Therefore investors would not be able to take advantage of the tax credit in the first year,

and given the time value of money, lose some of that benefit. Finally, there are no projections for determining yields. Instead of investors buying into a known product they are essentially buying the sponsor's expertise. HPP is only the second blind-pool that Boston Bay Capital has offered since 1986. Their track record in blind-pool offerings is fairly new although they have been in the syndication business since 1979, dealing exclusively in private syndications before the TRA. This leads to questions regarding whether this deal is an investment in a company or in a project and investors should look carefully at the sponsor's track record before investing.

Despite the unknowns, however, in general these blind-pools have proven to be incredibly popular with the small-scale investor [1]. This appeal can be interpreted in many ways. First, the fact that this credit is one of only two tax credits (outside of low income housing) left available as a tax sheltering mechanism for certain real estate investors. Second, the smaller unit sizes affords the small-scale individual the chance to invest in real estate deals that were usually only available to the wealthier income earner. Third, by being offered publicly, these deals are easy to obtain through local equities brokers and personal financial planners. Before 1986, most deals were largely private and catered to wealthy repeat customers. Now the less wealthy individual can enter this market more freely. Finally, the blind-pool may appeal to many investors because it spreads the

risk over a number of properties instead of placing the entire investment in one property.

The ability of the sponsor to sell the deal, acquire economically sound properties, and manage effectively will determine the success of HPP and other similar blind-pools.

Large-Public-Single-Property Offerings:

Large dollar-size single property offerings, however, will not be as successful. As seen from the analysis of the Pennsylvanian, the carrying costs of a large-public-single-property deal can lead to cash flow problems if the subscription period is prolonged. There is little chance that these large dollar sized single properties can be carried through the subscription period unless there is some public/private or large equity investor included as a joint venture partner.

Because of the large number of investors needed for a project the size of the Pennsylvanian, a one unit investor does not benefit from the full \$7,000 tax credit limit in the first year. Over 6,000 investors have diluted the pro rata share of the tax credit to the point where only \$1,808 is received. Instead, a large share of the investment's value is realized in the residual. In order to receive the full amount of the credit in the first year, investors would have to purchase over \$20,000 worth of units.

This shift in value leads to questions about the Pennsylvanian's future success. A majority of the risk, 62% of the overall return's value, is concentrated in sales. As noted,

estimated future sale prices are based on extremely aggressive assumptions. Here, the problem arises in trying to switch a deal from a tax sheltering vehicle to an economically productive one in mid-stream. Understandably, the TRA is a victim of circumstance but it holds lessons for those venturing into this investment type.

For example, publicly offered single property deals may be more successful if sponsors do not take a deal that would have been an excellent tax shelter and try to market it as an economically productive project. Unlike the Pennsylvanian, sponsors will have to look for properties where the cash flow comprises a larger share of the investment's value. By having less of the value being placed on the residual, it spreads the risk more evenly over the entire investment. Plus, the small-scale investor can benefit from this cash flow in two ways. First, cash flow can be offset by any passive losses available in that year, and second, any excess cash flow is realized as an additional source of income.

In addition, sponsors will have more success if they offer a single property that is a smaller dollar sized deal. This type would need fewer investors and thus shorten the subscription period. This would decrease the amount of time a sponsor would have to carry the property and the project's success would be more likely.

It is interesting to note that there is only one other publicly offered large single property deal on the

market today. This deal combines the RTC with low income housing credit for a property in Rock Island, Illinois. Otherwise, sponsors are staying away from the larger single property deals. The broker who is selling the private deal analyzed herein stated that a sponsor would have to be crazy to get involved with a publicly offered large scale project. The reasons given were the same as mentioned above; large carrying costs and a long subscription period. Future success for deals like the Pennsylvanian are unlikely unless there is some other large equity partner, ie. a public or institutional entity, that can relieve some of the carrying cost burden.

If the Pennsylvanian progresses as projected, the return to the small-scale investor will be significant; 16.04%. Fully 22% of this return is attributed to the tax credit. The TRA, however, adversely affected the Pennsylvanian and its success is questionable. The largest effect was forcing a tax driven deal to change and place more of the value on the residual. Unrealistic projections, coupled with unanticipated rising costs and subscription delays will undoubtedly have an adverse effect on the investor's return.

