

TAX SHELTERS FOR THE RICH
TO REHABILITATE HOUSING FOR THE POOR

by

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ABSTRACT

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The 1969 Tax Reform Act provided tax incentives for the rehabilitation of housing for occupancy by low income families and for eventual tenant ownership. In particular, Section 167(k) of the Internal Revenue Code now allows a taxpayer to depreciate over 5 years the cost of rehabilitation meeting certain standards. Section 1039 now allows deferral of the tax on the sale of low and moderate income property to the tenants if the proceeds are reinvested in similar property.

The rehabilitation depreciation incentive is not sufficient by itself. It must be used in conjunction with some other form of subsidy. The Section 236 limited-dividend program is found to be the most profitable subsidy program as well as the most harmonious with the goals of a community-based developer.

To take advantage of Section 167(k) developers create limited partnerships in which they, as general partners, retain control of the project and investors, as limited partners, claim ownership of the bulk of the property for tax purposes. Such ownership enables them to deduct large amounts during the five years of maximum depreciation and additional amounts during the period of construction.

With the depreciation, however, comes a large tax on sale. All methods of avoiding this tax, except death, are ineffective. A sale to the tenants is likely to benefit the investors only if the project looks like it might otherwise go into foreclosure. Then, tenants may not want to own the property. Generally, investors plan to hold the property for twenty years at which time the tax is tolerably low.

Based on this assumption regarding sale, investors are willing to pay as much as 32 percent of the mortgage for the right to the tax benefits and limited cash dividends from a typical project. This amount translates into an after tax rate of return of 25 percent for investors in a 50 percent tax bracket.

Even this high of a return is shown to be insufficient in view of the risks, particularly the risk of foreclosure. Such an occurrence requires the investors to pay a large tax. As a result of this tax the cost to the Government of using the investors' fund is no greater than their own cost of borrowing. Alternatively, the use of investor funds will be costly but will significantly reduce the incidence of foreclosure.

The net profit to developers is found to be twice as great on a Section 236 rehabilitation project as on a new project of the same size. However, the typical 236 new project in cities where rehabilitation is occurring is 2.2 times as large as the typical 236 rehabilitation project and requires no more effort on the part of the developer.

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The only excess costs in the tax mechanism are found to be the amount going to the broker on the sale of the limited partnership interests and the amount of tax benefits provided to those investors in higher tax brackets than the marginal 50 percent bracket.

The non-tax subsidy costs for a rehabilitation project are found to be considerably larger than the developer's incentive. The 236 interest subsidy is found to be the largest cost and least efficient in comparison with alternatives, in terms of cost per dwelling unit.

Consideration is given to several proposed incentive mechanisms for rehabilitation and tenant ownership. A shift to a tax credit system is found to be a marginal change which will be more efficient in terms of cost than the present system. The substitution of a low tax for the reinvestment requirement is suggested as a more effective means than Section 1039 to induce tenant ownership. A variation of the turnkey public housing program is suggested as, at least theoretically, the cheapest and most effective way to induce rehabilitation and tenant ownership.

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A. INTRODUCTION

Two of the goals of the 1969 Tax Reform Act were to provide an incentive for the rehabilitation of housing for low income people and to encourage the sale of such housing to tenants. Section 167(k) of the Internal Revenue Code now allows a taxpayer to depreciate over five years the cost of rehabilitating a building for occupancy by low income tenants. The amount depreciable includes not only the equity the taxpayer has in the property, but the debt portion as well. Thus a taxpayer can receive \$200,000 each year in depreciation benefits over a five year period by using borrowed money to purchase property and making \$1,000,000 worth of improvements on it. These deductions can shelter other personal income. To a taxpayer in a 50 percent bracket these benefits are worth \$100,000 in tax savings annually over this period; to a taxpayer in a 70 percent bracket they are worth \$140,000 per year. Only on a sale of the purchased property will any of this tax savings be recouped by the Federal Government.

Senator Carl Curtis proclaimed on the Senate floor:

A 5 year write-off of this nature is a powerful and effective incentive to rebuilding and rehabilitating existing housing facilities. It will result in the rehabilitation of deteriorating neighborhoods and slum areas. It will do this with private capital, saving the taxpayers' money.¹
(Emphasis added)

In opposition Senator Albert Gore argued:

This should be called the syndicate loophole--or loopholes--because it opens the way for high bracket income taxpayers, people in the 70 percent bracket, to combine into an investment syndicate to buy tax deductions from railroads, from housing combines, and from manufacturing combines with respect to pollution abatement.²

Senator Gore was referring to the fact that most housing tax shelters, like other tax shelters, are sold to groups of wealthy investors, known as

syndicates. Most developers either do not have enough taxable income they want to shelter or have far too many deductions to optimally use all of them.

Developers have found that tax losses generated from moderate income housing developments can be sold to a group or syndicate of outside investors.³ The legal framework which most developers use is the limited partnership. Wealthy investors pay the developer a capital contribution for the right to a limited partnership interest in the project. As limited partners, the investors treat their proportionate share of all of the partnership's income, losses, profits, gains, and deductions as part of their personal income tax returns. They further are entitled to receive a share in any annual cash dividends of any gains from the sale of the partnership property. The developer or whoever else serves as general partner has total operational control of the project. The general partners are liable, under local law, for all claims against the partnership. The limited partners are liable only to the extent of their investment provided they refrain from asserting control over the operation of the project.⁴

At the same time that Congress was encouraging such complicated patterns of ownership by the rich, it was also attempting to encourage tenant ownership. The Senate Finance Committee stated in its report on the 1969 Tax Reform Act:

In the case of federally-assisted housing projects (where the return to the investor is limited to approximately 6 percent) the Government is interested in encouraging the sale of these Government-assisted housing projects to the lower income occupants or to a tax-exempt organization which manages the property on their behalf (such as cooperatives and condominiums).⁵

Congress was responding to evidence that tenant ownership prevents the deterioration of housing. In his classic study of 566 slum properties in Newark, New Jersey, George Sternlieb concluded:

The factor of ownership is the single most basic variable which accounts for variations in the maintenance of slum properties. Good parcel maintenance typically is a function of resident ownership.⁶

The mechanism devised by Congress to encourage tenant ownership is Section 1039 of the Internal Revenue Code, known as the rollover provision. This provision allows the owner of a federally-assisted development to defer paying a tax on the disposition of the property to a tenant organization, provided he reinvests in a similar project. The pattern Congress seems to be suggesting is that developers use funds provided by limited partner investors to rehabilitate housing for low income families and sell the property to the tenants at a low price as soon as the five-year depreciation schedule runs out.

Literature on the Five-Year Write-Off

Government and academic studies on the 5-year write-off suggest that it will be a costly program. The U.S. Treasury and the Joint Committee on Internal Revenue Taxation have estimated that Section 167(k) will cost the Federal Government approximately \$330 million per year by 1979 in foregone tax revenues should it be extended that long. However, the loss would be only \$15 million in 1970 and \$200 million in 1974.⁷ The assumptions used to arrive at these figures are that one-half of all publicly-assisted rehabilitations are for the rental market, that the average cost of rehabilitation is \$10,000 per unit, that the average investor is in the 50 percent tax bracket, and that HUD 1969 estimates for 2,000,000 rehabilitation starts between 1969 and 1978 are accurate. What these figures imply is that nearly all of the rehabilitation benefits are windfall gains for developers of low income rehabilitation. The HUD estimates were made before the enactment of Section 167(k) and without regard for its enactment.

In fact, the HUD 1970 estimate for rehabilitation starts during the decade of 1969 to 1978 is 1,000,000 or one-half their own estimate a year earlier.

HUD concluded that:

A major consideration heading to this downward revision is the high cost of rehabilitation of older structures brought on by the general rise in construction costs. In addition, as it turns out there are relatively few cities which have a concentration of large blocks of units for which rehabilitation is feasible.⁸

HUD did mention that, the 5-year writeoff of rehabilitation expenditures permitted in the Tax Reform Act of 1969 would create new investor interest in rehabilitation.⁹ Yet, clearly, the number of rehabilitations which HUD expects will be started because of the 5-year writeoff is minimal.

A researcher for HUD, Arnold Diamond, has since found that 167(k) coupled with the limited-dividend Section 236 subsidy program can be very profitable. In his "Tax Incentives for Section 236 Rehabilitation," he suggests that the rate of return to the owner of a 236 project taking the 5-year writeoff is 34 percent (p. 19). However, the assumptions he makes are so atypical his numbers have little empirical validity. He assumes that the developers of the project are also the owners.¹⁰ He further assumes that the project will be sold at the end of 6 years for the original replacement cost.¹¹ His point that 236-167(k) combination can be highly profitable is, however, well-taken.

Emil Sunley, economist for the Department of the Treasury, in "Tax Incentive for the Rehabilitation of Housing," measures the incentive value of Section 167(k) in several ways. He finds that the difference between a five year write off and the previously most accelerated form of depreciation available (double declining over 20 years) for a taxpayer in a 50 percent bracket is equivalent to a reduction in the cost of a rehabilitated building by 16.5 percent, a decrease in the effective tax rate from 50 to 35.7 percent,

an increase in the rate of return to 19.3 percent, or an investment tax credit of 14.1 percent.¹² He shows that each of these measures has a far greater impact on an investor in a 70 percent tax bracket. Sunley's indexes, however, assume that the developer of the project is also the owner for tax purposes.

Former Assistant Secretary of the Treasury, Stanley Surrey, is known as the father of the school which proclaims that the tax system is generally an inefficient means to provide incentives. In his article, "Tax Incentives as a Device for Implementing Government Policy," Surrey concludes that tax incentives lead to confusion and divided authority in the legislative and administrative process, cause difficulties in budgetary control, distort the perception and setting of national priorities, and provide dangers to the tax structure, itself. In another article, "Federal Income Tax Reform," Surrey details many of his criticisms of Section 167(k). He states:

An increase in the supply of low and moderate income housing is clearly high on our national agenda, and this goal will require considerable federal assistance. But the crucial question is why that federal assistance should in the end be shaped around a tax expenditure policy never planned for that purpose and which as a consequence is thoroughly inequitable from a tax standpoint and inefficient from a housing standpoint. (p. 403)

James Wallace in "The Role of Federal Income Tax Incentives in the Development and Operation of Low- and Moderate-Income Housing," pursues Surrey's argument with numerical examples. Using a 10 percent discount rate, Wallace finds that the present value of the tax losses to the investors on a typical project is \$570,000 compared with \$360,000 which could have been provided directly to the developer for the same incentive. (p. 15)

What none of these papers have done is to determine the appropriate level of net incentive that should go to the developer and what form this incentive should take. In the words of Stanley Surrey:

Perhaps when all the parties to a proposed low-income housing venture come together and put in their contributions--the insurance company with its loan, the investor with his equity, the developer with his packaging, HUD with its subsidy check for the interest on the loan and maybe its check for rent supplements--still the venture will not move until the Treasury appears to put in its tax benefit check. But no one has really inquired just how large that Treasury check must be to make the venture feasible. The Treasury check simply arrives without any realistic financial relationship to the venture...The study that is sorely required is how necessary is that Treasury check and, to the extent it is necessary, how can the assistance it represents be shifted to direct federal assistance.¹³

Literature on the Rollover

To the best knowledge of the author, a 1039 tax-deferred rollover to a tenant group has yet to be attempted in actual practice. The IRS has yet to issue regulations on this section. The literature about 1039 reaches conflicting conclusions. None of it has included all of the subtle, but important, factors in analyzing whether a rollover would ever be feasible.

The way that Congress expects the rollover to work, as seen through the report of the Senate Finance Committee, is to allow the tenants to buy the property at a lower price than anyone else. Their report stated:

The maximum sales price permitted under these programs under present law is the amount the individual has invested in the property, plus an amount necessary to retire the outstanding mortgage liability and the taxes payable as a result of the sale. By providing that no gain is to be recognized in these cases, it would be possible to decrease the sales price to the occupants or a tax-exempt organization managing these properties. The committee believes this result would be desirable. This should enable them to make purchases they otherwise could not make.¹⁴

Willis Ritter and Emil Sunley in "Real Estate and Tax Reform," make the same arguments as the Senate Finance Committee report. They claim that the rollover will increase the marketability of units. The new arguments they

raise are that a rollover will allow greater interest deductions for the same size mortgage and allow a new round of construction cost deductions (p.42). They, however, like the Senate Finance Committee, fail to discuss the price which tenants can afford in comparison with the price which developers demand.

Arnold Diamond of HUD claims that a rollover will significantly increase the rate of return to the investor.¹⁵ Yet, he makes his comparison between an investor selling the project at the end of the sixth year on the open market and an investor rolling the project over to the tenants at that point and reinvesting in a second project for another six years. Simply holding the first project for another six to fourteen years will also significantly increase the rate of return to the investor.¹⁶ A more appropriate comparison would be between rolling over into a second project after 6 years to hold that project for 6 years and holding the first project for 12 years. Diamond, like Ritter and Sunley, assume that investors can redeem enough equity from the sale of the first project to pay the equity required to invest in the second. Yet, as will be seen, the tenants can pay little in equity while the developer of the second project will demand a considerable amount of equity.

John Sexton attacks the assumptions of the Senate Finance Committee and finds the rollover generally unworkable.¹⁷ He sees no reason for the owners of moderate income property to charge the tenants less than they can receive from another buyer. Yet, particularly on a rehabilitation project, the amount that the investors can reasonably expect to receive from any buyer is far less than the tax cost.¹⁸

James Wallace in "Role of Tax Incentives," concludes that a Section 1039 rollover is clearly unfeasible. He finds that investors would be better off to hold onto the original project. However, his numerical analysis

assumes that the investors will choose to reinvest in another rehabilitation project rather than in a new project and assumes that they will receive no charitable deduction or cash from the tenants.

Nathan Betnun and David Judelson in "Tax Incentives for Rehabilitation," and Judelson in "Incentives and Subsidies," agree with Wallace's conclusion that a rollover is clearly unfeasible. Both of these papers are correct in their assumptions about perceptions held by investors. However, they fail to quantify the gap between holding the first and rolling over into the second, and they fail to consider means to bridge this gap.

Summary

This thesis attempts to evaluate the amount of subsidy and incentive necessary for housing to be rehabilitated for low income people and the form the subsidy and incentive should take. The basic approach is to consider how the present system operates and then to compare it with alternatives. The questions that are asked are: Who serves as developers? What are their motives? What type of financing do they use? How much do they earn on a given project? Is this an appropriate amount? If not, what is? How much does this incentive cost the Federal Government? How else might the incentive be structured to provide the appropriate level at a lower cost?

Cutting across this analysis are questions concerning the degree of tenant and community control. Can tenant and community groups use the limited partnership mechanism? How much control do they have when they bring in limited partner investors? Does the Section 1039 rollover realistically encourage tenant ownership?

Chapter B describes the developers toward whom the incentives are directed and what their motives are. Developers are found to be of two basic types--"profit-oriented" and "community-oriented." The chapter shows

that many "community-oriented" organizations are increasingly becoming profit-oriented. They are also oriented toward providing low rents and toward controlling the development, relocation, construction, tenant selection, and management processes.

Chapter C shows that the Section 236 limited dividend program in conjunction with the 167(k) tax shelter is the combination of subsidy and financing which best satisfies the motivations of developers rehabilitating for low income people. The chapter shows that, contrary to Congressional expectations, the rents which must be charged by conventional financing are too high to qualify the apartments for the 167(k) write-off. The various existing subsidy programs are examined, including the 236 limited dividend, 236 non-profit rental, 236 cooperative, 312 direct loan, Turnkey, and Turnkey leasing programs. The profitability and rent range of the 236 limited dividend program are found to be the overriding factors to favor it. The amount of community control given up by a community group to investors is found to be comparatively small.

Chapters D and E lead up to determining the amount of incentive provided the developer who uses Section 167(k) in conjunction with 236. Chapter D discusses the value of the annual after tax cash flows generated by a typical project. The most significant flows result in the five years of maximum depreciation and in the year of the tax on sale. Methods of avoiding this tax are discussed. Particular stress is placed on the Section 1039 rollover as a means of avoiding the tax because it purports to allow for ownership by the tenants. The conclusion reached is that only under special circumstances will the investors be as well off to dispose of the project to the tenants or to anyone else until the 20th year of the project or until they die.

Chapter E discusses the amount of capital contribution which investors

are willing to make in exchange for the right to take the project cash flows. The elements of risk are shown to warrant approximately a 33 percent return rather than the 25 percent currently demanded by investors. Based upon a 25 percent rate the capital contribution which investors are willing to make over a two year period is about 32 percent of the mortgage.

Chapter F discusses the net incentive to the developer of a Section 167(k)-236 project. Deductions are made from the capital contribution for the broker's commission, the contractor's profit, the project equity, taxes, and an amount to make the project operational. The net incentive is shown to be 2.0 times as great on rehabilitation as compared with new construction based upon a 25 percent rate of return to the investors and 1.4 times as great based upon a 33 percent rate of return to the investors. These high returns are shown to be justified by the fact that the average new project, which requires little or no more effort than the average rehabilitation project, has had a mortgage of 2.2 times that of the average rehabilitation project in cities where rehabilitation has been occurring.

Chapter G examines the efficiency of the rehabilitation incentives and subsidies from the point of view of the U.S. Treasury in terms of dwelling units rehabilitated per dollar expended. The broker's commission, and that portion of the investors' return in excess of the amount afforded investors in a 50 percent bracket, are found to be the primary inefficiencies in the tax incentive. The bulk of the average return to the investors is relatively costless to the Treasury because the high incidence and severe tax consequences of foreclosure are likely to produce considerable tax revenue. The 236 interest subsidy is found to be the most inefficient subsidy in the whole process in terms of cost to the Treasury particularly in comparison to alternative forms of subsidy.

Chapter H discusses some alternatives to the present development

incentives and subsidies and some alternative means to induce tenant ownership. A shift to a tax credit system which provides equal benefits to investors in all brackets would seem to be the most effective marginal change. A more idealistic system is suggested as well.

FOOTNOTES

1. Congressional Record, p. s16202, December 9, 1969.
2. Ibid., p. s16203, December 9, 1969.
3. According to Professor Daniel Weisberg, Max Kargman of First Realty was the first to use the limited partnership mechanism with regard to moderate income housing. (Seminar, Department of Urban Studies and Planning, January 22, 1971).
4. Uniform Limited Partnership Act (U.L.A.) Sec. 7.
5. U.S. Code Congressional and Administrative News, November 21, 1969, p. 2330.
6. The Tenement Landlord, p. 227.
7. U.S. Congress, House, First Annual Report on National Housing Goals, 91st Cong., 1st Sess., p. 14, as cited in Emil Sunley, "Tax Incentive," p. 19. Sunley estimates that the cash grant equivalent of 167(k) would be \$82.5 million in 1970 and increase to \$268 million in 1979.
8. U.S. Congress, House, Second Annual Report on National Housing Goals, 91st Cong., 2nd Sess., p. 44. As cited in Sunley, op. cit.
9. Ibid., p. 25, (p. 23 in Sunley).
10. This assumption reduces the amount of depreciation allowable by eliminating the step-up in basis allowable when a developer is actually paid a fee. See p.44 infra for an explanation of the step-up.
11. See pp.44-47 infra for a discussion of cost of disposition.
12. "Tax Incentive", p. 382, Sunley uses a 15 percent discount rate.
13. "Federal Income Tax Reform", pp. 406-407.
14. U.S. Code Congressional and Administrative News, November 21, 1969, p. 2330.
15. "Tax Incentives for Section 236 Rehabilitation," p. 15. He shows an increase in the rate of return from 41 percent per year over 6 years to 56 percent over 12 years. These rates are high because he assumes that the owners of the project are also the developer and that the owners discount losses at the same rate as they discount profits. (see pp. 52-57 infra).
16. See Table D-II infra.
17. "Working with the New Tax Deferral Provisions."
18. See pp. 44-49 infra.