Private Single Property Offerings:

The private deal analyzed in Chapter Three represents deal structuring changes that are directly attributable to the TRA. First, the nature of the unit sizes and installment payments are such that the investor receives the full \$7,000 dollar-for-dollar reduction in the first year. This full use of the

benefit in year one serves to increase the return to the investor by allowing a large portion of the benefit to be taken up front. As noted above, investors in the Pennsylvanian do not realize the full credit amount and HPP does not its specify its credit use.

Second, the value of components as they relate to overall return are fairly evenly spread. This approximately equal share of cash flow, refinancing, residual, and tax credit, serve to spread the risk among all components so they contribute equally to the deal's overall value. This spreading of value implies that the cash flow will play a more significant role than otherwise seen in the Pennsylvanian. The structure of this deal is more dependent on property performance and does not rest solely on the value of the tax credit.

This is clearly not a tax sheltering deal. The assumptions used in the cash flow projections are realistic and a large emphasis is place on the economics of the project. The only reservation with respect to the success of this deal, is the likelihood of not acquiring enough accredited investors.

The deal must appeal to accredited and non-accredited investors alike. What does the deal offer to the accredited investor, especially one who is wealthier and cannot even take advantage of the tax credit? If the accredited investor were a corporation or a passive income investor, the deal would appeal for its tax credit, tax losses, and economics. If the investor were an active income investor, however, the econom-

ics of the property's performance would be the major selling point. This private deal is stressing the economics and only time will tell whether this is enough to attract these accredited investors.

Otherwise, if the deal does sell all its units, given unforeseen market changes, it is likely that this deal will be a success. This is because of the property's strong performance potential (albeit based on the Sponsor's conservative assumptions), the relatively equal value among the deal's components (thus spreading the risk more evenly), and the full use of the tax credit in the first year.

FUTURE OUTLOOK FOR REHABILITATION SYNDICATIONS

Although the success of some of the deals analyzed is questioned, the tax credit has proven to be a substantial benefit to all three. Both the Pennsylvanian and the private offering realize almost one-quarter of their value in the tax credit. It is important to stress here that the tax credit is the only real estate benefit (outside of low income housing) left after the TRA. The passive loss limitation restrictions apply not only to rehab projects, but across the board to every other type of real estate investment. Every syndication has been equally affected. The tax credit, by remaining relatively intact, was clearly favored when the TRA was passed.

It was inadvertently affected by the restrictions on passive loss use, but it has not lost its total value.

Table 4.1 presents estimated IRR's for the small-scale investor in the Pennsylvanian and the private offering before the TRA, after the TRA, and without any tax benefit at all; including the tax credit.

TABLE 4.1

COMPARATIVE IRR'S FOR THE PENNSYLVANIAN AND PRIVATE OFFERING BEFORE 1986, AFTER 1986, AND WITHOUT ANY TAX BENEFIT

Deal	IRR'S		
	Before 1986	After 1986	No Benefit
The Pennsylvanian	20.79%	16.04%	10.36%
Private Offering	16.64%	15.23%	8.86%

The tax benefit adds 5.7% to the Pennsylvanian's after 1986 projected return and 6.4% to the private offering's return. Theoretically, if the tax credit were unavailable, these returns calculated without the tax benefit represent the projects' status at a level equal to similar types of real estate investments. Clearly the tax credit provides greater benefit to the real estate investor than without.

It would appear that the doom and gloom outlook taken by many discussed in Chapter One is not the case. Although rehab

activity has slowed, the tax credit still allows greater benefit to eligible investors over other real estate investments. As long as there is a tax shelter available, those who can take advantage of it will.

Investor Market:

The groups most likely to take advantage of this shelter are the small-scale investor and certain corporations. The credit appeals to the small-scale investor, not only for its dollar-for-dollar reduction, but this group is also largely in the highest tax bracket; ie. the 33% bracket for married couples earning between \$79,100 and \$171,090 and individuals earning between \$43,150 and \$100,480. Above \$171,090 and \$100,480 respectively, the rate begins to decline again. Thus, the small-scale investor who lies in the highest marginal tax bracket has the most to benefit from the tax credit.