B. DEVELOPERS AND INCENTIVES

The groups toward which incentives have been focused are developers and sponsors. They initiate projects and see that the rehabilitation is carried out. Through their control passes the funds to pay the other actors.

The functions of the developer are:¹

- 1) To obtain control over the property,
- 2) To obtain necessary community support to allow the project to proceed,
- 3) To provide seed capital,
- 4) To obtain interim and permanent financing,
- 5) To obtain project subsidies,
- 6) To obtain all legal documents including clear title and zoning,
- 7) To engage and oversee the architect,
- 8) To engage and oversee the contractor,
- 9) To engage the management agent,
- 10) To inform and consult with the existing tenants, if any, on the progress of the project,
- 11) To supervise the relocation of these tenants, if need be,
- 12) To maintain finances, and
- 13) Possibly to initially rent the project.

Whether rehabilitation occurs depends upon whether the developer has enough incentive to spend the time and effort necessary to perform these functions. The form of incentive preferred by most professional developers is, of course, monetary profit. The amount of profit he demands depends upon the amount of time, effort, and capital he must expend, particularly in comparison to other types of development or investment.

Still 57 percent of the multifamily, low income rehabilitation projects insured by the Federal Housing Administration (FHA) were classified as non-profit developments.² These projects were initiated by non-profit sponsors. The role of the non-profit sponsor is generally to acquire the site, provide community support, handle tenant relations, and retain ownership of the property. In certain cases the non-profit sponsor may be the creation of a profit-oriented developer. In other cases the developer, although the hired agent of the non-profit sponsor, becomes the decision maker. The most socially significant type of non-profit sponsor is the community group that

serves as its own developer. Yet, these groups are learning that the profit-oriented approach to development best serves their goals. These groups realize that they, like the professional developer, can create limited partnerships and sell tax shelter.

The most important distinctions between community group-developers and professionals are in the uses to which they put their profits and in the compromises they make in trying to appeal to investors.

To the extent that a community group identifies with the tenants, it may use or sacrifice profits for lower rents, greater tenant satisfaction, and better relocation services. Profit might also be sacrificed for control over the jobs created by the project. The Emergency Tenants Council (ETC), a Puerto Rican group in the South End of Boston, has completed the syndication of a 71 dwelling unit project. It decided to use a part of the syndication proceeds to pay staff salaries, a part to invest as seed money for its next project, and a part to subsidize the management of its buildings. The Roxbury Action Program (RAP), a black, tenant-oriented group also of Boston, decided to apply the syndication proceeds from its first project directly to the reduction of the mortgage and thereby reduction of rents.³ The Columbus Avenue Tenants Association (CATA), an organization consisting of the tenants in two large buildings in the South End of Boston, is considering investing the proceeds they receive from syndication and use the principal to meet cost overruns both from construction and operation and use the earnings to support the tenant association and to reduce rents.

Community groups use different criteria from professional developers in choosing their development team. The profit-oriented developer will seek the most reputable architect, contractor, attorney, syndication broker, and management agent he can afford. All of these agents help to determine the level of confidence which investors will have in the project and hence

the amount they are willing to pay for an interest in it. Community groups, however, will consider only those architects and contractors who will allow members of the community to participate in the design and construction processes. Participation in design would include both an expression of desires, particularly as to bedroom sizes, and a review of the plans. Participation in construction would include hiring and training of community labor. Whether the architect and contractor, themselves, are from the community is another significant criterion.

Choice of the attorney and syndication broker are of lesser concern to the community. Still, preference is certainly given to community members. Choice of the management agent and control over the replacement of it, are major concerns of both the community and the investor. The tenants will have to live with the management. The community would like to see the fees remain in the community. As will be seen in a later chapter, the investors look primarily to the management agent to keep the project out of foreclosure.

The community group will also have several choices to make directly concerning the present tenants. It must decide how to phase the construction process to avoid relocation problems but to still keep construction costs low. It may decide to exclude certain tenants because they have too high income or are students and hence do not allow the apartment to qualify for the five-year write-off.⁴ The alternative is to accept reduced proceeds from the sale of the tax shelter. How it makes these choices will depend upon who its constituency is.

FOOTNOTES

1. Adapted from James Morey and Mel Epstein, "Housing Development", p. 15.
2. U.S. Department of H.U.D., "0-2 Forms", June 30, 1970.
3. Alternatively, the syndication proceeds can be invested in bonds earning, say, 6 percent and withdrawn at an annual rate of 6.62 percent over 40 years, 8.62 percent over 20 years, or 13.38 percent over 10 years. These amounts compare with saving only 3.04 percent per year for 40 years of the amount of any part paid on a Section 236 mortgage.
4. Internal Revenue Code Regulations, Sec. 1.167(k)-3(b)(2).

C. FINANCING ALTERNATIVES

Developers of all types who acquire and rehabilitate property generally require mortgage financing in order to afford it. Until very recently lack of financing prohibited rehabilitation in most low income areas. Now a developer often has several sources of financing for rehabilitation, only some of which will allow him to use 167(k) depreciation. He might obtain 1) a conventional loan from a bank, 2) a Section 221(d) 4 market rate mortgage insured by the FHA, 3) a Section 236 limited-dividend loan subsidized by HUD, 4) a Section 312 loan direct from HUD, 5) a construction loan with a turnkey sales commitment, or 6) a conventional loan with a turnkey leasing commitment. In addition to all of the above, a non-profit developer can receive financing as a sponsor of a Section 236 non-profit rental project or of a Section 236 non-profit cooperative project.¹

Which of these programs a developer chooses depends upon his own motives and upon the availability of funds for the program he prefers. As seen in the previous chapter the profitability of a project is the most important criterion for the professional developer and an important one for the community-oriented developer. The level of rents, and the possibilities of community control and tenant ownership are also important to community oriented developers. This chapter will compare all of the above financing programs using all of these criteria.

The conclusion reached is that the 236 limited dividend program is the most profitable. Those programs which include no subsidies will be shown to be incompatible with using Section 167(k). The 236 limited dividend and turnkey leasing programs are shown to best satisfy the needs of community groups, although funding for the latter is rarely available.

The project which will be used to compare the programs is the rehabilitation of the Newcastle Court and Saranac Buildings in the South End of

Boston. This case will be used throughout the paper. The reasons for using this case are: 1) the author is thoroughly familiar with it from his involvement with the project, 2) the project contains exactly 100 units to readily allow switching from an analysis by project to an analysis by unit, 3) the total development costs are reasonably typical of costs on other rehabilitation projects.² The buildings will be nearly gutted. All of the plumbing and wiring will be replaced; certain walls will be removed.

The rent levels shown for all of these types of financing are based upon modest assumptions for operation and replacement costs and real estate taxes to clearly demonstrate the incompatibility of certain financing methods with 167(k). The \$770 per unit per year for operation and replacements³ is minimal. It is in line with the amount suggested by the Experience Exchange Committee of the Institute of Real Estate Managers. However, one study of five moderate income housing projects compiled for the Boston Model City Administration showed these costs as ranging from \$890 to \$1450.⁴ The real estate tax level shown is based upon 16 percent of gross project income. This rate is generally attainable only under a special legal arrangement.⁵ Generally, real estate taxes average around 18-24 percent of gross rent.⁶

Profit Making Programs

The rents projected in Table C-I using conventional financing are too high to allow the unit to qualify for the five-year write-off.⁷ The unit must be held for occupancy by a tenant earning no more than 150 percent of local public housing income admission levels.⁸ In Boston this level is \$7800 for a family of four. The rent charged cannot exceed 30 percent of the income of a marginally qualified tenant. A rent of \$2539 per year (\$211 per month) is 32 percent of the income of a marginally qualified

Table C-I Derivation of Rent for 100 Unit Project by Type of Financing

Program Type	236 limited divd.	236 non-prof	Conventional profit	221(d)4 lim. divd.	312 profit
Interest	1%	1%	8%	8%	3%
Term (years)	40	40	20	20	20
Mortgage %	90%	100%	70%	90%	100% *
Mortgage Amt.	1,252,000	1,383,000	968,000	1,252,000	1,320,000
Implied Equity	139,000	0	415,000	139,000	10,000

Calculation of Rent - Annual per Apartment

Operation	700	700	700	700	700
Real Estate Taxes @16% gross	250	241	407	432	337
Replacements	70	70	70	70	70
Dividend @6% equity	83	0	249	83	6
Debt Service	<u>1040</u>	<u>1149</u>	<u>986</u>	<u>1277</u>	<u>887</u>
Net Market Rent	<u>2143</u>	<u>2160</u>	<u>2412</u>	<u>2562</u>	<u>2000</u>
Interest Subsidy	659	729	0	0	0
Net Basic Rent	<u>1484</u>	<u>1431</u>	<u>2412</u>	<u>2562</u>	<u>2000</u>
Vacancy Reserve @5% gross	78	75	127	135	105
Gross Basic Rent	<u>1562</u>	<u>1506</u>	<u>2539</u>	<u>2697</u>	<u>2105</u>
Basic Monthly Rent	130	126	211	225	175
Income Served @30%	5207	5020	8463	8990	7023
Income Served @25%	6248	6024	10156	10788	8420
Family of 4 limit- Boston	7800	7800	7800	7800	7800
Family of 3 limit- Boston	7190	7190	7190	7190	7190

* 100% of construction costs only.

family, clearly too high.

The assumptions used in arriving at this rent are modest. As seen previously, development costs are below average for extensive rehabilitation, and operation and replacement costs may even be low. An 8 percent interest rate and a 70 percent mortgage are certainly minimal for apartment rehabilitation in today's market. The dividend is calculated at only 6 percent of equity rather than at 15 percent which most investors would expect. The only way for this conventionally financed rehabilitation project to qualify for the 167(k) write-off would be for the owner to reduce his dividend to zero and undermaintain the unit. Even then the potential market would be limited to a narrow income span paying a high percentage of income for rent. A far more profitable alternative for an owner intent on using conventional financing would be to forego the five-year write-off and charge a high rent to people who can afford it.

A developer seeking to use Section 221(d) 4 faces the same high interest rates and relatively short amortization period as under conventional financing. The 90 percent mortgage it can receive reduces the equity requirement but forces the rents to be \$225 (See Table C-I), far higher than the \$195 maximum to charge a family of four and qualify the rehabilitation costs on the dwelling unit to be written off over five years.

The Section 312 program does allow rents sufficiently low for a rehabilitated apartment to qualify for the five-year write-off. Still, a rent of \$175 per month can hardly be considered to be within the means of low income people. The 1969 Housing Act gives priority on 312 loans to owner-occupants. Only owners of rental property can take depreciation. Thus, Section 312 will rarely be used in conjunction with 167(k).

Another alternative is the turnkey public housing program. This program requires the developer to obtain a construction loan from a

conventional lender and sell the project to the local housing authority. No tax shelter is available on the normal turnkey program because a tax shelter implies private ownership. However, certain developers prefer the turnkey program because they have a guaranteed buyer before they begin. Construction for Progress, Inc., a subsidiary of American Standard, Inc. and Celanese Corp. in New York City is able to earn 12 percent after taxes on a turnkey venture.⁹

A community group would certainly have to split any profit it made with the general contractor unless it could perform this role itself. To the extent that it insisted upon job training programs which failed to effectively train inexperienced workers, the profits would be reduced. The potential profit for a community group on a turnkey project would thus be slight in most instances.¹⁰

The one possibility for more profit is the turnkey leasing program. Here, the owners of the project lease it to the local housing authority under Section 10(c) of United States Housing Act of 1937. Leases run for 40 years. The local authority would then sublease the apartments to individual tenants at subsidized rents. A developer has the opportunity of syndicating the project to limited partners before executing the lease with the local authority.¹¹ The problem with the program is that funding is scarce and local authorities are reluctant to use the Sec. 10(c) leasing funds they do have for rehabilitation projects.¹² They fear the useful life of the buildings is likely to be less than 40 years.

The low rents charged in a turnkey public housing project are a mixed blessing. The rents are approximately 25 percent of the tenants income, or only \$62 per month for a family earning \$3000.¹³ However, a family of four (in Boston) must earn less than \$5700 to qualify. The problems caused by high concentrations of low income families have been

well documented.¹⁴

A turnkey project does allow for a considerable degree of community control. A community group serving as the developer has complete control over who it hires to reconstruct the building. It must negotiate with the local housing authority as to who will serve as the management agent. The local housing authority reserves the right to fire the management agent. Turnkey II provides for private management of public housing. However, the housing authority still reserves the right to fire the management. Turnkey III provides for tenant ownership through "sweat equity," or through cash payments as the tenant's income rises. However, fee ownership does not occur for 13 to 21 years. Elderly people and welfare mothers, the two groups that head the bulk of public housing families, are unlikely to ever be able to contribute a sufficient amount of maintenance or cash payments to secure even fee ownership.

The Section 236 program¹⁵ provides FHA mortgage insurance for a 40 year term even though Congress has declared the useful life of the improvements to be only 5 years. The program subsidizes the debt service paid by the tenant down to the equivalent of 1 percent interest. The limited dividend variant provides financing for 90 percent of the total development cost. The other 10 percent, the implied equity, can be provided in cash or through a waiver of the Builders and Sponsors Profit and Risk Allowance. Since this allowance is worth 10 percent of the non-land costs,¹⁶ the minimum cash equity required is generally no more than 2 or 3 percent of the total development costs. Any sponsor who is willing to limit its annual cash dividend to 6 percent of the original implied equity can become a limited dividend sponsor. As will be seen in the next chapter, the discounted net profit to the developer for a project like Newcastle, would be \$193,300 before taxes.

As Table C-I shows the rent required to support this unit under Section 236, limited-dividend financing and pay the maximum dividend would be \$1562 per year or \$130 per month.¹⁷ This rent level falls easily within the limit allowed for the unit to qualify for the five-year write-off.

Non-Profit Programs

A 236 non-profit rental project has little to recommend it in comparison with the limited-dividend route. A non-profit 236 cooperative fares somewhat better. The computation of rents for either type of non-profit is identical. As Table C-I shows, the rents in either type of non-profit project will be at the most only slightly lower than those in a limited dividend building. The only variables are the dividend and the mortgage debt. The dividend has been calculated to be the maximum of 6 percent of the implied equity or \$84 per unit per year. Experience puts it at less than 3 percent.¹⁸ A community organization serving as the general partner in a limited partnership will be likely to keep the dividend even lower in order to keep rents at a minimum for a given level of maintenance. Cutting the dividend reduces the real estate taxes and the vacancy allowance as well. Were the dividend to be half of the maximum, the annual rent on a limited-dividend apartment would be \$1505 or \$1 per year less than on a non-profit unit. Were no dividend to materialize, the rent would be \$1457 or \$105 less than on a non-profit.

The reason the mortgage is larger on the non-profit project than on the equivalent limited-dividend project is basically that a non-profit sponsor is allowed a mortgage on 100 percent of the total development costs. As Table II shows, certain differences arise in the calculation of the total development cost for the two projects. The most significant difference is that a limited-dividend developer is entitled to a Builders and Sponsors

Profit and Risk Allowance of 10 percent of all development costs except land; a non-profit sponsor receives a Builders Profit allowance based upon a percentage of the actual construction costs. A non-profit also receives an Amount to Make Project Operation (AMPO) of up to 2 percent of the mortgage. A limited dividend developer must use his own cash to keep all of the bills paid before the units are fully rented. The consultant's fee allowed a non-profit sponsor is likely to appear as a legal and organizational expense to the same group operating as a limited dividend developer although the limit is slightly lower. The different fees will be higher for a non-profit developer because the mortgage amount on which they are based is higher.

Promoters of cooperative housing boast of lower maintenance costs in cooperatives than in rental housing.¹⁹ However, the reason they give for this reduction is the psychological identification by the occupant with the property. The same degree of identification is likely to be present when a tenant organization serves as a general partner for a limited dividend project or as a sponsor of a non-profit rental project.

The difference between a non-profit and a limited dividend, limited partnership project in terms of community control is simply the items of control which the community anticipates that investors will not accept. Selection of the management agent and of the contractor would be the most significant issues of control about which an investor might disagree. Both of these actors must first be approved by the FHA or state insuring agency. The construction lender must also approve the contractor. Any investor uneasiness on these issues might be met by monetary guarantees using the syndication proceeds. Should a package ever pass the agencies, but fail to produce a high enough price without compromising community control, the community group may be able to go back to FHA for a 100 percent loan.

Table C-II Comparison between Development of a 236 Project by
Type of Sponsorship

	Limited Dividend	Non-Profit
a. Land Improvements	10,000	10,000
b. Structures	1,000,000	1,000,000
c. Builders Overhead @2%b	20,000	20,000
d. Builders Profit @8%b	-----	80,000
e. Other Construction Fees	65,000	65,000
f. Interest during Construction @0.8%v/2*	50,000	55,000
g. Taxes*	34,000	34,000
h. Insurance*	8,000	8,000
i. FHA Mtg. Ins. Pre. @0.5%v*	6,000	7,000
j. FHA Exam Fee @0.3%v	4,000	4,000
k. FHA Inspec. Fee @0.5%v	6,000	7,000
l. Financing Fee @1%v*	13,000	14,000
m. AMPO @2%v	-----	28,000
n. FNMA/GNMA Fee @1.5%v*	19,000	21,000
o. Title and Recording	5,000	5,000
p. Legal and Organizational	15,000	10,000
q. Consultant Fee	-----	5,000
r. Builder & Sponsor Profit & Risk	<u>126,000</u>	<u>-----</u>
s. Subtotal	1,381,000	1,373,000
t. Land	10,000	10,000
u. Total	1,391,000	1,383,000
v. Mortgage	1,252,000	1,383,000

*Deductible during construction.

The primary difference between the non-profit approach and the limited dividend approach is the profit. No profit would accrue to a community group serving as sponsor of a non-profit rental project. Members of a cooperative, however, would be able to take certain deductions on their own taxable income in place of receiving this profit. Tax deductions are far less valuable to cooperators than to high income investors. Unlike an investor, a cooperator cannot deduct depreciation from his income tax. A member of a cooperative can deduct from his personal taxable income only an amount equal to his share of the real estate taxes and interest paid by the cooperative.²⁰ The real estate tax deduction is straight forward. A cooperator can deduct \$339 per year from his taxable income for this reason. Determination of the interest paid by the cooperator is more complex.²¹ The most plausible interpretation would show an interest deduction of \$583 although alternative interpretations would show as little as \$125 or as much as \$1001.

In order to be able to take these deductions a taxpayer must itemize his deductions rather than take the standard deduction. In 1966 of those families with incomes less than \$5000 per year only 13 percent itemized their deductions.²² Many of them undoubtedly, already owned their home. The remaining 87 percent all took the standard deduction. The standard deduction for a typical family of four earning \$5000 would have been \$500, i.e., 10 percent of \$5000.²³ The amount itemizable for this family was certainly less than \$500, probably about \$300.

Beginning in 1972, however, a taxpayer may take a low income deduction of \$1000 in lieu of either itemizing his deductions or taking the percentage standard deduction.²⁴ Assuming \$919 in project-related deductions and \$300 in other itemizable deductions a taxpayer would be about \$31 per year better off by itemizing. (See Table C-III) This savings is

worth about a \$2.60 decrease in rent.

Table C-III Tax Savings to Family of Four in 236 Cooperative

	With Low Income Allowance	With Itemized Deductions
Gross Income	5,000	5,000
Deductions	<u>-1,000</u>	<u>-1,319</u>
	4,000	3,781
Exemptions (4x750)	<u>-3,000</u>	<u>-3,000</u>
Taxable Income	1,000	781
Tax @ 14%	\$140	\$109

Certain cooperatives allow for the build-up of equity by the tenant. A limited partnership can easily structure an equity repayment scheme which, to the tenant would work exactly the same way as in a cooperative.²⁵ Incoming tenants would buy into the cooperative. Outgoing tenants would receive a cash payment based upon the amount they paid in at the beginning, the amount of equity they had contributed in the form of rents, and the amount of damage they had done to the property. As in a coop, any equity repayment scheme which provided the outgoing tenant with a large payment could lead to requiring too high of a payment by an incoming household and thus restrict the mobility of a tenant desiring to leave. A tenant organization with substantial syndication proceeds, however, has the option of creating a sinking fund to subsidize high payouts to those leaving and low payins for those moving in. When a tenant organization acquires fee ownership of the property from the limited partners by assuming the mortgage, the equity repayment scheme could continue just as though the project had been a cooperative since the outset.

The only significant difference between a cooperative and a limited partnership is in who can claim ownership for tax purposes. Clearly, upper

income investors will pay dearly for this privilege.

Thus, virtually all developers using the Section 167(k) tax write-off will also use Section 236 limited-dividend financing. Organizations which had been using non-profit financing are likely to turn to Section 236 limited-dividend financing to take advantage of 167(k).

Table C-IV Comparative Analysis of Various Rehabilitation Programs

Criteria	236 Limited-Dividend	236 Non-Profit Rental	236 Non-Profit Cooperative	312	Turnkey	Turnkey Leasing
Profit	Roughly 10% the total development cost as a discounted net after taxes *	0	0	0	Excess of sales price over construction costs	Considerable
Rents	\$121-130 Up to 40% at public housing levels	\$126 Up to 40% at public housing levels	\$126 Up to 40% at public housing levels	\$175 (Uncontrolled)	\$62	\$62
Control Development team	Subject to approval by FHA, construction lender and investors	Subject to approval by FHA and construction lender	Subject to approval by FHA and construction lender	Subject to LPA Approval	Subject to approval by LHA and construction lender	Subject to approval by LHA and construction lender
Management agent	Subject to approval by FHA and investors	Subject to approval by FHA	Subject to approval by FHA	No limits	Subject to approval by LHA continually	Subject to approval by LHA continually

* See Appendix

Criteria	236 Limited Partnership	236 Non-Profit Rental	236 Non-Profit Cooperative	312	Turnkey	Turnkey Leasing
Tenant Selection	236 and 167(k) regu- lations	236 regulations	236 regulations	No limits	Public housing levels	Public housing levels
Fee Owner	Partnership for 5-20 years	Non-Profit	Tenants	Developers	Local housing authority; some tenants after 13 to 20 years	Local housing authority.
Tax Deductions by Tenants	None for 5-20 years	None	\$31/year	None	None	None

FOOTNOTES

1. The Section 221(d)3 and 221(h) programs are not included because HUD is phasing them out.
2. At the time of this writing the project is still in the planning stage. Thus, all of the numbers are likely to change. Still, they represent reasonable estimates based upon comparable experience and are completely suitable for usage in this paper. The total development cost is slightly less than \$14,000 per unit. This amount is about \$1,000 less than total development costs on the average Section 236 project (U.S. Department of HUD, "0-2" forms, through July 31, 1970).
3. The replacement fund is used to replace worn-out items, like refrigerators.
4. Experience Exchange Committee, Income-Expense Analysis, p. 56. Karlis Zobs, "Management Operation and Administrative Costs," (for Model Cities), Table 5. The Newcastle project actually projects operating costs of over \$100 per year more.
5. The City of Boston Tax Assessors Office will make such arrangements. Organizations granted the status of a Ch.121(A) Corporation (M.G.L.A.) in Massachusetts are guaranteed this low rate for 40 years.
6. Experience Exchange Committee, op.cit., shows a nationwide average of 18 percent of gross for low rise buildings with 25 or more units. It shows an average of 24 percent in Boston.
7. Congress, apparently believed that Section 167(k) can work independently of other Government subsidies to provide rehabilitated housing for low income people. The House Ways and Means Committee described 167(k) thusly:

Your committee's bill also recognizes the importance of encouraging rehabilitation of buildings for low-cost rental housing. The tax stimuli aid new construction more than improvements to existing housing since it appears that remodeling of risky low income projects cannot be conventionally financed as well as new housing. (House Report No. 91-413, 8/2/69, U.S. Code Congressional and Administrative News, p. 1819.)
8. I.R.C. Proposed Reg. Sec. 1.167(k)-3(b)(2).
9. Leonard Sucsy, Vice-President-General Manager, seminar at the Harvard Business School, February 12, 1971.
10. The only example of this process being used by a community group known to this author occurred in the South End of Boston. There, a coalition of three groups, the People's Elected Urban Renewal Committee, the South End Tenant's Council, and the Emergency Tenants Council carried on a series of demonstrations against a local landlord who owned a block of 100 units of slum property. A community-oriented development company was drawn in and bought the property. The community groups were able to exert enough political leverage with local government officials at the time of an election to make it clear that this developer or any

other developer which may have come onto the scene, would have to rehabilitate the buildings in a manner consistent with the wishes of the community. The community considered the alternative of syndicating the tax shelter under Section 236 but instead chose the turnkey route. One controlling factor in this case was the apparent immediate availability of turnkey funds in comparison with 236 funds.

11. The net lease to the housing authority may reduce the value of the tax shelter slightly because the amount of interest allowed on property not "used in a trade or business" such as property held under a net lease, is \$25,000. (I.R.C. Sec. 163)
12. The Boston Housing Authority was one of the few authorities to approve such a project. However, the present director of their long-term leasing program told the author that they will not approve any further rehabilitation projects.
13. \$62 was the average rent in Boston in 1968. (Metropolitan Area Planning Council, Federal and State Housing Programs, Vol 2, 1969, p. 21).
14. See, for example, Lee Rainwater, Behind Ghetto Walls and Jewell Bellusch and Murray Hausknecht, "Public Housing: The Contexts of Failure", in Urban Renewal: People, Politics and Planning (eds. Bellusch and Hausknecht) pp. 457-61.
15. National Housing Act of 1949.
16. Assuming a minimal identity of interest is established between the builder and the sponsor.
17. If the local FHA or state insuring office and the local housing authority are agreeable, the rents can be skewed in such a manner that the rent on the leased housing unit is higher than the others. The effect can be to lower the rent in the other units as well.
18. Zobs, op.cit., found no cash dividends being paid out in the 5 projects he studied. Certain developers subordinate a portion of their management fee to a 3 percent cash flow.
19. Roger Willcox, President of Foundation for Cooperative Housing, seminar at M.I.T., Jan. 14, 1971. In fact the Experience Exchange Committee of the Institute of Real Estate Management shows the total annual operating expenses for cooperatives in a nation-wide sample to have been \$169 per room compared with \$225 for rental housing (Income-Expense Analysis p. 239).
20. I.R.C. Sec. 216
21. Theoretically, the cooperator pays interest at 1 percent per year or about \$125 per year at the outset. However, the mortgage is being paid on the basis of an 8 percent loan. During the first year the bank holding the mortgage receives \$1001 in interest and only \$39 in amortization. The cooperative on behalf of the cooperator pays an amount equal to the constant payment necessary to retire the debt over 40 years if it were at 1 percent interest. That amount is \$381 per year.

HUD pays the balance of the debt service payment of \$659. Even if the cooperative assumed the entire burden of the amortization and HUD subsidized only the interest, the cooperator would have paid \$342 in interest rather than only \$125. Yet, this interpretation cannot work throughout the life of the mortgage. Toward the end of the loan HUD's \$659 constant payment exceeds the amount of interest being paid. Apparently, HUD is subsidizing some of the amortization as well.

The I.R.S. has yet to issue a ruling on this point although according to Victor Altman of Kruth and Altman, the law firm handling the account of the Foundation for Cooperative Housing, the I.R.S. has issued a private ruling on this point. Stanley Surrey of Harvard Law School told the author in an interview that in his opinion the cooperator should be able to deduct the entire \$1001 in interest paid to the bank. If the I.R.S. were to treat the subsidy as a form of public assistance apart from the project, then the subsidy would be a form of tax-free income to the cooperator and the deduction allowable would be for the full \$1001 or interest paid on the mortgage.

The most plausible method of determining the interest paid by the cooperator is to treat the HUD subsidy in the same manner as income which a cooperative might earn from commercial rents. This method calculates the tax deductions by multiplying the rent paid by the cooperator times the ratio of deductible expenses of the cooperative to its total expenses. In this case a cooperator could deduct a total of \$922 ($\$1609(339+1001)/2338$) in the first year. If the real estate tax were still considered to have a value of \$339, the interest deduction would be worth \$583 in reduced taxable income. The average total deduction over the first five years would be \$919.

22. U.S. Code Congressional and Administrative News, House Comm. on Ways and Means, Report # 91-413, Aug. 2, 1969, p. 1857. (Compiled by Treasury).
23. I.R.C. Sec. 141(b)
24. I.R.C. Sec. 141(c)
25. David Judelson, John McRae, and Robert Yelton, Tenant Cooperative Rehabilitation, pp. 98-103.

D. VALUE OF THE AFTER-TAX CASH FLOWS

The incentive value to developers using the combination of Section 167(k) and Section 236 depends upon the value of the after-tax cash flows from the project, the return demanded by investors, and the amount which the developer must pay the broker, the contractor, as equity, in taxes, and as an amount to make the project operational. This chapter discusses the value of the after tax cash flows generated by the project including the eventual tax on sale. Special emphasis is placed upon the Section 1039 rollover not only because it seems to hold the promise of allowing investors to defer or escape paying any tax on sale, but also allow tenants to gain ownership of the property.

Income-Expense Analysis

Table D-I shows a summary of the items of taxable income and taxable expense for the Newcastle project. The two sources of income to the partnership are the rents collected and the 236 debt service subsidy from HUD. The rents collected allow for a 5 percent vacancy or non-payment factor. The 236 subsidy is very nearly \$65,900 each year. It is based upon the difference between the annual constant payment necessary to pay off the mortgage over 40 years at a $7\frac{1}{2}$ percent interest rate plus $\frac{1}{2}$ percent mortgage insurance premium and that necessary to pay off the loan at 1 percent interest. The total rental income is about \$222,800 per year. Deducted from this income are the items of operation and replacements, real estate taxes, interest and mortgage insurance premiums, and depreciation. The amount of interest and mortgage insurance deductions allowed is the full market rate paid, rather than the 1 percent actually paid by the project. However, because the debt service subsidy is treated as taxable income, the net effect is a wash. The only expensed item which

is not actually paid out is the depreciation. In this case, depreciation occurs primarily during years 2 through 6. The items for which income is received but which are not deductible are the amortization and the dividend. Amortization starts accruing slowly as it would on a loan at 8 percent interest and a 40 year term. During the first few years amortization represents only \$4000 to \$5000 compared with a total debt service payment of \$104,000. On a 1 percent loan with a 40 year term the amortization would be \$12,000 to \$13,000 in each of the first few years. The only value which amortization has to the investor is a lower tax on sale. However, this tax usually will not occur until the 20th year and is at capital gains rates. By allowing this slow build-up of amortization, the 236 subsidy is more costly to the Treasury than a direct loan at 1 percent interest would be.

The assumption has been made that operating expenses, real estate taxes, and rents will remain constant for the 20 year period. Clearly, this is an unrealistic assumption. To the extent that rents are raised to keep pace with increased expenses the net effect is the same to the investor. Rent increases are inconsequential for those tenants who are on leased housing are covered by rent supplements or are already paying more than the basic rent, i.e. for those tenants whose rent is based on their income. However, tenants who pay the basic rent are likely to resist rent increases.

Project deficits are first taken out of the investors' cash dividend. If deficits persist the developer will have to contribute cash, otherwise the project will go into default and possibly foreclosure. The non-payment of the cash dividend and the occurrence of foreclosure represent risks to the investors.¹ Investors are under no obligation to provide additional funds. Their liability is limited to the amount of their original investment.

D-I Income-Expense Analysis

	1	2	3	4	5	6	7	8	9	10
Income:										
1. Gross rent	0	156,900	156,900	156,900	156,900	156,900	156,900	156,900	156,900	156,900
2. HUD subsidy	0	65,900	65,900	65,900	65,900	65,900	65,900	65,900	65,900	65,900
3. Total income	0	222,800	222,800	222,800	222,800	222,800	222,800	222,800	222,800	222,800
Expenses:										
4. Operation & replacements*	0	77,000	77,000	77,000	77,000	77,000	77,000	77,000	77,000	77,000
5. Real estate taxes	34,000	33,400	33,400	33,400	33,400	33,400	33,400	33,400	33,400	33,400
6. Interest & mortgage insurance	0	100,160	99,850	99,510	99,150	98,760	98,340	97,880	97,390	96,860
7. Expenses from construction	96,000	---	---	---	---	---	---	---	---	---
8. Depreciation	0	301,060	300,950	300,870	300,780	300,700	630	570	510	460
9. Total expenses	130,000	511,620	511,210	510,780	510,330	509,860	209,370	208,850	208,300	207,720
10. Taxable income (loss)	(130,000)	(288,820)	(288,400)	(287,980)	(287,510)	(287,060)	13,430	13,950	14,500	15,080

Allocation of Cash:

11. Amortization	---	3,880	4,190	4,530	4,890	5,280	5,700	6,160	6,650	7,180
12. Cash dividend	---	8,350	8,350	8,350	8,350	8,350	8,350	8,350	8,350	8,350
13. Cash flow after taxes (50% bracket)**	65,000	152,760	152,550	152,340	152,110	151,880	1,640	1,370	1,100	810
14. Mortgage balance	1,252,000	1,248,120	1,243,930	1,239,400	1,234,510	1,229,230	1,223,530	1,217,370	1,210,720	1,203,530
15. Depreciable Basis	1,510,600	1,209,640	908,680	607,810	307,030	6,330	5,700	5,130	4,620	4,160

* A more sophisticated analysis would show interest accruing in a reserve fund and replacement expenditures in the year made. This refinement is irrelevant for current purposes.

** Line 12 minus 0.5 times line 10.

D-I Income-Expense Analysis (Continued)

	11	12	13	14	15	16	17	18	19	20
Income:										
1. Gross rent	156,900	156,900	156,900	156,900	156,900	156,900	156,900	156,900	156,900	156,900
2. HUD Subsidy	65,900	65,900	65,900	65,900	65,900	65,900	65,900	65,900	65,900	65,900
3. Total income	<u>222,800</u>	<u>222,800</u>	<u>222,800</u>	<u>222,800</u>	<u>222,800</u>	<u>222,800</u>	<u>222,800</u>	<u>222,800</u>	<u>222,800</u>	<u>222,800</u>
Expenses:										
4. Operation & replacements	77,000	77,000	77,000	77,000	77,000	77,000	77,000	77,000	77,000	77,000
5. Real estate taxes	33,400	33,400	33,400	33,400	33,400	33,400	33,400	33,400	33,400	33,400
6. Interest & mortgage insurance	96,280	95,660	94,990	94,270	93,490	92,640	91,730	90,740	89,680	88,530
7. Expenses from construction	---	---	---	---	---	---	---	---	---	---
8. Depreciation	<u>420</u>	<u>370</u>	<u>370</u>	<u>370</u>	<u>370</u>	<u>370</u>	<u>370</u>	<u>370</u>	<u>370</u>	<u>370</u>
9. Total expenses	<u>207,100</u>	<u>206,430</u>	<u>205,760</u>	<u>205,040</u>	<u>204,260</u>	<u>203,410</u>	<u>202,500</u>	<u>201,510</u>	<u>200,470</u>	<u>199,300</u>
10. Taxable income (loss)	15,710	16,370	17,040	17,760	18,540	19,390	20,300	21,290	22,330	23,500
Allocation of Cash:										
11. Amortization	7,760	8,380	9,050	9,770	10,560	11,400	12,310	12,300	14,360	15,510
12. Dividend	8,350	8,350	8,350	8,350	8,350	8,350	8,350	8,350	8,350	8,350
13. Cash flow after taxes (50% bracket)	490	160	(170)	(530)	(920)	(1,350)	(1,800)	(2,300)	(2,820)	(3,400)
14. Mortgage Balance	1,195,780	1,187,400	1,178,350	1,168,570	1,158,020	1,146,620	1,134,310	1,121,010	1,106,650	1,091,140
15. Depreciable basis	3,740	3,370	3,000	2,630	2,260	1,890	1,520	1,150	780	410

The sum of the amount of depreciation is \$1,510,200. This value is calculated by taking the \$1,391,000 total development cost shown to the FHA, subtracting the \$10,000 in land, and adding the \$259,600² in equity which the investors are willing to provide in excess of the implied equity.³ The excess equity is an actual out-of-pocket expense to the investors which is a cost to the Government which is not included in official estimates for Sec. 167(k).

The most important line to investors is line 13 (Table D-I), the cash flow after taxes. This value is the sum of his tax savings resulting from taxable loss and of the cash dividend payable to him. During the first six years the after-tax cash flows are large and positive. Beginning in the seventh year the depreciable basis has been largely used up. In most instances depreciation of the shell of the building will continue to be depreciated long after the depreciation of the repairs has been completed. However, in this case, the total acquisition price of the buildings is only \$10,000. Subtracting out the value of the non-depreciable land leaves an insignificant value for the shell. However, the excess depreciable basis over \$1,500,000 is depreciated over 20 years. The after-tax cash flow after the seventh year is relatively insignificant. Beginning with the 12th year the after-tax cash flows are negative. At this point the amortization has grown larger than the after-tax value of the dividend. From this point on rehabilitated property is a liability to investors.