Corporations of certain sizes can also benefit from the tax credit. Large corporations like ITT and IBM are too big to find the tax credit of any significant value relative to other tax shelter mechanisms at their disposal. Usually, corporations will buy ailing business where the buyer can sell off the assets and apply the losses, which can be carried back five years, against their own income. On the other end of the spectrum, smaller corporations who experience large business fluctuations from year to year will not want to take advantage of this type of illiquid investment. In addition, most corpo-

rations rarely make investments in areas outside of their field of knowledge. Instead, the preference is for investing in areas they are more familiar with; ie. buying similar businesses.

The type of corporation who may be interested in the rehab tax credit is one who has a very diverse portfolio to begin with, and an investment adviser who is familiar with real estate investments. In this arena, a corporation may see a place for the tax credit as a portion of their portfolio. The reason for this investment may range from portfolio diversification to realizing a measurable benefit through the use of the tax credit and passive losses. It is unlikely, however, that investments in rehab syndications will comprise a large share of any corporation's investment portfolio. This is due to the illiquid nature of the deal and the unfamiliarity with real estate investments. Many corporations will not want to tie up their funds in a long-term investment nor will they want to do business in an area they know very little about.

Continued Slowdown or Increased Activity?:

The decreased pool of eligible investors after TRA leads to questions regarding future activity. The current slowdown has led many to believe that activity will practically die out altogether. On the contrary, rehab activity will start to increase as time goes by for a number of reasons.

First, as mentioned above, the tax credit is one of two real estate tax sheltering mechanisms available today. Because the TRA is so new, many accountants are still trying to fully understand the complex provisions relating to the tax credit and the passive loss limitation rules. Once a greater understanding is reached, accountants will be able to better advise clients who can take advantage of this tax credit.

In addition, there are provisions where the TRA contradicts itself. Technical corrections are being undertaken in Congress now. Once these corrections are made, a clearer assessment of the TRA and its effects on rehabilitation can be made.

Finally, many brokers and syndicators have adopted a "wait and see" attitude. Since the TRA had such broad reaching effects over the entire real estate market, the slowdown in syndication activity has been across the board; not specific to rehabilitation projects. Once the TRA has been fully understood, and the level of demand assessed, syndicators can begin to offer deals that make strong economic sense and, in some instances, provide full use of the tax credit through rehabilitation offerings. Since the tax credit is one of two remaining available, it is likely that many syndicators will move into the rehab sector to capitalize on this benefit.

**PROPOSED CHANGES TO THE FEDERAL TAX LAW WITH RESPECT TO
REHABILITATION PROJECTS**

It is apparent that although rehabilitation activity has declined from pre-1986 levels, the benefits afforded to it will insure its continued existence and possibly an increase in activity. There are many proposals being discussed in Congress that aim toward increasing the benefit to investors, and allowing a greater number to participate. Proposed changes under discussion include:

1. **Raising the \$7,000 limit.** This proposal will not increase the investor pool. It merely allows greater tax credit benefit in the first year but does not provide for any passive loss benefits. This increase would possibly attract more eligible investors, and more than likely result in an increase in rehabilitation activity.
2. **Phase out the \$7,000 limit at a higher income.** This would increase the investor pool to more wealthy individuals. As discussed in Chapter Two, this would result in more intermediate-size projects being reactivated because wealthier investors would be re-introduced into this investment sector. Overall rehab activity will increase as a result.
3. **The ability to use \$7,000 tax credit plus up to \$25,000 in passive losses against tax liability on active income.** An increase in the benefit package is clear, and may serve to draw more small-scale investors into the investor pool.
4. **Move the tax credit's use limitations into the general rules that limit the use of general business credit.** There would still be a limit to the tax credit use, but it would apply to all taxpayers regardless of income level and type (i.e. active or passive).

5. **Community Revitalization Tax Act.** This proposal serves to reduce the tax liability limit to \$20,000 but then allow another 20% reduction of the taxpayer's tax liability above \$20,000. Once again, this would increase the benefits to the investor by allowing a larger reduction in tax liability than currently allowed, but will not increase the investor pool outside of the small-scale investor.