Tax on Sale

The usual reason why an investor would hold the property is to avoid the large gains tax on sale. The taxable gain from sale is equal to the difference between the sales price (including the mortgage) and the adjusted basis.⁴ An investor wishing to sell out quickly cannot expect a

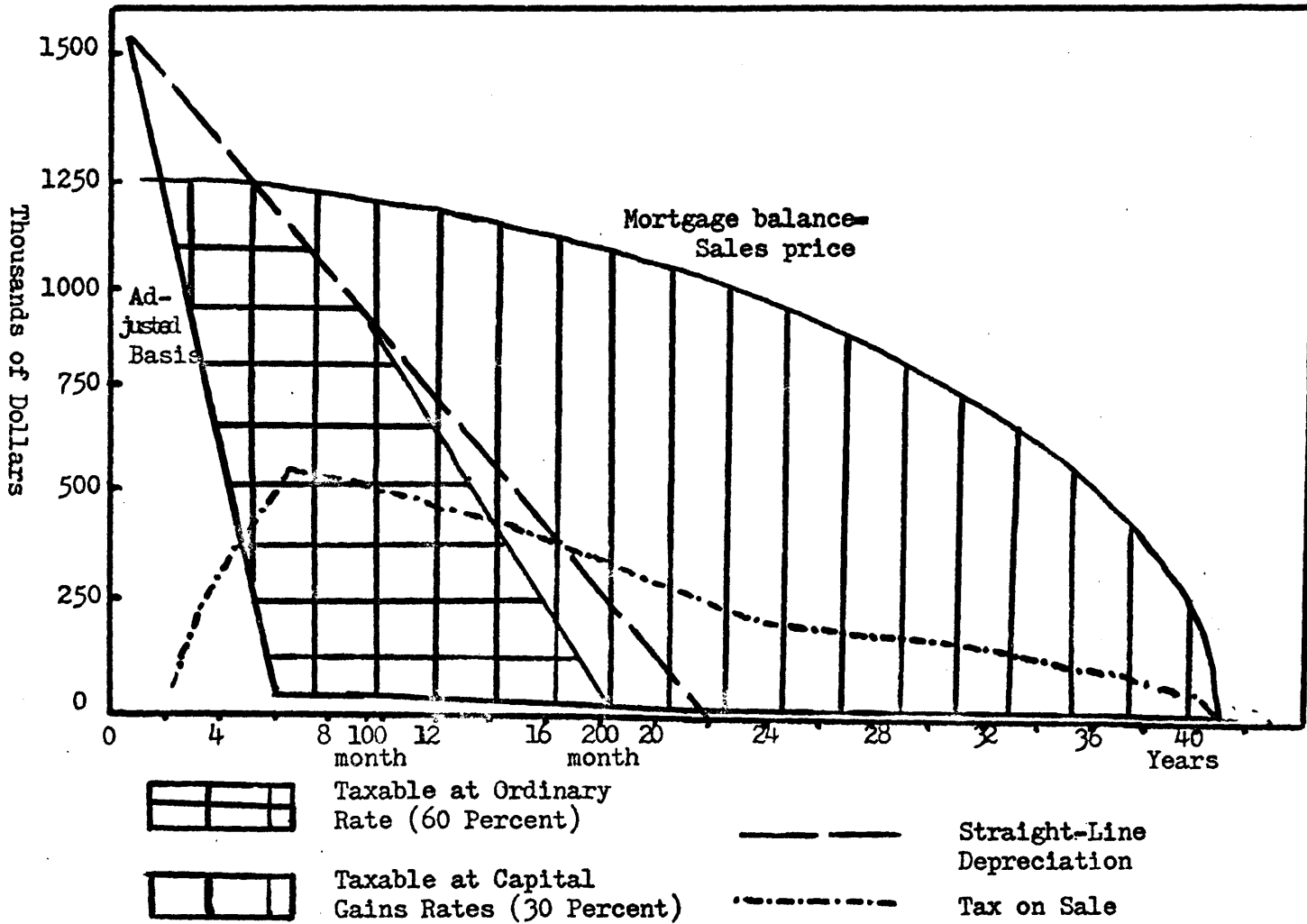
sales price much above the mortgage. He could abandon ownership at that point. The second and successive owners of the property can only depreciate it using the 125 percent declining balance method over the actual useful life of the property (about 25 years). If the remaining useful life is less than 20 years they can only use straight-line depreciation.⁵ These forms of depreciation are the equivalent to only about 5 percent depreciation of the undepreciated balance per year.⁶ The adjusted basis of the property to the initial owner in any year after the 6th is \$10,000. This amount represents the nondepreciable land costs. Assuming a sales price equal to the mortgage balance, the taxable gain from sale is thus well in excess of \$1,000,000 in any year from the seventh to the twentieth. The rate at which this gain is taxed depends upon the ordinary tax bracket of the investor and the year of sale.

Up until the 200th month of holding the property, any taxable gain from selling it is split between a portion taxed at ordinary income rates and a portion taxed at capital gains rates. Capital gains rates are one-half of ordinary rates. The portion taxed at ordinary rates is the "excess depreciation" taken over straight line depreciation computed upon the actual useful life of the buildings. This tax is known as recapture. Between the 100th month and 200th month the applicable percentage taxed at ordinary income rates declines from 100 percent to 0 percent at the rate of 1 percent per month.⁷ (See Fig. D-I) After the 200th month all of the tax is at capital gains rates.

The addition of a share of the large taxable gain to the taxable income of an investor normally in a 50 percent bracket will undoubtedly raise his bracket to at least 60 percent. His capital gains bracket would then be 30 percent.

As seen in Fig. D-I the tax on sale declines from a maximum of \$734,000

FIGURE D-II DETERMINATION OF A TAX ON DISPOSITION



in year six to \$327,000 in year 20. After this point the after-tax cash losses are greater than the savings in deferring the tax.

Disposition Alternatives

Real estate tax guides provide a plethora of legal means to avoid or defer paying gains tax on the sale of property on which substantial depreciation has been taken.⁸ Refinancing, giving the project to a charity, negotiating a tax free exchange, selling in installments, and passing the property onto heirs at the time of death are the usual means for avoiding an overburdensome gains tax. Except for the last method, none of these methods will work after a five-year write off has been taken. The Section 1039 rollover is a new alternative means of escaping taxation.

Refinancing instead of selling is prohibited by FHA until the 20th year. Even if it were allowed it would only yield a small amount of equity. Giving the property away, even to a charity, does not solve the problem. In Crane v. Commissioner 221 U.S. 1, 12-13, the Supreme Court ruled that the value of the outstanding mortgage is considered part of the sales price. Hence, in this case, "giving" the project away at the end of 6 years would be equivalent to selling it for the value of the outstanding mortgage at that point, \$1,229,000. The taxable gain from sale is equal to the sales price less the adjusted basis ($\$1,229,000 - 16,300 = \$1,212,700$).⁹ Of this amount \$1,226,000 would be recaptured at ordinary rates of about 60 percent and \$86,300 would be taxable at capital gains rates of about 30 percent. The total tax would be \$588,200.

The value of a charitable deduction would be the difference between the fair market value of the property and the disposition price.¹⁰ The fair market value is the price at which a willing seller would sell and a willing buyer would buy in an arms' length transaction. The methods used

by appraisers to determine this price are by market comparison, by taking original cost less depreciation, and by capitalization of income.¹¹ A market comparison would be difficult since few 221(d)3 or 236 projects have ever been sold. Taking the original cost less depreciation based upon 5 percent depreciation per year would yield a value of less than the outstanding mortgage unless the land value appreciated substantially. The capitalization of income approach depends upon the cash flow generated from the project, and the capitalization rate selected. Assuming that the cash flows on the project average 3 percent of the original implied equity or \$4150 and taking a capitalization rate of 15 percent, a rate indicative of a risky project, the fair market value would be only \$27,800 above the mortgage.

The amount of the charitable deduction is unlikely to be more than this amount. The net tax cost of giving the property away to a charity to an investor normally in a 50 percent bracket is thus $(588,200 - [.60 \times 27,800]) = \$571,500$.

Another way to avoid a high gains tax in some transactions where the basis has shrunk is the tax free exchange. Here, the owner of the depreciated property receives a second piece of property which has a depreciable basis equal to the amount of equity the investor had built up in the first project plus any additional cash put in. Since an investor has little equity to trade for depreciable basis, a tax free exchange has little value to him. The installment sale method of deferring gains tax also has little applicability in cases of this type. This method allows the gains tax to be paid as the buyer receives his money. However, the year that the mortgage is transferred to the buyer is the year that the seller must pay a tax on that portion of the sales price. If the mortgage value plus any other payments made in that taxable year exceed 30 percent of the total sales price, as they almost invariably will, the installment method will not

apply.¹²

The only sure method for an investor to dispose of the property without being subject to a gains tax is for him to pass it on to an heir at the time of death. The heir need pay no gains tax. He receives the property with the basis stepped-up to the fair market value upon receipt.¹³ Short of dying none of the traditional escape routes are relevant. The new Section 1039 rollover is a far more complicated matter.

Value of the Rollover to Investors

The Section 1039 rollover allows a taxpayer to pay no tax on the disposition of a 236 or 221(d)3 project to the tenants provided that the "net amount realized" is reinvested in another project of these types. This advantage is mitigated by the fact that the depreciation benefits taken on the first project are reflected in the tax on the sale of the second project and in a reduced basis on the second project (thereby eliminating most of the depreciation on the second project).¹⁴ The developer of the second project would require a substantial capital contribution based upon the depreciation benefits normally available to investors. The sales price of the first project to the tenants, as will be seen is unlikely to be much above the mortgage balance.

Closer investigation reveals several more subtle advantages and disadvantages in a rollover in comparison with holding the first project. The second project would generate construction expenses which are deductible without reduction of basis.¹⁵ The minimum size of the mortgage on the second project is smaller than that on the first. For this reason and because payments on the second mortgage are likely to begin at least six years after payments on the first, the taxable amortization payments on the second project will be lower than the continuing payments on the

first. The low mortgage, however, will mean lower potential cash dividends. The investors may be able to take a small charitable deduction for giving the first project to the tenants. They may also be able to take some new depreciation on the second project. Their tax on the sale of the second project 14 years later may actually be slightly higher than the tax they would have paid on the sale of the first project at that time. Any expenses incurred on the sale of the first project must be paid in cash but would be deductible. As will be seen a rollover will be beneficial to investors only in projects which look like they will fail or in projects where refinancing is allowed.

Whether a single investor can elect the rollover or whether the partnership as a whole must make this decision is open to question. Section 1039(a) says that gain will be deferred "at the election of the taxpayer." If an individual investor otherwise fulfills the requirements of 1039 he would appear to be the appropriate "taxpayer." However, one commentator¹⁶ has suggested that since the partnership must make all elections for the partners,¹⁷ it is the relevant "taxpayer." Certainly, regulations will have to clarify this point.

In the case of the Newcastle project with an original mortgage of \$1,252,000 the mortgage balance at the end of the sixth year (after the construction losses and the 5-year write-off have been taken) would be \$1,229,200. For purposes of determining the taxable gain from sale Sec. 1039(b)(4) defines the "net amount realized" on the sale of the first project as the amount realized less the closing cost incurred. If the sale price to the tenants were \$500 above the mortgage and closing costs were \$500, the "net amount realized" would be equal to the mortgage.¹⁸ The taxable gain from this disposition will be "recognized only to the extent that the net amount realized on such approved disposition exceed

the cost of such other qualified housing project."¹⁹ The "cost" of the second project will most probably be defined by the regulations as the amount paid in cash or other property less real estate taxes.²⁰ In other words the "cost" of the second project does not include those items which are expensed, i.e. deducted in the year that they are paid. Thus, in order to fully defer the gains tax at this time, the investors would have to reinvest in a project in which the "cost" of their interests, including both the new mortgage and their capital contribution less those items which are expensed equalled at least \$1,229,200, the net amount realized. Unless the cost of the second project was more than this amount, the basis of the second project would be its cost reduced by an amount equal to the amount of gain not recognized by reason of the rollover.²¹ The basis of the second project would be equal to the adjusted basis of the first, \$10,000. Finding a second project of the appropriate size would be easier than it might first appear. Investors could buy into a larger project so that their interest after deducting the expensable items equalled the amount of gain not recognized on the disposition of the first project.

If the partners decide to use the rollover at all, they are almost certain to choose a new project as their second project rather than a rehabilitation project. The capital contribution required to invest in a rehabilitation project would equal 32 percent of the mortgage if it were similar to the Newcastle case or as low as 19 percent if it were being syndicated by a more conservative developer.²² The minimum capital contribution required to invest in a new project would be about 15 percent of the mortgage.²³ Investors perceive new projects to be generally less risky than rehabilitation ones as shown by the lower rate of return they normally expect. On a rollover where the potential depreciation benefits on the second project are nil, the relative security of a new project is the

overriding factor. This greater security is also more likely to yield residual value from the sale of the project. A further advantage to a newly constructed project is that the period for phasing out of recapture of excess depreciation occurs between the 20th and 120th month rather than between the 100th and 200th month.²⁴ Since the holding periods for each project tack together,²⁵ assuming a sale of the first project five years after its completion, recapture at ordinary income tax rates would vanish after only sixty months of holding the second project. This advantage, however, would affect only those investors who choose to sell or are forced to sell at some point between the 20th and 200th months.

As Table E-I shows, assuming a sale to the tenants at the mortgage balance rolling over into a new project will be disadvantageous for any investor in any bracket using any discount rate. This example assumes a minimum capital contribution to loan value ratio of 15 percent. The cash cost would be \$1,229,000 including a mortgage of \$1,181,900 and a capital contribution of \$177,300. The closing costs are assumed to be negligible because they normally would consist of only paying a lawyer to record the deed and transfer the regulatory agreement with the FHA to the buyer.²⁶ The construction losses would be a maximum of \$130,000 or 11 percent of the mortgage. In actual cases they seem to run from 7 percent to 11 percent of the mortgage.²⁷ Taxable amortization is reduced by about \$59,300 over a 14 year period. The lower mortgage means potentially lower cash dividends paid out although these are taxable.

The depreciation benefits are less certain. The adjusted basis on the first project is \$16,330 at the time of the rollover. This basis consists of \$10,000 in non-depreciable land costs and \$6,330 in as yet undepreciated rehabilitation costs in excess of the \$15,000 per unit limit. The basis on the second project is "its cost reduced by an amount equal to

the amount of gain not recognized by reason of the application of subsection (a) [the rollover].²⁸ When the cost of the second project equals the net amount realized on the first, the basis of the second project would equal the adjusted basis on the first, or \$16,330 in this case. By the statute all of this basis would then seem depreciable. However, when the IRS writes regulations for 1039 it could keep a portion of the basis being carried over to the second project tied to the land. An optimistic reading of the statute would allow the new construction to be depreciated to the extent of the basis using the double declining balance method and a $33 \frac{1}{3}$ year useful life, i.e. at 6 percent per year of the as yet undepreciated amount. In this case depreciation on the second project would start at zero in the year of construction, jump to \$980 in the following year, and decline gradually to \$460 by the 14th year of the second project. These amounts compare with retaining the first project where \$630 in depreciation would be allowable in the first year of the second project and a lesser amount would be allowable in succeeding years down to \$370 in years 7 through 14. The additional depreciation does, however, increase the taxable gain from sale by \$2,500. This tax is only at capital gains rates and occurs several years after the rollover. The discounted net gain from the increased depreciation in this case is \$500 to an investor in a 50 percent bracket and \$800 to an investor in a 70 percent bracket.

While this benefit may be nearly insignificant in this case, it would be important in another case where the amount of original land cost now available for depreciation was \$2,500-\$3,000 per unit rather than \$100.

Another possible benefit accruing to investors who use the 1039 rollover would be a charitable deduction on the disposition of the first project. Taking this deduction would require that the recipient tenant association be a charitable foundation under IRC Sec. 501(c)3. The amount

Table D-III Net Gain to Investor from Rollover

Balance outstanding on original mortgage	\$1,229,200
Net amount realized	1,229,200
Mortgage on 2nd project	1,181,900
Capital contribution @ 15% mortgage	177,300
	<u>1,359,200</u>
Construction expenses @ 11% mortgage	130,000
Cash cost of 2nd project	1,229,200

Tax Consequences	<u>Project 1</u>	<u>Project 2</u>	Difference	
			<u>Project 2-Project 1</u>	<u>Present Value @ 4%</u>
Construction losses (year 1)*	---	130,000	130,000	125,000
Depreciation**(years 1-14 weighted to year 7)*	3,000	5,900	2,500	1,900
Amortization** (years 1-14 weighted to year 9)*	(138,100)	(78,800)	59,300	41,900
Annual cash dividend** (years 1-14)*	(4,170)	(3,680)	490	8,700
Charitable contri- bution (year 1)*	---	27,800	27,800	<u>26,800</u>
				204,300
Value to investor: in 50% bracket				102,200
in 70% bracket				143,000
Taxable gain on sale (year 14)*	(1,081,000)	(1,083,500)	(2,500)	(1,400)
Value to investor: 50% bracket				(400)
70% bracket				(500)
Non-Tax consequences				
Annual cash dividend** (years 0-13)*	4,170	3,680	(490)	(8,700)
Capital contribution (year 0)*	---	(59,100)	(59,100)	(59,100)
(year 1)*	---	(59,100)	(59,100)	(56,900)
(year 2)*	---	(59,100)	(59,100)	(54,700)
				<u>(179,400)</u>
Net value to investor in 50% bracket				(77,600)
in 70% bracket				(36,900)

* Years refer to years of project 2. Year 1 of project 2 corresponds to year 7 of project 1.

** No depreciation cash dividend or amortization occurs in year of construction.

of the charitable deduction, if any is likely to be no more than \$27,800.²⁹

All of these benefits and disbenefits must be discounted to their present value before being summed. Since all of the positive and negative cash flows of the first project after the fifth year of that project are presumed to be balanced in a sinking fund at a discount rate of 4 percent, the appropriate discount rate to compare rolling over into a second project with holding onto the first would be 4 percent. The net result is that an investor in a 50 percent bracket would lose the discounted equivalent to \$77,600 by rolling over into a second project. An investor in a 70 percent bracket would lose \$36,900.³⁰ It must be remembered that this low a level of losses was achieved through some rather liberal assumptions. The losses would be greater if the tenant organization has not been deemed by the IRS as a tax-deductible organization, if the IRS forbids the depreciation of the amount allocated to the land on the first project, or if the construction losses are a lower percentage of the mortgage. Using more conservative assumptions would increase the discounted loss to about \$40,000 for a 50 percent bracket investor and to about \$57,000 for a 70 percent investor.

Any investor who did choose to use the rollover would have to lay out funds to meet the first capital contribution payment before any tax deductions accrue. This cash requirement theoretically could come out of the sinking fund.³¹ Because a tax will eventually occur on the sale, the sinking fund will eventually have to be replenished.

In light of the costs the only reason why an investor would consider a rollover at the mortgage balance would be to avoid foreclosure. A foreclosure at this point would cost investors taxed at a 60 percent rate,³² \$733,000. This tax is equivalent to a sale at the mortgage balance. By comparison using a discount rate of 4 percent the present value of the

tax on sale at the mortgage balance 14 years later would be \$194,000. Thus if a foreclosure is likely, the cost of the rollover is lower than the tax liability of foreclosure. Still the investors must find a second project which is safer than the first. Foreclosure of the second project is equally as costly as foreclosure of the first.

The investors must also convince the tenants of the first project to accept ownership. If the project is in financial trouble their acceptance of it is questionable. When the financial trouble is accompanied by poor maintenance, tenant groups are unlikely to want to take over the property unless repairs are made. The Development Corporation of America planned Academy Homes in Roxbury to be a cooperative shortly after it was built in the 1960's. Because of the deteriorated condition of the buildings arising from poor design and construction the tenants now refuse to assume this role.³³ Similarly, the tenants of the Cathedral public housing project are eager to take over the ownership of the buildings from the Boston Housing Authority. However, they refuse to do so until the project is "modernized."³⁴

For those projects that are financially stable, i.e. those projects which are likely to be most desirable for tenants to own, another means is needed to induce the investors to dispose of them. One way would be to provide them with enough financial incentive to make a rollover desirable. A tenant organization which wanted to buy the project from the investors would have to raise approximately \$80,000. These sums amount to about \$800 per family. Clearly, few projects could raise this amount from each family. However, an alternative which may be open to the tenants is for the FHA to refinance the project so as to provide a 100 percent non-profit mortgage rather than the 90 percent limited-dividend mortgage. FHA Reg. Sec. 236.40(c) reads:

In the case of a project financed with a mortgage insured under this subpart which involves a mortgagor other than a cooperative or a private nonprofit corporation or association and which is sold to a cooperative or a nonprofit corporation or association, a mortgage given to finance the purchase may be insured under this subpart. The amount of such mortgage shall not exceed the appraised value of the property at the time of purchase. Such value shall be based upon a mortgage amount, the debt service of which can be met from the income remaining after payment of all operating expenses, taxes, and required reserves, and with the project being operated on a nonprofit basis.

According to this formula the amount of equity to which the investors would be entitled would be based upon the amount of the cash dividend they had been earning. The rent to the tenants would remain the same. The only change would be that whatever amount of the rents that had been going for a dividend would be capitalized at 3.04 percent and added to the mortgage. To capitalize the \$80,000 or so necessary to make a rollover feasible in the Newcastle case,³⁵ the FHA formula would require the dividend to have been $(0.0304 \times \$80,000 = 2,400)$, or about 1.7 percent of the original implied equity. If the project had been earning the full 6 percent dividend the refinancing would yield about \$275,000 above the mortgage.

The FHA, however, has been reluctant to provide additional equity money for this purpose. No limited-dividend projects have been fully converted to cooperatives.³⁶ Projects which yield no dividend would allow the investors no equity. However, in such cases, the investors are likely to be willing to give the project to the tenants simply to avoid the possibility of foreclosure.

Even if a rollover does occur, it will not alter the net cash flows to the investors shown earlier in this chapter.

FOOTNOTES

1. See pp. '68-73 infra.
2. The only depreciation not taken is \$370 which would be taken in the 21st year.
3. See pp. 117-21 of Appendix infra.
4. IRC Sec. 1001, Crane v. Commissioner requires the mortgage to be included in the sales price.
5. IRC Sec. 167(j)(5).
6. See pp. 47-48 infra. for an analysis of the fair market value of the property.
7. Actually, the period for phasing out of recapture for 236 property depreciated under the 167(k) 5-year method is ambiguous. IRC Sec. 1250(a)(1)(c) allows recapture to be phased-out under the pre-1969 Tax Reform Act period of the 20th to 120th months. IRC Sec. 1250(a)(1)(c)(iii) says that recapture on property depreciated under 167(k) is to be phased out beginning after the 100th month. The 100-200th month rule is generally assumed applicable.
8. See for example, Institute for Business Management, "Real Estate Investments and How to Make Them," Feb. 1970, pp. 9-11. See also Philip David, Urban Land Development, pp. 107-108.
9. See I.R.C. Sec. 1001.
10. I.R.C. Reg. Sec. 1.70-1(c).
11. Ratcliff, Real Estate Analysis, pp. 134-135.
12. IRC Sec. 453.
13. IRC Sec. 1014.
14. IRC Sec. 1039(d).
15. IRC Sec. 1016(a)(1)(A).
16. The Tax Lawyer, Fall 1969, v.23, p.671.
17. IRC Sec. 703(b).
18. IRC Sec. 1039(b)(4) defines the net amount realized as being equal to the amount realized less expenses and taxes (other than income taxes) incurred on the sale. Based upon Crane v. Commissioner, the amount realized includes the mortgage
19. IRC Sec. 1039(a).
20. In instances where the basis equals the "cost" of the project, the "cost" of the project is defined in this manner. See IRC Reg. Sec. 1.1012-1(a),(b).

21. IRC Sec. 1250(d)(8) deliniates a set of very complex rules which simply mean that to the extent that the reinvestment is less than the net amount realized the normal gains tax is applicable. Any excess reinvestment is treated like a new investment.
22. See Practicing Law Institute, Subsidized Housing, p. 249.
23. The Practicing Law Institute, op.cit., shows a confidential memorandum with a contribution of 12 percent of the mortgage for an 80 percent interest in the project and one with 15 percent for an 85 percent interest (pp. 375,429). James Wallace, op.cit., Table II-1, shows a 15 percent capital contribution to mortgage ratio with no phasing of the payments. Marvin Gilman of Leon Weiner Builders told a conference of the Practicing Law Institute that his firm would accept no less than 14 percent for a 90 percent interest. Walter Wincester of the State Street Development Corporation said at an M.I.T. seminar on Jan. 22, 1971 that they too expect 14 percent for the sale of 90 percent of a project.
24. IRC Sec. 1250(a)(1)(c). At the start of the holding period all excess depreciation over straight-line based on the actual useful life (approximately 4 percent per year on rehabilitation or 3 percent on new construction depending upon the useful life allowed by the IRS), is taxed or recaptured at ordinary income tax rates. At the end of the period the tax is all at capital gains rates.
25. IRC Sec. 1250(e)(4).
26. Interview with Robert Gunderson, Lawyers for Housing.
27. Cf. Harvard Business School (p. 26,29), Practicing Law Institute op.cit., (p. 388,389,432,462,491,522).
28. IRC Sec. 1039(d).
29. See pp. 47-48 supra.
30. If another project with original land and shell costs of a few hundred thousand dollars had been selected, a rollover might show a slight positive return for a 70 percent bracket investor only. This proposition assumes that the IRS would allow accelerated depreciation in the second project of the amount in the first project that had been allocated to non-depreciable land and a slowly-depreciable shell.
31. See page 77 infra.
32. The taxable income from the foreclosure is likely to raise the bracket of a 50 percent bracket investor to at least 60 percent.
33. Interview with Robert Gunderson, Boston Lawyers for Housing.
34. Peoples' South End News, May 1971, p.12.
35. A sale to the tenants for an amount in excess of the mortgage would increase the "net amount realized." Thus, to fully defer a gains tax

the investors would have to reinvest in a slightly larger project than shown in Table D-III. They would, however, be able to depreciate this increment. They would no longer be able to receive a charitable deduction. The net effect is that \$70,000 will make a rollover feasible.

36. Roger Willcox of the Foundation for Cooperative Housing stated at a seminar at M.I.T. on January 14, 1971, that FHA refused to convert a large group of buildings in Roxbury to cooperatives through this means. According to Washington attorney, Irwin Nestler, "every deal is different." Nestler's firm has secured FHA approval to refinance a limited dividend project in Detroit to provide a 100 percent cooperative mortgage. This commitment required political muscle and such legal finesse as calling equity going back to investor a "return of the Builder's and Sponsor's Profit and Risk Allowance that had been previously waived."

E. THE INVESTORS

The primary purpose of this chapter is to consider how much investors are willing and should be willing to pay for the after-tax cash flows discussed in the previous chapter. This chapter first looks at who the investors are. A 25 percent rate of return is taken to be the rule. Upon evaluation of the alternative costs and the risks, particularly the risk of foreclosure, the appropriate rate of return is found to be around 33 percent.

The capital contribution to the developer is calculated at \$398,600 using a 25 percent return and \$320,000 using a 33 percent return.

Description of Typical Investor *

The tax benefits are generally sold to a group of wealthy investors. The Treasury examined the returns of several passive investors in real estate in 1964. The Treasury found that they reported an average wage or salary income of \$140,000 and an average deduction from real estate of \$77,500, offsetting other income.² Thus, at 1970 rates the typical investor filing a joint return would be in a 66 percent marginal federal tax bracket; the taxpayer would save 60 percent of the amount of the deduction.³ Beginning in 1972, however, the maximum tax on earned income will be 50 percent.⁴ Only those people receiving large amounts of dividends, interest, or short term capital gains will pay higher.

The reason that the average investor is so wealthy relates not only to the added benefits that an investor in a high tax bracket can receive, but also to Federal Securities laws.⁵ Basically, these laws protect the interest of investors vis-a-vis the partnership. The penalties for failure to comply with them can be extreme. Unless exempt every syndication must be registered with the Securities Exchange Commission. Failure to register can cause payment of damages and the rescission of the transaction.⁶

"Willful" violation of the Acts can lead to five years in jail and a \$5000 fine.⁷ The costs of registering are almost as severe as the penalties. The legal, auditing, and printing costs can add up to \$100,000; the delay is six or seven weeks for even a small issue.⁸

Generally, developers and brokers will seek a private offering exemption under Section 4(1). Under this exemption they must restrict the number of offerees to less than 25 "sophisticated" potential investors. "Sophistication" primarily depends upon experience and ability. Where an offeree is extremely wealthy so that he can afford sophisticated counsel, he too is considered sophisticated. Care must be taken so that securities do not fall into the hands of unsophisticated investors even after the initial sale.⁹

Variation from the typical investor depends to a large extent upon how the investors are found. When a stock brokerage house locates the investors, they are likely to be extremely wealthy as a result of investment income. Recently when the Development Corporation of America checked who had purchased its limited partnership interests, handled through Kidder-Peabody, it found that virtually all were in a 70 percent tax bracket.¹⁰ The tax shelter in the case of the Roxbury Action Program's Rap-Up I all went to the partners in the law firm handling the case.¹¹ When lawyers and accountants make the placement, the investors are likely to be clients, who have an income through earnings or investments in excess of \$50,000. When members of the organization serving as the general partner locate the limited partners, the wealthy people they are most likely to know are doctors and dentists.

When the National Housing Partnership serves as a limited partner, the tax losses are passed on to the nation's largest industrial firms, insurance companies, and banks.

The structure of the transaction will also help to determine the type of investor. When a community group is the general partner, a more socially motivated breed of investors might be attracted. Whether this social motivation will allow them to accept a lower rate of return, or whether it would merely give them some after-the-fact satisfaction, remains to be seen.

How wealthy and how sophisticated an investor is will determine the type of transaction he will accept. The most sophisticated potential investors, i.e. persons knowledgeable in real estate, will rarely enter a partnership structured by anyone else, simply because they would have enough tax shelters of their own.¹² Among those investors who do enter limited partnerships, the most sophisticated and most wealthy will be most conscious of when payments will have to be made and received. Their discount rate, i.e. the value they place on having money over time will be higher than that of the typical investor. The longer they can defer the heavy tax which occurs on the eventual sale of the property, the better off they are.

Relatively naive investors often will check the profitability of a transaction by adding up the cash payments required of them and adding up the benefits accruing to them and compare the two sums without regard to when they occur.¹³ Investors in relatively low tax brackets, i.e. approximately 50 percent, prefer guaranteed dividends more than those in higher brackets. Such profits are taxed at only 50 percent rather than at 70 percent.

The age of the investor and the certainty of his future earnings would determine whether he would invest in a rehabilitation tax shelter or some other form of tax shelter. The rehabilitation tax shelter appeals most to a high bracket investor in his mid-fifties.¹⁴ Such an investor

would be able to take the profits from his investment during the first six years and defer sale until his death. At this time his heirs would be entitled to a step-up in basis, thus avoiding a gains tax on the depreciation already taken.

Rate of Return to Investors

The amount a developer can ask from investors depends upon how much an investor can receive from the Government in the form of tax shelter less the rate of return expected by the investor. On a low income rehabilitation project, investors in a 50 percent tax bracket expect, as a rule of thumb, a 25 percent rate of return. Investors in higher or lower brackets pay the developer the same capital contribution, but retain from the Government a higher or lower rate of return.

The rate of return to investors has little to do with the total amount of tax shelter available. Before the enactment of Section 167(k) investors in rehabilitation projects received nearly 25 percent on their money.¹⁵ Developers charge as much for limited partnership interest as the market will bear. The amount that investors will pay depends upon the risks they perceive in comparison to alternative investment opportunities available to them. To evaluate the appropriateness of a 25 percent after tax rate of return (or any rate of return) requires looking at what alternative investments will yield and what the elements of risk are.

If low income rehabilitation tax shelters were risk-free, their return would approach that given on the safest tax-free bonds or about 4 percent. Alternatively, this amount roughly represents the impact of inflation during normal years. Bonds, however, are more liquid than tax shelter. While a bond can be readily traded on the stock exchange, the

transferability of limited partnership interests is generally limited to avoid having the partnership be taxed as a corporation.¹⁶ To sell his interest in a project an investor must first find another buyer generally at the cost of a discount, a commission, or considerable effort. In most limited partnerships the general partners must unanimously approve the substitution of a limited partner. Overall, this difference in liquidity is worth approximately an additional 2 percent rate of return.

Risks

The rate of return afforded investors in excess of the inflation and liquidity factors is a function of risk. Part of the risk relates to the financial situation of the individual investor, part relates to the will of Congress, and the bulk relates to the project itself.

Regardless of the financial success of the project, an investor must worry about the fluctuations in his own income. His rate of return is based upon his tax bracket. Should his income decrease significantly during one of the first six years his tax benefits would decrease. A drop in bracket from 50 percent to 30 percent during one of the five years of accelerated depreciation would cost investors owning the entire Newcastle project about \$41,000. This loss would cut the rate of return to about 20 percent. Risk on the downside during the period of maximum depreciation is reduced to the extent that the investor is able to resell his interest.

The bracket for any investor with income from capital may also increase during this period to as high as 70 percent and increase the rate of return. Some investors may be in a 70 percent tax bracket throughout the life of the project, in which case their rate of return would be about 50 percent, assuming no tax preference items. Fluctuations in tax

bracket after the sixth year have a relatively insignificant effect on the rate of return on the project. From this point on, the risk is in having too high a tax bracket. The only substantial tax or tax savings occurs in the year of sale. The large capital gain will automatically put the investor in a high tax bracket. The present value at a 4 percent discount rate, of the difference between the computed 30 percent capital gains tax and the maximum gains tax of 35 percent on the sale of the project in the 20th year for the mortgage balance is about \$3000 or the equivalent of a 0.1 percent difference in the rate of return.

Another factor relating primarily to the taxpayer that can reduce the effective rate of return to the investors is the minimum tax on preference items. The 1969 Tax Reform Act places a limit on the amount of tax shelter an investor can take.¹⁷ Accelerated depreciation from 167(k) as well as long-term capital gains has been labeled as a tax preference item. If the amount of the tax preference items exceeds by more than \$30,000 the amount of tax which the investor normally pays, then the investor must pay a minimum tax in addition to his normal tax. This minimum tax is equal to 10 percent of the excess.

Confidential memoranda to investors generally state words to the effect of, "These projections do not include consideration for tax preference items. Consult your tax counsel for their effect in individual cases."¹⁸ Those projections which do show a consideration for tax preference items, show an extreme reduction in the rate of return. One memorandum assumes that all tax preference items are subject to the minimum tax. In this case this assumption reduces the rate of return to an investor in a 50 percent bracket from 34 percent to a rate of return of 7 percent.¹⁹ David Judelson shows that full consideration of tax preference income reduces the rate of return for an investor in a 50 percent bracket from 25 percent to a rate of return of 11.8 percent.²⁰

However, for the typical investor, the impact of the tax on tax preference items is minimal. As seen before, the U.S. Treasury found that the average passive investor in real estate had an earned income of \$140,000. He had an average of \$77,500 in deductions in excess of real estate income. For the Newcastle case, for the same amount of deductions an investor would have to buy approximately a one-quarter share in the project. In this case his total net deductions during each of the first five years of depreciation would be about \$72,000. (See Table F-I) His tax preference items would be \$56,000 in excess depreciation. The combination of the ordinary tax he pays and the \$30,000 exemption makes his minimum tax only about \$100 in each of these five years and nothing in all other years.

Table E-I Tax Preference Items--One-Quarter Share in Newcastle Project

	1	2-6	7-19	20
a. Year span	1			
b. Depreciation	0	75,000	100	100
c. Straight line depreciation (20 year useful life)	0	19,000	100	100
d. Excess depreciation (line b minus line c)	0	56,000	0	0
e. Capital gains	0	0	0	82,000
f. Total tax preference items(line d plus line e)	0	56,000	0	82,000
g. Earned income	140,000	140,000	140,000	140,000
h. Project taxable income	(33,000)	(72,000)	2,000	88,000
i. Total taxable income (line g plus line h)	107,000	68,000	142,000	228,000
j. Tax	53,000	25,000	60,000	110,000
k. Income subject to minimum tax (line f minus line j minus \$30,000)	0	1,000	0	0
l. Minimum tax (10 percent of line k)	0	100	0	0

Another risk to the investors which is unrelated to the project is the risk that Congress will change the existing legislation or that the IRS will change its existing regulations. The only way in which such changes are at all likely to affect ongoing partnerships is in the tax consequences on sale. Total elimination of this liability is at least as likely as any increase in it.

Two types of risks are directly related to the project--failure to receive the projected dividend and foreclosure. The FHA limits the cash dividend to 6 percent of the implied equity. Since the true equity of investors is 32 percent of the mortgage instead of 11.11 percent of the mortgage, the maximum dividend per year is about $2\frac{1}{2}$ percent of the equity or $1\frac{1}{4}$ percent after taxes. The real value of the dividend rests with the fact that the dividend is payable in 19 out of 20 of the years of the project²¹ while the investors have their investment paid back after 5 years. Thus, the difference between a "6 percent" dividend and no dividend is worth about $5\frac{1}{2}$ percent of the true equity after taxes.²²

Payment of at least some portion of the dividend is guaranteed in some partnerships. The Development Corporation of America, for instance, will subordinate up to 60 percent of the management fee it is entitled to receive to insure that the investors receive at least an average of a 3 percent dividend.²³ When a community group serves as developer and manager the probable resolution of the conflict between paying the full dividend and raising rents or reducing project services is in favor of the tenants. The one advocate on the behalf of the investors in this conflict may be the FHA or its local counterpart. Still, every dollar spent on maintenance or on reduced rents serves the interests of the investors by reducing the chances of foreclosure.

A developer can retain for himself a share of the dividend but only at the expense of depriving the limited partners of a corresponding share of the tax shelter. Section 704 of the Internal Revenue Code states that

all items of income, gain, loss, deduction, or credit shall be allocated to the partners in the manner described in the partnership agreement. However, allocation of deductions will be made in accordance with the partner's distributive share of taxable income or losses if:

the principal purpose of any provision in the partnership agreement with respect to the partner's distributive share of such item is the avoidance or evasion of any tax imposed by this sub-title.

IRC Sec. 704(b)2

The test for whether the principal purpose is tax evasion is whether the allocation has "'substantial economic effect' that is, whether the allocation may actually affect the dollar amount of the partners' shares of the total partnership income or loss independently of tax consequences."²⁴

Community groups with no substantial assets will sell all or nearly all of the tax shelter.²⁵ Wealthier developers needing some tax shelter themselves, will generally sell only about 80 to 90 percent of the interests in the project. In calculating the value of the capital contribution, this paper will assume that 100 percent of the profits, gains and losses are sold to limited partners. Any portion held back has at least this much value to the developer.

The bulk of the return to the investors comes from the U.S. Treasury. The only effect that the project would have on these returns would be in the event of a calamity. The important risks are whether the rehabilitation can be successfully completed within the mortgage and equity amounts; whether the apartments will be able to be rented up to qualified tenants; and whether the income generated from the project will be sufficient to keep the mortgage from being foreclosed.

The risks attendant to construction in a large measure depend upon the skill, the financial security, the motivation and the bonding capacity of

the contractor. A highly skilled contractor is more certain to complete the project for under the cost to which he agrees.

Where cost overruns occur as a result of unforeseen construction difficulties or labor problems, the financial ability of the contractor to fulfill his commitment is important. Alternatively, the general partner might agree to meet any cost overruns not met by the contractor. The desire to secure additional work is usually a sufficient motive for him to finish the job within the budgeted amount. Should some calamity occur before the construction is completed, the bond will usually protect the contractor and the investor although project expenses will undoubtedly increase. Contractors who have not demonstrated the ability to complete projects are usually unable to secure sufficient bonding. Investors use bonding capacity as a measure of skill, financial ability, and experience.²⁶

The fact that most of the capital contribution is not payable until the completion of construction further reduces the risk to the investor. Of the 1840 projects which have been insured by FHA under either the 221(d)3 or 236 programs only 5 have been taken over by the FHA before the completion of construction.²⁷

Initial rent-up of 236 housing, unlike some unsubsidized housing, is not a significant risk. When the interest is subsidized down to 1 percent and the cash profit is limited, the rent charged for the apartment is certain to be well below the market level for an equivalent unit in the area. With the scarcity of funds available for 236, the FHA is unlikely to approve a project in a location which cannot be rented. Virtually every 236 project in the country has a waiting list. Deferment of a portion of the capital contribution until after 95 percent occupancy has been obtained reduces this risk to the investor.