The proposals that aim to increase the benefits but not increase the investor pool outside of the small-scale investor, will certainly make rehab investments even more attractive. It seems that an increase in the investor pool, however, will better serve to increase the amount of rehab activity. If intermediate sized projects are falling by the wayside, an infusion of wealthier investors will help to curtail this decline.

By keeping the tax credit, Congress made a clear move to help rehab projects stay alive. The inadvertent effect of the passive loss limitation rule, however, has counter-acted most of the benefit previously afforded the investor. Only time will tell if Congress will make steps in the right direction to resurrect this error. Meanwhile rehab activity will continue, and probably at increasing levels over time as a clearer interpretation of the TRA is accomplished.

CONCLUSION

The analysis in Chapter Three reveals that, although syndicators have had to restructure their deals, there are still benefits available to a specific investor market. The nature of the benefits have changed however from sheltering taxable income to realizing a return through the tax credit, a property's strong performance during the holding period, and appreciation on sale or refinancing. To quote Peter Weiss, executive Vice-President and Chief Financial Officer of Historic Landmarks for Living, the sponsor of the Pennsylvanian:

"Don't overlook the fact that the prime motivation for investing in the property is the return on the investment - the growth potential for profit. The prime motivation is not tax sheltering." [8,p.31]

There will continue to be some tinkering with the investment structure of some rehab deals. For instance, deals like the Pennsylvanian will have to find ways to carry their construction costs during a subscription period if single property deals of this dollar size are going to continue. In addition, they will have to look for a property where the economics of the cash flow, residual, and tax credit that will spread the risk equally among a property's value components. Public blind-

pool syndications will have to sell the expertise of the sponsor as well as potential returns and use of the tax credit. And finally, the privately offered deals will have to look for economically sound projects that will appeal to accredited and non-accredited investors alike.

There is no doubt that rehab activity will continue and that rehabilitation syndications, if well structured, will remain as an attractive investment for eligible investors.

NOTES

CHAPTER ONE

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- [2] "No Silver Lining for Rehabs," Engineering News Record, Vol. 217 (July 17, 1986), 10-12.

CHAPTER TWO

- [1] Kass, Stephen L.; LaBelle, Judith M.; and Hansell, David A. Rehabilitating Older and Historic Buildings. New York: John Wiley & Sons, 1985.
- [2] Higgins, William J., and Covell, Anne B. "Historic Rehabilitation and the Tax Reform Act of 1986" The Real Estate Finance Journal, Summer 1987, 44-51.
- [3] Kass, Stephen L.; LaBelle, Judith M.; and Hansell, David A. Rehabilitating Older and Historic Buildings. New York: John Wiley & Sons, 1985.
- [4] Ibid.
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- [7] Chittenden, Betsy. "Tax Incentives for Rehabilitating Historic Buildings, Fiscal Year 1987 Analysis." National Trust for Historic Preservation. Washington, D.C. 1987.
- [8] Rypkema, Donovan D., and Spatz, Ian D. "The Tax Reform Act's Passive Activity Rules; An Inadvertent Body Blow to Rehabilitation Activity." Urban Land, October 1987, 7-11.
- [9] Chittenden, Betsy. "Tax Incentives for Rehabilitating Historic Buildings, Fiscal Year 1987 Analysis." National Trust for Historic Preservation. Washington, D.C. 1987.
- [10] Rypkema, Donovan D., and Spatz, Ian D. "The Tax Reform Act's Passive Activity Rules; An Inadvertent Body Blow to Rehabilitation Activity." Urban Land, October 1987, 7-11.
- [11] Ibid.
- [12] Ibid.
- [13] Ibid.
- [14] Brooks, Andree. "Talking: Tax Credits; Changes on Historic Rehabs." The New York Times. August 23, 1987.
- [15] Rypkema, Donovan D., and Spatz, Ian D. "The Tax Reform Act's Passive Activity Rules; An Inadvertent Body Blow to Rehabilitation Activity." Urban Land, October 1987, 7-11.

CHAPTER FOUR

- [1] Brooks, Andree. "Talking: Tax Credits; Changes on Historic Rehabs." New York Times. August 23, 1987.