One further risk to the investor results from an interagency discrepancy of regulations. The definition of income by the I.R.S. under 167(k) conflicts with the one of HUD under 236. The proposed regulations on 167(k) state that upon admission, the income of the household must be less than 150 percent of the income allowable for a household of that size in public housing or else the investor cannot take accelerated depreciation on that unit. The definition of income means gross income during the previous taxable year less trade or business expenses allowed under Section 162.²⁸

The income limitations for occupancy of a 236 project are set at 135 percent of public housing limits during the initial rent-up period. However, the definition of income under Sec. 236 allows a \$300 deduction for each minor, a 5 percent deduction for unusual income (social security and withholding), exclusion of unemployment compensation which does not occur regularly, and exclusion of wages earned by someone no longer with the household. A family can have a net income which is less than 135 percent of public housing limits to qualify under Section 236 but still have a gross income of more than 150 percent of public housing limits and not qualify that unit under 167(k). Further, once the 236 project has been fully rented, the income limits for admission increase to 90 percent of 221(d)3 limits or to 160-180 percent of public housing limits, clearly in excess of the 150 percent limit. To avoid losing depreciation benefits, the investor must protect against the general partners' admission of unqualified tenants. Some investors insist upon a penalty clause to prevent the general partner from admitting such tenants. Other partnership agreements allow for the admission of one or more unqualified tenants. Once a tenant has been admitted, his income can increase without restriction.²⁹

Investors worry that even though the particular project may be sound, vandalism, fires, and riots present in the neighborhood may affect their

project.³⁰ When disasters occur which directly destroy the particular project, the investors are largely protected. Proper insurance is compulsory under 236. Section 1033 of the Internal Revenue Code allows an investor to avoid any tax on the compulsory or involuntary conversion of property as the result of destruction in whole or in part, or of condemnation. Similar to the 1039 rollover Sec. 1033 requires the investor to reinvest the proceeds within a two year period in a similar project. If, for example, a property burns down, reinvestment of the insurance proceeds in similar property will avoid tax liability. The "similar property" can be any real property, improved or unimproved.³¹ The only precaution that the investor need take is that the cost of the second project, including the mortgages, be at least as great as the amount of taxable gain realized from the insurance proceeds. By using the bulk of the insurance proceeds to pay off the mortgage on the first project and the remainder to invest in other heavily mortgaged property, the investor will defer tax liability.

The Risk of Foreclosure

The consequences of foreclosure pose the most serious threat to the investor. The effect is the same as a sale at the mortgage balance. Should foreclosure occur within the first five years after occupancy the investor will lose part of the depreciation he had expected. Its occurrence at any time before the one hundredth month will subject the investor to full recapture of the "excess depreciation" he has taken. Its occurrence at any time between the one hundredth and two hundredth month will subject the investor to partial recapture of this depreciation. Table D-IV shows the rate for a foreclosure in each year.

While the FHA is said to be reluctant to foreclose, their foreclosure rate for moderate income, multi-family rehabilitation projects has been

quite high.³² As of June 30, 1970, under the 236 program no foreclosures had occurred out of 39 rehabilitation mortgages and 3073 dwelling units.³³ However, under the 221(d)3 program (the predecessor to the 236) the FHA had foreclosed upon or taken in lieu of foreclosure 18 of 172 rehabilitation projects representing 955 out of 12,277 dwelling units. The combined foreclosure rate for both programs has thus been 6.2 percent based upon dwelling units. Many of the mortgages still in force have only been in existence for 1 or 2 years. The 221(d)3 program is only 10 years old; the 236 program is only 3 years old. Projecting the foreclosure rate over a 10 year period for each project would increase the rate to 22.7 percent. All of these foreclosures have occurred in Chicago, Washington, D.C., or Roxbury. How many of these are the result of a calamity or involuntary conversion is not known. For new construction no foreclosures had occurred out of 284 mortgages and 58,199 dwelling units under the 236 program, and only 20 foreclosures out of 1184 projects (2848 out of 146,880 dwelling units) under the 221(d)3 program. The total foreclosure rate for new construction has thus been 1.4 percent based upon dwelling units. The total break-down of foreclosures between non-profits, cooperatives, and limited dividends has been roughly proportional to the total number of projects in each category.

The tax consequences of a foreclosure combined with its high incidence in rehabilitation projects poses severe risks to the investor. Table E-II shows the probability of a foreclosure in a given year and the overall rate of return accruing to an investor if a foreclosure does occur in a given year. The weighted average rate of return is only 4.4 percent allowing for foreclosures compared with 25 percent disregarding them. This rate is barely enough to compensate investors for the effect of inflation let alone their loss of liquidity, risks on the cash flow, and risks of a drop in bracket and change in laws.

Table E-II Effective Rate of Return to Investor in FHA-Insured Multifamily Rehabilitation Projects Assuming Projected Return of 25 Percent

n (year)	A Units insured for at least n years ¹	B Units foreclosed by year ²	C Probability of fore- closure in year n*	D Rate of return if foreclosure in year n**	E Effective rate of return***
1	11,600	184	.016	-.50	-.01
2	7,300	225	.031	-1.50	-.05
3	4,700	54	.011	-1.40	-.02
4	3,500	81	.023	-.80	-.02
5	2,800	143	.050	-.50	-.03
6	2,200	200	.089	-.35	-.03
7	1,800	32	.018	-.25	-.00
8	1,400	0	0	-.15	0
9	1,000	0	0	-.05	0
10	700	0	0	.05	0

Projects earning maximum return

Total			.762	.25	<u>.19</u> .04
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* Column B divided by column A

** Computed by discounting capital contributions and cash flows on Newcastle Project at various rates until their present values are equal

*** Column C multiplied by column D

1. The total number of rehabilitation units is taken from the U.S. Department of HUD "0-2" forms through July 31, 1970 for 236 and 221(d)3 projects. The distribution of rehabilitation units per year has been assumed to be proportional to the total number of units insured by year in these programs as supplied by the FHA Bureau of Research and Statistics

2. FHA Bureau of Research and Statistics.

The one possibility for profit to the investors which is not included as part of the rate of return is the proceeds from the eventual resale of the project. Generally the sales price is assumed to be only \$1 over the outstanding mortgage. The value of the project to another buyer is limited by the fact that 125 percent declining balance is the most accelerated method of depreciation available on used property and by the fact that FHA limits dividends to 0.667 percent of the original mortgage. As seen previously, realtors generally estimate a fair sales price on a reasonably risky property by multiplying six times the pre-tax dividend generated by the property and adding the product to the value of the outstanding mortgage. If the project were earning the maximum dividend, the estimated sales price would thus be only 4 percent of the original mortgage plus transfer of the outstanding mortgage. Even if this amount does materialize, the duration of 20 years makes its present value insignificant.

The only instance when the residuals would be significant would be if the value of the land appreciated considerably and the FHA allowed the project to be refinanced. Such occurrences are highly unlikely given the areas where rehabilitation generally occurs. Most limited partnerships provide for the reduction of the limited partners' shares in the residual to about 50 percent of their pre-sale shares to reduce the profit to the investors in such a case.

If the record of syndicated rehabilitation projects conforms to that of previous projects in terms of the incidence of foreclosures and of other elements of risk, then the rate of return demanded by investors as a rule of thumb should climb. Assuming that a 25 percent rate of return is sufficient compensation for the risk of foreclosure and the effects of inflation, then added to this amount should be about 3 percent for the risk of a smaller cash dividend, another 2 percent for the loss of liquidity, and

approximately another 3 percent for the other assorted risks. A total rate of return of about 33 percent would thus seem appropriate.

Even with the rule of thumb being a 25 percent rate of return, investors demand a considerably higher rate on projects they perceive as being relatively risky. Investors look to an established developer, general partner, and management agent as signs of a secure project. These groups have reputations to protect. The Roxbury Action Program (RAP), a tenant-oriented group, had no experience as the developer and general partner in RAP-UP I. They are delegating the management to the tenants. Consequently, investors demanded and received a 49.7 percent rate of return on that project.³⁴

Developers with substantial assets often make implicit guarantees against foreclosure by holding a high percentage of the partnership interests for themselves. Investors know that a developer who must suffer from recapture on a foreclosure will find it in his self interest to put in a considerable amount to keep the project alive.

The Emergency Tenants Council (ETC), an organization without substantial assets, is serving as developer and manager of their first project. By making the contractor a general partner and by providing certain guarantees, ETC has been able to make the project appear secure enough that investors will take only a 26 percent rate of return. The general partners have agreed to hold \$70,000 of the syndication proceeds in escrow to guard against operational losses. Upon payout of more than \$40,000 of this amount, ETC forfeits its right as property manager and the contractor can appoint a new management agent. The general partners have further guaranteed the completion of construction and have agreed to refund the capital contributions if construction is not completed within a specified length of time.

Amount of Capital Contribution

Calculation of the maximum capital contribution by the investors for a given rate of return requires a sophisticated knowledge of how investors think as well as what the IRS will allow. Generally, investors will not discount the losses that occur in the later years at the same rate as they expect to receive profit. While investors may be able to invest in other ventures and earn a 25 percent or higher rate of return, they cannot do so without incurring new risks. They can, however, expect to earn a certain amount over time without risk. The after-tax rate of return to an investor (assumed to be in a 50 percent tax bracket) on the safest tax-free bonds is about 4 percent. Sophisticated brokers and developers assume that investors can put a portion of their early earnings aside in a sinking fund which will grow with accumulated interest to be exactly large enough to pay for the losses in the later years. The effect of assuming a sinking fund with interest at 4 percent as compared with assuming that no interest will be earned during this period increases the capital contribution by about 20 percent.³⁵

Another means of increasing the capital contribution is to phase the payments coming to the developer and make him assume some of the risk. Thus, rather than ask for the entire capital contribution at the time the investor agrees to join the partnership, a sophisticated developer will accept only one-third of it then, one-third at the completion of construction assumed to be about a year later, and one-third upon the renting of at least 95 percent of the units assumed to be still another year later. This type of phasing reduces the investor's risks at two key points. In the meantime the investors can put their money to use elsewhere. Assuming a 25 percent rate of return to the investors, phasing the capital contribution over three payments will increase the capital contribution by 23 percent.

The calculated value of the capital contribution using a 25 percent rate of return is \$398,600.³⁶ The contribution is phased over two years including three payments of \$132,900 each. The capital contribution thus equals about 32 percent of the mortgage. Based upon a 33 percent rate to the investor the capital contribution would be about \$320,000 or about 25 percent of the mortgage, phased over two years.

FOOTNOTES

1. Much of this section appeared in Betnun and Judelson, op.cit., but was written by the present author.
2. U.S. Treasury, Tax Reform Studies, p. 444.
3. The discrepancy between a 66 percent bracket and a 60 percent savings occurs because a "tax bracket" is a loose term for a marginal tax rate.
4. I.R.C. Sec. 1348.
5. The Federal Securities Act of 1933 defines "securities" to include an "investment contract" and a "participation in any profit sharing agreement" (Sec. 2(1)). In SEC v. W.J. Howey Co. 328 US 293,293 (1946), the Supreme Court defined "investment contract" in this context as "a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party." Clearly, the sale of a limited partnership interest for low income housing is a security.
6. Federal Securities Act, Sec. 2(1).
7. Ibid., Sec. 24.
8. Robert Haft, Practicing Law Institute Conference.
9. Exemption from registration with the SEC does not imply exemption from the anti-fraud provisions of the Federal Securities Acts. Section 10b-5 of the 1934 Act states:

It shall be unlawful for any person, directly or indirectly, in the use of any means or instrumentality of intrastate commerce or of the mails, or of any facility of any national securities exchange,

- (1) to employ any device, scheme, or artifice to defraud,
- (2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, not misleading,
- (3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase of any security.

Section 12(2) of the 1933 Act is the equivalent to subparagraph 2 of 10b-5. The effect of these provisions is to require confidential memoranda to investors to be complete and honest portrayals of all material facts relevant to the offering rather than be simply a sales pitch. In other words, all of the risks to the investors must be mentioned. Should any limited partner ever lose money for a reason not hypothesized in the confidential memorandum, anyone associated with the issuance of the security could be held liable. For a more complete discussion of this and other exemptions see Betnun and Judelson, op.cit., pp. 19-24; see also Judelson, op.cit., pp. 31-38.

10. Harold Grabino, seminar at M.I.T., January 22, 1971.
11. Hank Gutman, seminar at Harvard Law School, December 3, 1970.
12. Harold Howell, Boston Financial Technology Group, interview.
13. Ibid.
14. Ibid.
15. According to Ralph Cole of Continental-Wingate, one of the few firms which syndicated rehabilitation projects both before and after 167(k), the return to investors has increased slightly but more out of a greater awareness of risks than amount of money available.
16. For a more complete discussion of this matter, see Betnun and Judelson, "Tax Incentives," pp. 9-15; see also Judelson, "Incentives and Subsidies," pp. 21-28.
17. IRC. Sec. 57
18. Practicing Law Institute, Subsidized Housing, p. 375,507.
19. Ibid., pp. 281-283.
20. "Tax Incentives", p. 114.
21. No dividend is paid in the year of construction
22. The real significance of the dividend is in helping to keep the I.R.S. from declaring the creation of the partnership as a transaction not entered into for profit. In Knetsch v. United States 364 US 361, the plaintiff constructed a deal so blatantly and purely for tax reasons that the Court ruled that a transaction must have economic substance otherwise it is tax evasion. Section 183 of the Internal Revenue Code precludes any deductions in excess of income on any activities not engaged in for profit. Presumably such activities engaged in by partnerships are also affected. The I.R.S. has applied this provision to prevent owners of hobby horses from deducting the cost of these horses as though it were a business expense. No test is given in the statute for what constitutes an "activity not engaged in for profit," but the statute does create the presumption that when in two or more of a period of five consecutive years the gross income of an activity exceeds the deductions attributable to it, such activity is engaged in for profit. Whether an activity like low income housing rehabilitation, with deductions in excess of income for a five year period, is considered an "activity not engaged in for profit", is unclear in the statute. Limited partnerships using accelerated depreciation generally allow for the possibility of some cash profit; none have been denied deductions on Section 183 grounds.
23. Harold Grabino, seminar at M.I.T., January 22, 1971
24. I.R.C. Reg. Sec. 1.704-1(b)(2).

25. Some legal questions exist as to whether a developer is a bona fide member of the partnership if he sells 100 percent of the interests in the partnership to limited partners. (Interview with Fred Becker, Ropes and Grey) However, the Roxbury Action Program sold 100 percent of the interests in Rap-Up I without any questions being raised by the IRS.
26. Milton Young and Stephen Ziegler, letter, p. 13
27. HUD, "0-2 Reports," as of June 30, 1970.
28. Proposed regulations Sec. 1.167(k)-3(b)(3).
29. Proposed Internal Revenue Code Regulation 1.167(k)-3(b).
At a conference of the Tax Section of the New York State Bar Association Assistant Secretary of the Treasury Edwin S. Cohen stated that the final regulations on 167(k) are likely to allow the option of admitting persons who meet the 236 exception income limits.
(U.S. Department of the Treasury, News, January 28, 1971, pp. 10-11.
30. Young and Ziegler, letter, p. 14.
31. I.R.C. Reg. Sec. 1.1033(g)-1(a) and 1.1031(a)-1(b).
32. Curtis Burger in "Slum Area Rehabilitation" (pp. 756-57) claims that FHA will never foreclose provided the management is making an honest attempt to collect rents and provide at least minimal services.
33. U.S. Department of HUD, "0-2" forms.
34. James Morey and Mel Epstein, "Housing Development: A Tool for Community Economic Development in Low Income Areas," p. 25.
35. David Judelson, "Incentives and Subsidies," p. 81.
36. See Appendix for a derivation of the formula to calculate the capital contribution and for the calculations in this case.

F. DEVELOPERS PROFIT

This chapter determines the profit which the developer of the Newcastle project would receive. The various project expenses are subtracted from the syndication proceeds to determine the net amount receivable by the developer. To determine the appropriateness of this level of profit, a comparison is made with the profits possible from a 236 new construction project.

Net to the Developer

The primary expenses entailed by a developer which are not provided for in the mortgage are the project equity, the syndication broker's fee, the contractor's profit, and an amount to make the project operational. While the full project equity is equal to 10 percent of the total development costs or \$139,100 in this case, most of this amount is met by the Builder's and Sponsor's Profit and Risk Allowance (BSPRA). This allowance is valued at 10 percent of all costs other than land. In the Newcastle case it is worth \$126,000. Thus, the total cash equity required in this case is only the \$13,000 difference between the full equity and the BSPRA.

The syndication broker's fee is generally approximately 20 percent of the full capital contribution, payable as the payments are made by the investors. Their fee includes legal, accounting, and at times real estate appraisal fees.¹

Contractors on 236 rehabilitation projects generally receive a profit of about 8 percent of the construction costs.² This amount is in addition to the 2 percent overhead included in the mortgage. In the present case a developer would have to pay the contractor about \$80,000. The amount to make the project operational may or may not have to be paid. This amount is the cost of all operation expenses incurred prior to full

occupancy. It may include certain financing fees not included in the mortgage. A non-profit sponsor is allowed to add 2 percent to the mortgage in consideration of these costs. Two percent of the Newcastle mortgage would cost its developers \$33,800. The total discounted net compensation to the developer is thus \$193,000. (See Table F-I)

The developer's profit is likely to be subject to taxation. However, that portion of the fee used for project-related items such as overhead and salaries, would escape taxation. A non-profit corporate developer with tax-exempt status under IRC Sec. 501(c)3 may be able to avoid taxation entirely. It must show that the generation of the syndication proceeds is related to the charitable purpose of the organization and that the use to which the money is put is a charitable one.³ Regardless of the acceptability of these arguments, the developer's fee on most projects will be taxable. Assuming a tax at one-half of corporate rates, i.e. at 24 percent, would cut the after-tax, discounted profit to \$146,600. This return is more a compensation for services rendered than a return on equity capital, although the equity risks are significant.

Based upon the rate of return to the investor found to be most comensurate with his risks, 33 percent, the net to the developer would be considerably reduced. As seen before the capital contribution would be \$320,000. The net to the developer would then be \$132,500 before taxes or \$100,700 after taxes. (Table F-I)

The developer must maintain his own or another general partner's net worth at 15 percent of the total value of the capital contributions made by the investors.⁴ Otherwise the IRS could rule that the general partner is a dummy and that the limited partnership be taxed as a corporation. While this is only a "safe harbor" rule, lawyers for the limited partners insist that it be followed. In no way does the rule limit the amount of

Table F-I Net Benefits to the Developer - Rehabilitation

Mortgage = 1,252,000	At 25% to Investor		At 33% to Investor	
	Amount	Present Value @4%	Amount	Present Value @4%
Capital Contribution				
Payment 1	132,900	132,900	106,600	106,600
Payment 2	132,900	127,800	106,700	102,500
Payment 3	132,900	122,900	106,600	98,600
BSPRA *	126,000	121,100	126,000	121,100
Project Equity	(139,000)	(133,800)	(139,000)	(138,800)
Broker's Fee				
Payment 1	(26,600)	(26,600)	(21,300)	(21,300)
Payment 2	(26,600)	(25,600)	(21,400)	(20,400)
Payment 3	(26,600)	(24,600)	(21,300)	(19,700)
Contractor's Profit	(80,000)	(76,900)	(80,000)	(76,900)
AMPO **	(25,000)	(24,200)	(25,000)	(24,200)
Net Profit before Taxes		193,000		132,500
Tax @ 24%		<u>46,400</u>		<u>31,800</u>
Net Profit after Taxes		146,600		100,700

* Builders and Sponsors Profit and Risk Allowance

** Amount to Make Project Operational

profit accruing to the developer but it does limit the amount of profit which can be spent by an impecunious developer.

Comparison with New Construction

Virtually from the start of the 236 program the demand for funds by developers has far exceeded their supply. The waiting list for these funds is several months in almost every part of the country. No evidence exists that Congress has expanded or will expand the supply of 236 funds because of the enactment of 167(k). Rather, Congress understood 167(k) to work with conventional financing.⁵ Allocations of 236 funds depend more on fiscal and political considerations than they do on the demand by developers for funds.

Prior to the 1969 Tax Reform Act the FHA had financed only 214 rehabilitation projects compared with 1466 new projects under Section 221(d)3 or 236. Of the rehabilitation projects 122 were done by non-profit sponsors and 28 were done as a result of the special processing and other incentives provided by the Boston Rehabilitation Program (BURP).⁶ The extent to which the increased profit available on rehabilitation projects will increase the proportion of units rehabilitated under the 236 program depends upon the relative profitability of rehabilitation compared with new construction.

Given the same developmental costs on a 236 new construction project and on a 236 rehabilitation project, the only components of the net profit to the developer which would differ on the two would be the capital contribution, the broker's fee, and the contractors profit. A sophisticated developer is likely to receive 18 percent of the mortgage, or \$234,700, as a capital contribution were he to sell 100 percent of the interests in the project.⁷ The broker would keep 20 percent of this amount, or \$79,800.

Table F-II Net Benefits to the Developer - New Construction

Mortgage = 1,252,000

	Amount	Present Value @4%
Capital Contribution		
Payment 1	78,200	78,200
Payment 2	78,200	75,200
Payment 3	78,300	72,500
BSPRA *	126,000	121,100
Project Equity	(139,000)	(133,800)
Broker's Fee		
Payment 1	(15,600)	(15,600)
Payment 2	(15,600)	(15,000)
Payment 3	(15,700)	(14,500)
Contractor's Profit	(50,000)	(48,100)
AMPO **	(25,000)	(24,200)
Net Profit before Taxes		95,800
Tax @ 24%		<u>23,000</u>
Net Profit after Taxes		72,800

* Builders and Sponsors Profit and Risk Allowance

** Amount to Make Project Operational

The return to the contractor is generally higher on rehabilitation projects than on new construction. Contractors generally expect only 5 percent profit plus 2 percent overhead on 236 new construction compared with 8 percent and 2 percent on rehabilitation.⁸ The general overhead expense is a cost certified part of the mortgage; the profit comes out of the Builders and Sponsors Profit and Risk Allowance otherwise going to the developer. In the Newcastle case where construction costs are \$1,000,000 the difference between paying the contractor an 8 percent profit and paying him 5 percent is \$30,000 to the developer.

Certainly the risks to the contractor on a rehabilitation job are greater. Virtually every commentator on the rehabilitation process has cited the fact that costs cannot be accurately estimated until after the work has begun and walls and floors have been removed.⁹ Generally the profit is based upon the estimated cost of the project but the contractor often must bear the risk of meeting any cost overruns. Another factor making rehabilitation more risky than new construction is the level of skill required by the work force. The level of tolerance to fit new pieces onto old sections is much lower. A further problem for the contractor is the fact that the size of the job is likely to be smaller on rehabilitation than new construction and the work sites more dispersed. For all of these reasons most large contracting companies have avoided rehabilitation jobs.

Summing all of the benefits and disbenefits to the developer yields a net profit before taxes of \$95,800 (See Table F-II). This amount compares with \$193,000 or \$132,500 available on rehabilitation depending upon the return to the investor. In other words, rehabilitation is either 2.0 or 1.4 times as profitable as new construction for the same size project.

Still, for the same amount of effort a developer can generally develop more units of new construction requiring higher costs per unit. In most

cities vacant land can be assembled more readily than clusters of buildings of a similar type and in a similar state of disrepair. The amount of profit a developer receives is a function of the size of the mortgage. The average 236 rehabilitation project has had 79 units and a mortgage of \$1,167,500 (\$14,820 per unit). The average 236 new construction project has had 132 units and a mortgage of \$1,977,700 (\$15,030 per unit). In those cities where 236 rehabilitation has occurred the average new construction project has had 151 units and a mortgage of \$2,599,000 (\$17,200 per unit).¹⁰ Thus, the average new project has had a mortgage 1.7 times as great as the average new construction project. Those new projects in cities with rehabilitation activity have had mortgages 2.2 times as great as on rehabilitation.

The amount of administrative processing time and effort is similar for any FHA multifamily project regardless of its size. Robert Whittlesey estimated that administrative costs to obtain a \$50,000 mortgage have been as high as \$12,900.¹¹ Only a slight amount more administrative time and money could have led to the construction of several hundred units of new construction. Regardless of the size of the project the same steps have to be traced through the various governmental agencies and the same delays occur.

From the foregoing analysis more developers are certainly going to be attracted to rehabilitation. The popularity of the new Project Rehabilitation program would substantiate this claim. However, the profit to the developer of the typical new 236 project is still likely to be greater than that on the typical 236 rehabilitation. The factor of 2.2 for the differential in size between the two types of projects within the same set of cities is greater than both the factors of 2.0 and 1.4 for the differential in profit on equivalent size projects using different

assumptions for the rate of return to investors in rehabilitation.

FOOTNOTES

1. According to the experience of William McGuire of the Duke Power Company, brokers charge a minimum of 10 percent (seminar at Harvard Business School). Kendall Lutes of the Wall St. brokerage firm, Kendall Lutes Lutes & Co. stated that the fee is 20 percent (conference of the Practicing Law Institute). Roger Evans of the Law firm, Ropes & Grey, claims that the usual fee is 33 percent.
2. Interview with Roger Evans, Ropes and Grey.
3. See Judelson, op.cit., pp. 91-99.
4. The Tax Lawyer, p. 666.
5. See p.37, note 7 supra.
6. U.S. Department of HUD, "0-2" Forms, through July 31, 1970.
7. See p.51 supra.
8. Interview with Roger Evans, Ropes & Grey.
9. See statement of Professor Davenport during the hearings on 167(k) p. 4903; U.S. President's Committee on Urban Housing; A Decent Home, p. 108. Milton Young, letter, pp. 11-12, quoting letter of former Secretary Robert Weaver to the Senate Committee on Baring and Currency; interview with Lawrence Smith, United Community Development, Inc.
10. U.S. Department of HUD, "0-2" forms, through July 31, 1970.
11. The South End Row House, p.p. 5-12.

G. COST TO THE TREASURY

Thus far this thesis has shown that the five-year write-off has costly elements. Section 167(k) has been seen to only be feasible in conjunction with a subsidized mortgage, generally under the 236 program. The tax incentive brings in securities brokers who demand a sizable profit. Investors in 50 percent tax brackets demand and receive a 25 percent rate of return. This chapter will add up these and other costs to the Government so that comparison can be made between various elements between rehabilitation and new construction and between alternative systems.

Cost of Tax Shelter

The total discounted tax revenue foregone is the sum of the tax savings each year to the investors. This amount, of course, depends upon the average tax bracket of the investors. While 50 percent is the marginal tax bracket at which the market is geared, investors can be in higher brackets. Securities laws and the inability to earn a high return preclude investors in lower brackets. Beginning in 1972 the maximum tax on earned income will be 50 percent. Most people who are capital wealthy pay most of their taxes in the form of capital gains. Approximately 80 percent of the clients of Boston Financial Technology Group, a firm marketing housing tax shelters exclusively, are earned-income wealthy. They account for 60-65 percent of the dollar volume. Assuming that the other 35-40 percent of the investments are made by investors in a tax bracket which enables them to deduct 60 percent of the value of the losses from a project,¹ the average tax bracket is about 54 percent.

The appropriate discount rate for the Government depends upon the type of analysis being made. For purposes of comparing the tax route with more direct systems of finance, the interest which must be paid to obtain funds

directly is the appropriate discount rate. The Treasury can sell bonds at about 6 percent and collect a tax on the interest it pays out. Including the taxes receivable on interest, the alternative cost to the Treasury is about 4 percent. For purposes of determining whether the tax incentive is appropriate at all, the cost of taking money out of the private sector is the appropriate discount rate. Economists generally suggest that this rate is between 8 and 10 percent.²

As Table G-I shows, the total discounted tax revenue foregone by the Treasury is really insensitive to the discount rate used, at least within the range of 4 to 10 percent. Using a 4 percent discount rate the total discounted tax revenue foregone is \$561,000 or 44.8 percent of the mortgage; using a 10 percent rate the total is \$544,000 or 43.4 percent of the mortgage.

Eventually, this money is divided between the developer, broker, and investor. The Federal Government does collect a tax from the developer and broker on their net profit. Salaries and other project expenses should cut the tax on the developer's fee from the maximum of 48 percent to about 24 percent and yield a tax of \$76,500 over a 3 year period. Legal, accounting, and other fees and salaries should cut the broker's fee by about the same amount. The broker's tax is \$19,100 over a 3 year period. Using a 4 percent discount rate the net cost to the Government in foregone tax revenues is \$465,400. Using a 10 percent rate the net cost is \$456,600.

The argument is often made that if the low income housing tax shelters were plugged up investors would simply transfer their funds to one of the other tax loopholes, such as cattle, boxcars, and oil.³ If investors did behave in this manner, the Government would not collect any more taxes by repealing 167(k). Certainly this argument is true in part. Yet investors have a far broader choice of investments than simply other tax

G-I Discounted Taxes from Project Cash Flows

Year	A Taxable Income	B Bracket	C Discount @ 4%	D Discounted Tax @4%*	E Discount @ 10%	F Discounted Tax @10%**
1	(130,000)	0.54	.962	(67,500)	.909	(64,000)
2	(288,800)	0.54	.925	(144,000)	.826	(129,000)
3	(288,400)	0.54	.889	(138,000)	.751	(117,000)
4	(288,000)	0.54	.855	(129,500)	.683	(106,000)
5	(287,500)	0.54	.822	(127,500)	.621	(96,500)
6	(287,100)	0.54	.790	(122,500)	.564	(87,500)
7	13,400	0.54	.760	500	.513	500
8	14,000	0.54	.731	500	.467	500
9	14,500	0.54	.703	500	.424	500
10	15,100	0.54	.676	500	.386	500
11	15,700	0.54	.650	500	.350	500
12	16,400	0.54	.625	500	.319	500
13	17,000	0.54	.601	500	.290	500
14	17,800	0.54	.577	500	.263	500
15	18,500	0.54	.555	500	.239	0
16	19,400	0.54	.534	500	.218	0
17	20,300	0.54	.513	500	.198	0
18	21,300	0.54	.494	500	.180	0
19	22,300	0.54	.475	500	.164	0
20	23,500	0.54	.456	500	.149	0
Sale	1,090,700	0.32	.456	<u>161,000</u> (561,000)	.149	<u>52,000</u> (544,000)

* Column D equals column A times column B times column C

** Column F equals column A times column B times column E

shelters. People who do invest in low income housing are generally not particularly interested in tax shelters.⁴ They want a high rate of return for a given level of risk.

The amount of waste in the Government costs is divided in pieces. Out of the foregone tax revenues comes the developers profit of \$146,600. As seen in the previous chapter this level of incentive is required to make the returns on the typical rehabilitation project equal to those on the typical new project. The \$291,200 going to the investors is, on balance, largely costless to the Treasury. In the event of a foreclosure the Treasury collects a substantial tax from the investors. As seen previously the net return to investors in a 50 percent tax bracket in light of the incidence of foreclosures is only 4.4 percent or just slightly above the Government's discount rate.⁵ The only portion of this amount which is excessive for the Treasury is the difference between the return given the marginal investor in a 50 percent bracket and the average investor in a 54 percent bracket. This discrepancy would cost the Treasury about \$42,000 on this project.

The other item of waste to the Treasury is the \$40,200 going to the broker after taxes. The broker's role is solely dependent upon the fact that the equity financing comes from investors rather than from the Government itself. Through fully disclosing risks to investors, brokers often force developers of risky projects to provide guarantees against foreclosure. In other cases they require guarantees of the cash flow which can have the effect of deferring maintenance and thereby of increasing the possibility of foreclosure. Any reduction in the rate of foreclosure has the effect of reducing the possibility of the Treasury recapturing the excess depreciation taken; any increase in the rate of foreclosure helps the Treasury but hurts FHA.

The amount of excessive tax revenue foregone is thus the \$42,000 going

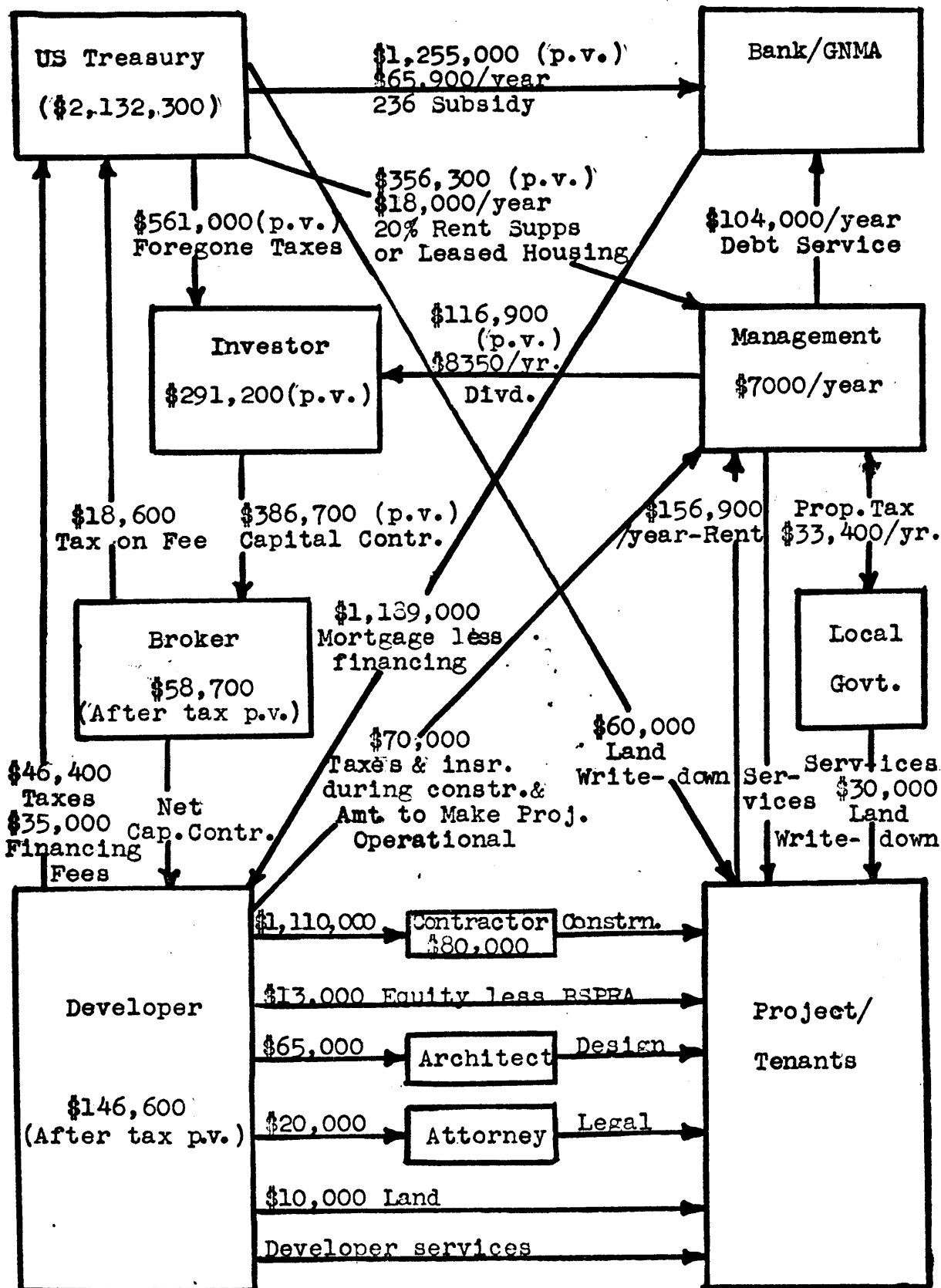
to investors in greater than a 50 percent bracket and the \$40,200 going to the broker of a total of \$82,200. To the extent that investors would otherwise have invested in a different tax shelter, this amount is reduced.

Other Project Costs

The project does, however, incur costs to the Treasury other than foregone tax revenue. The biggest of these costs is the interest subsidy. The present value of this subsidy at a 4 percent discount rate is a maximum of \$1,254,700 or slightly more than the \$1,252,000 mortgage it is helping to pay off. This anomaly results from the fact that the subsidized difference between the constant debt service rate on an 8 percent interest rate loan (where the constant over 40 years is 8.31 percent) and on a 1 percent rate loan (where the constant is 3.04 percent) is 5.27 percent. Were the Treasury to borrow the mortgage amount directly and not charge the tenants any amount for debt service, the subsidy would be only 5.04 percent per year. Were it to borrow the mortgage amount directly and charge tenants the same as it does now, the Government would save the difference between the 5.27 percent it pays now and the $(5.04 - 3.04 =)$ 2.00 percent it would otherwise pay or a net savings of 3.27 percent. This savings represents \$40,900 per year for 40 years or \$778,000 discounted to the present at the rate of 4 percent per year.⁶ This inefficiency, by itself, dwarfs all others.

Another expense to the Government is the leased housing or rent supplements. These programs reduce the rents for a portion of the tenants to approximately 25 percent of their income. Assuming that 20 percent of the tenants in the project receive one of these subsidies and that their average income is \$3000 (yielding a rent of \$62.50 per month) the Government subsidy would be \$18,000 per year or when discounted over 40 years, \$356,300.⁷ As project expenses go up this cost may increase. All of this subsidy goes directly toward paying real project costs.

Table G-II Analysis of Project Cash Flows Discounted at 4%



On this particular project, the urban renewal write-down is another Governmental subsidy going directly into the project. Assuming that the market value of the land and unrehabilitated structure was \$100,000, the amount of the subsidy would be \$90,000. Of this amount \$60,000 would be borne by the Federal Government and \$30,000 by the Local Government. The one amount which the Federal Government receives back from the project is \$35,000 as a financing fee.

The total discounted cost of the project to the Government using a 4 percent rate is thus \$2,132,300. Of this amount over \$900,000 represents dollars which could be saved through an efficient subsidy mechanism. These figures compare with a mortgage of \$1,252,000 and an FHA approved total development cost of \$1,391,000.

Comparison with New Construction

As seen in the previous chapter, the profitability of a typical rehabilitation project is not sufficient to divert developers from 236 new construction despite the fact that profits are up to twice as great on projects of equivalent size. The encouragement of rehabilitation does produce standard dwelling units at a lower price per unit, \$15,030 as compared with \$17,200. The difference in the 236 interest subsidy has a present value of \$2170.⁸ The difference in rent from the lower mortgage is \$6.50. These values compare with a difference in tax subsidy of only 44.8 percent of the difference in the mortgage or about \$900.⁹

Much of the cost difference between a unit of new construction and a unit of rehabilitation is likely to be eliminated as the demand for rehabilitatable shells increases. Since the supply of such shells is very nearly fixed, any increase in demand will increase their price and hence the 236 subsidy required.¹⁰ Any final determination of the merits of encouraging

rehabilitation as compared with new construction must also consider the useful lives of the finished products and the relative social benefits and disbenefits. These considerations are left to the reader,

FOOTNOTES

1. 60 % was the average level of deduction for passive investors in a study conducted by the U.S. Treasury. See p. 61 supra.
2. William Baumol, "On the Discount Rate for Public Projects", in U.S. Congress, The PFB, p. 491.
3. For example, see Yoskowitz, "New Construction and Tax Incentives," p. 25.
4. Harold Howell, Boston Financial Technology Group and Emil Sunley, economist for the Department of the Treasury.
5. See p. 73 supra. If the rate of return to investors should increase as might be expected from an analysis of the risk factors the taxable capital contributions would be reduced and the net average return to investors would become greater than the cost of money to the Government.
6. This value is discounted to the year construction begins. The cost of the subsidy in the year amortization begins is \$1,304,300.
7. Rent supplements under Sec. 101 of the Housing and Urban Development Act of 1965, 12 U.S.C. 1701s, provides supplements for 40 years. The Section 10(c) leased housing program (U.S. Housing Act of 1937) also provides a 40 year subsidy. The Section 23 program (U.S. Housing Act) provides up to 20 years of subsidy.
8. The subsidy has a present value almost identical to the mortgage differences as seen on p. 95 supra.
9. See p. 92 supra.
10. The price of shells will increase to the limit where the shell price plus the rehabilitation costs produce mortgage costs such that the rents are up to the maximums allowed by FHA. Such is already the case for new construction in high cost areas. The prices of other factors in the rehabilitation process such as labor are not likely to rise to the extent they are simply diverted from new construction.

H. GOVERNMENT ALTERNATIVES

Suggestions to Improve the Developer Incentive Mechanism¹

As has been seen, the 5-year writeoff has inefficient elements. The question remaining is what form of incentive would be better. Several people have suggested alternatives. Ralph Taylor of Mid-City Developers in Washington, D.C. is lobbying for several sweeteners to the existing shelter. Professor Stanley Surrey has advocated that a tax credit system is generally a more efficient form of providing tax shelter, although a direct system would be most preferable. Professor Charles Haar has suggested that HUD buy the tax shelter from the Developer. James Wallace suggests that either the developer be paid more in cash or that the mortgage be increased along with a deeper subsidy. Emil Sunley of the Department of the Treasury suggests that the Government play the role of the developer but contract out the rehabilitation work and sell the buildings upon completion.² These suggestions will be examined in turn.

The specific suggestions of Ralph Taylor are: 1) to provide that capital gain on the sale of such property be taxed at 25 percent rather than at 25-35 percent, 2) to provide that such capital gains not reduce the amount of capital gain an individual can take within the \$50,000 limit of Section 1201(d), 3) to exempt such accelerated depreciation as a tax preference item, and 4) to entirely eliminate recapture of accelerated depreciation taken on low income property. The primary effect of these changes, especially the first three would be to allow wealthy investors to drain more tax benefits from the Treasury without affecting the incentives to developers to rehabilitate housing. The syndication price is based upon the rate of return which is received by the investor in a marginal tax bracket, i.e. a 50 percent bracket. Most confidential memoranda to investors

already assume that the tax on sale for the marginal investor is 25 percent and the investors are unaffected by the \$50,000 capital gain limit. They further assume that the minimum tax preference tax on accelerated depreciation does not apply to the marginal investor. The effect of eliminating recapture would be to reduce the cost of a foreclosure before the 200th month. This change would reduce the consequences of a risk faced by all investors. Hence it would lead to their being willing to pay developers more for the right to be a limited partner. As has been seen, the incentives are already more than sufficient to attract developers to rehabilitate housing for low income families.

A slight variation to this proposal would be to eliminate recapture of accelerated depreciation only on the sale of the project to the tenants. This variation is discussed later in this chapter.

A tax credit system has more to offer in terms of Governmental policy. It would attack the regressivity of tax shelters. Presently, on a \$10,000 deduction a taxpayer in a 30 percent bracket saves \$3,000 in taxes; a taxpayer in a 50 percent bracket saves \$5,000; and a taxpayer in a 70 percent bracket saves \$7,000. On a rehabilitation tax shelter where the rate of return to an investor in a 50 percent bracket is 25 percent, the return to an investor in a 30 percent bracket would only be about 3 percent; and the return to an investor in a 70 percent bracket would be about 50 percent. Tax credits would allow any taxpayer, regardless of his bracket, to credit against the tax he would otherwise pay a fixed percentage of the deduction. If the rate were set at 50 percent, for example, taxpayers in a 50 percent bracket would receive exactly the same tax benefits for the same amount of depreciation as under the present system. A 70 percent bracket investor would be limited to the same deductions as the 50 percent bracket investor. Persons in a bracket lower than 50 percent would be able to receive as great

of a tax shelter as anyone. With the average investor being in a 54 percent bracket, a tax credit system would save 7 to 8 percent of the anticipated tax losses or about \$40,000 on the Newcastle project.

A tax credit system would allow investors to accept a slightly lower rate of return since it would eliminate the risk that their tax bracket might drop.

Adjusting the rate of tax credits would be an efficient means to regulate the amount the developer receives. Investors demand virtually the same rate of return regardless of the amount being passed through to the developer. If the incentives were found to be insufficient to produce the desired level of rehabilitation, Congress could set the value of the tax credit at, say, 60 percent. If the incentives were found to be too great, the tax credit value could be set at, say, 40 percent. The revenue losses or gains from such adjustments would vary very nearly directly with the rate set.

A tax credit system, however, would not open tax shelters to investors in tax brackets much under 50 percent without a concomitant loosening of securities laws. Developers must register any limited partnership with the Securities Exchange Commission unless they obtain an exemption.³ The cost of registering even a small transaction with the SEC is several thousand dollars and several weeks of delay. The usual way to avoid registration is to sell limited partnership interest to a small number of "sophisticated" investors. Any investor who is sufficiently wealthy to afford competent tax counsel is considered "sophisticated." Presumably, most investors in a bracket less than 50 percent would not be "sophisticated."⁴

The suggestion that HUD "buy the depreciation" tries to bypass the investor market. By "buying the depreciation," HUD would increase the developer's fee and the IRS would allow no depreciation on the project.

Presumably the only sales of limited partnership interests which would then be made on the open market would be those being sold at a price higher than HUD would be willing to pay. Such sales would either be made to investors in a bracket that is higher than 50 percent who would benefit from the tax shelter more than a 50 percent bracket investor or be made to an investor buying a relatively secure tax shelter.

Most developers, particularly, community organization-developers, would benefit by selling the depreciation to HUD. No portion of the syndication proceeds would accrue to brokers. Community groups could expect the same cash proceeds from HUD as any other developer selling to HUD without the discount of the project being perceived as being more risky. The advantage of this system to the Government would be its cost. Rather than paying investors a 25 percent to 30 percent after-tax rate of return, the Treasury could borrow at 4 percent to provide HUD with sufficient funds to pay developers. The government might also save the cost of paying a broker. The disadvantage would be the elimination of the investors protection against foreclosure.

For the sake of bureaucratic simplicity, HUD would probably only want to buy the depreciation and not all of the other items of taxable profit and loss. Without any depreciation an absentee owner would have to pay a tax on the amortization as well as on the cash dividend.⁵ The property owner is unlikely to ever realize the amortization except in the form of a reduced tax on sale. The sales price is likely to be for the mortgage balance plus a constant. Even retaining the depreciation on the shell would not be sufficient to shelter the tax on the amortization, particularly after the first few years. Members of a cooperative, however, would receive tax benefits from ownership. Their tax savings depends upon the amount of interest and property taxes paid and bears no relationship to depreciation,

amortization, or cash income. For this reason, the sale of the tax shelter to HUD would encourage cooperatives and discourage absentee ownership.

The cheapest method of controlling tax shelters is by eliminating them entirely. Unlike selling depreciation to HUD, simply paying the developer a fee would totally eliminate the possibility of selling tax shelter on the private market.

The primary problem with direct subsidies is a political one. The Section 608 program became a national scandal after it had been in operation for five years. The public realized that developers had been receiving mortgages of 110 to 150 percent of total project costs.⁶ The solution to this problem, according to one commentator, is to use enough finesse to cover up the fact of the subsidy and its extent.⁷ Certainly 167(k) is achieving this end, probably simply because the mechanism is too complex for the general public to comprehend. Paying the fee directly to the developer would be equally scandalous as adding the fee to the mortgage. It would have the further political disadvantage of impacting the budget immediately.

Probably the most fundamentally different proposal for reducing Governmental costs in rehabilitating low income housing is the Sunley proposal to have the Government play the role of the developer. Under his model, the Government would acquire a building suitable for rehabilitation at the existing market price. Presumably, the use of eminent domain powers could be grafted onto his model to facilitate the upgrading of an area sufficiently large to withstand any negative spillovers from the rest of the neighborhood. Sunley calls for the selection of the contractor simply on the basis of price. Presumably, the ability to train and employ unskilled minority workers could also be a criterion. Finally, Sunley would have the Government sell the building to the highest bidder willing to operate it according to specified criteria for maintenance, rents, and tenant

selection. An open bidding process would eliminate the fear of a scandal and the need to cover up the amount of profit. The deductibility of interest and property taxes would be the only economic advantage given to tenant cooperatives to become owners. Yet, tenants and community groups would lack the credit with financial institutions which large corporations and wealthy individuals would possess. In fact, without at least FHA insurance of the mortgage, to which anyone would have relatively equal access, the amount of potential profit under a given set of operating rules would be a function of the financing terms obtainable by the mortgagor.

Thus, a revised Sunley model would have the Government acquire the site by either paying the market price or using eminent domain; selecting a contractor based upon price and other factors; selling the property to a private party using a subsidized loan. For the Government, this model would eliminate the need to pay a developer's fee; although it would increase administrative costs by nearly as much.⁸ Administrative costs would come out of current budgetary expenditures rather than out of foregone tax revenues as presently, or out of the program budget as with a system of a direct developer's fee. For the tenants and the community whether the Government or a profit-oriented firm served as the developer would be an insignificant matter. The quality of the work by the architect, contractor, and management agent and the employment of community people are more important concerns. For those tenant and community groups who would be engaged as developers, the taking over of this function by the Government would be a severe blow.

Suggestions to Improve the Incentives Providing Tenant Ownership

From the point of view of the Government, the 1039 rollover seems like a conceptually marvelous idea. Were it to work it would not only turn the first project over to the tenants, but it would provide for the development of

a second project without any depreciation. The problem with this incentive, as has been seen, is that it provides no real incentive except on projects which seem sour, and tenants are not likely to want.

Eliminating the reinvestment requirement from the non-recognition of gain on the sale of the project to the tenants would provide a tremendous incentive to investors. They would be able to keep the amount they already had, at least theoretically, set aside in a sinking fund to pay the tax on a disposition of the property in year 20 and they would no longer have the threat of foreclosure. The amount in this fund in the sixth year of the Newcastle project (immediately after the construction losses and the five year writeoff have been taken) would be about \$192,000. This amount compares with a tax of \$592,000 which would normally be payable on a disposition at the mortgage balance or on a foreclosure at this point. Simply eliminating recapture and assessing the normal tax at capital gains rates as has been suggested would reduce the tax to \$355,000. Even then unless foreclosure seemed imminent, investors would be better off putting aside the cash flows from the project to pay the \$327,000 tax due on a sale in the twentieth year.

The amount of tax which the investors would be willing to pay and donate the project to the tenants would be the \$192,000 put away in the sinking fund. The investors would then never have to worry about foreclosure. At least from a political perspective such a policy would be beneficial to the Government. Not only would tenants be helped, but tax dollars would accrue to the Treasury immediately rather than some 14 years later. Such a policy would only be costly to the Government if the project would have otherwise gone into foreclosure and the Government would have then been able to collect a large gains tax.

Still, no matter how a sale to the tenants is structured, the five-year

writeoff precludes tenant ownership until after this depreciation has been taken.

An Ideal System

An ideal system would provide developers with sufficient incentives in a direct manner so as to minimize costs, be structured to avoid a scandal, and provide for immediate tenant ownership. The safest way to accomplish the first two of these ends is by some form of competitive bidding. The Turnkey public housing program offers the basis of a workable model.⁹ Under this program the local housing authority advertizes for bids on projects of specified types, sizes, and sometimes locations. Once a developer has been selected he works with the local authority in a similar manner as he would with a private client. This form of procedures at least in theory saves time and paper-work. If the project conforms to certain specified requirements and satisfies various inspections and appraisals made by the authority, then the authority buys the project from the developer.

Certain variations could be made in the program to satisfy the goals set forth in this thesis. First, the financing could be obtained through the sale of Government bonds and the issuing of a mortgage at about $\frac{1}{2}$ percent over the borrowing rate. This method of finance is currently being used by the Massachusetts Housing Finance Agency. Moderate income borrowers could pay the principal and as much of their share of the interest as they can afford. Low income tenants would still pay just 25 percent or less of their income.

Legal ownership of the property could be given to a cooperative of tenants immediately; rather than to individuals as in Turnkey III; or to a cooperative, but only after at least 6 years as in a rollover. Tenants could also be given a say in setting the criteria for the rehabilitation

process, particularly when they are already occupants of the rehabilitated structure. While more research is needed as to the empirical workings of Turnkey, the result of such a system would seem to be tenant owned and controlled rehabilitated housing at minimal cost to the Government.

Conclusion

On balance the tax shelter mechanism for the rehabilitation of housing works reasonably well. What remains to be seen is whether the amount of tax savings afforded wealthy investors is costless because so much of it will be recaptured through foreclosure, or if the cost is considerable because the Government is buying an effective foreclosure prevention service.

The most expensive aspect of the rehabilitation incentive and subsidy mechanism is the 236 interest subsidy program. This flaw, however, can be remedied through direct Governmental loans and without regard to changes in the tax laws. The inefficiency resulting from the fact that the average investor is in a higher tax bracket than the marginal investor can be remedied by amending Section 167(k) to make it operate as a tax credit. The only excessive cost which cannot be legislated away all by itself is the amount going to the syndication broker. As more brokers enter the field, however, this cost might also be reduced.

In terms of tenant and community control and ownership, the most effective use of the present system is made by such groups serving as developers rather than hoping to secure ownership on a 1039 rollover. The simple reduction of the gains tax down to the amount already put aside by investors in their sinking fund would be a far more effective mechanism for securing tenant ownership than the present rollover.

Still, an ideal incentive and subsidy mechanism can be constructed that surpasses these marginal changes both in terms of cost and in terms of

tenant ownership and control. Such a system would be a modified Turnkey public housing program.

FOOTNOTES

1. Portions of this section appeared in Betnun and Judelson, op.cit., but were written by the present author.
2. Taylor presented his suggestions at a conference at Harvard Law School, December 12, 1970. "Tax Incentives as a Device for Implementing Government Policy," pp. 720-725. Haar made his suggestion at a seminar at M.I.T. on January 27, 1971. See Wallace, "Role of Tax Incentives," pp. 24-27. See Sunley, "Tax Incentives for Rehabilitation," pp. 30-32.
3. For a more complete discussion of securities questions as they relate to syndicating limited partnership interests in rehabilitation projects, see Betnun & Judelson, op.cit., pp. 18-25; See also Judelson, op.cit., pp. 31-38.
4. Investors at Boston Financing Technology Group must sign a statement saying that they are in at least a 50 percent bracket.
5. See pp. 42-43
6. The Five-Year Old Scandal, House and Home, April 1954, pp. 1A-1P.
7. Eil Goldston, "New Prospects for American Business," p. 90.
8. Congressmen are more prone to cut agency requests for administrative expenses than for program items. See Aaron Wildavsky, Politics of the Budgetary Process, p. 103.
9. Metropolitan Area Planning Council, Federal and State Assisted Housing Programs, V.II, pp. 27-29.

APPENDIX - FORMULAE TO CALCULATE THE CAPITAL CONTRIBUTION

Derivation of the Formulae

In deriving the formula to calculate the capital contribution the first step is to be able to find the value of the sinking fund. Here the most important values are the year in which the sinking fund must begin and the amount of after-tax cash flows which must be tucked away in that year. These values can be determined by taking the value of the after-tax cash flow in the presumed year of sale, discounting it at 4 percent back one year, adding the result to the after-tax cash flow in the previous year, and discounting it back another year. This process continues until the accumulated, discounted cash flows have a value of zero. On a rehabilitation project where the 5-year write-off is taken, where sale is assumed to occur in the 20th year at the mortgage balance, where interest on the sinking fund is assumed to accrue at 4 percent per year, where the maximum 6 percent cash dividend is assumed to be paid, and where the investors are normally in a 50 percent bracket, the sinking fund will have to start in the fifth year of the project. Part of the after-tax cash flows in that year and all of the after-tax cash flows in the following years must be allocated to the sinking fund. Knowing this fact the equation for the amount allocated to the sinking fund in the 5th year for the jth iteration* can be stated as:

$$(1) \quad \frac{S_j}{(1.04)^5} + \sum_{i=6}^{20} \frac{Cd - Br(Cd + A_1 - D_{1,j})}{(1.04)^i} - \frac{TsBc}{(1.04)^{20}} = 0$$

Where:

S_j = amount allocated to sinking fund in 5th year in the jth iteration

Cd = Cash dividend

Br = Income tax bracket

A_1 = Amortization in the 1th year

* As will be seen later, because of a step-up in basis, S will have to be calculated several times, each time with a different value for j.

Ts = Taxable gain on sale (assumed at mortgage balance)

Bc = Capital gains tax bracket

D_{1,j} = Depreciation in the ith year and jth iteration of the step-up

Solving for S_j, the formula becomes:

$$S_j = (1.04)^5 \frac{Ts Bc}{(1.04)^{20}} - \sum_{i=6}^{20} \frac{Cd - Br(Cd + A_1 - D_{1,j})}{(1.04)^i}$$

Simplifying:

$$(2) \quad S_j = \frac{Ts Bc}{(1.04)^{15}} - \sum_{i=6}^{20} \frac{Cd - Br(Cd + A_1 - D_{1,j})}{(1.04)^{i-5}}$$

Once S is determined, the amount of the capital contribution can be calculated. The capital contribution is that amount of money on which the after-tax cash flows accruing before the sinking fund begins, yields a specified rate of return, R. The present value of the after-tax cash flow in the year of construction can be expressed as:

$$\frac{Br E}{1+R}$$

Where:

Br = Income tax bracket

E = Expensed items during construction period

R = Rate of return expected.

During the next 4 years, years 2 through 5, the after-tax cash flows can be represented by:

$$\sum_{i=2}^5 \frac{Br (D_{1,j} - A_1 - Cd) + Cd}{(1 + R)^i}$$

Where:

Br = Income tax bracket

D_{1,j} = Depreciation taken in the ith year the jth iteration

Cd = Cash dividend

The value of the sinking fund, S_j, must be subtracted.

Summing all of these expressions gives a formula for the jth calculation of the capital contribution, C_j.

$$(3) \quad C_j = \frac{Br E}{(1+R)} + \sum_{i=2}^5 \frac{Br(D_{1,j} - A_1 - Cd) + Cd}{(1+R)^i} - \frac{S_j}{(1+R)^5}$$

This formula assumes that all of the capital contribution is received at the start of the 1st year of the construction period. However, sophisticated developers have found that the capital contribution can be increased significantly if it is phased over time. Generally, investors are asked to pay one-third of their capital contribution at the time they sign the agreement, one-third at the completion of construction (final closing), and one-third at the later completion of the renting of 95 percent or so occupancy or two years after the first payment. This type of phasing reduces certain risks for the investor and allows him to use part of his money elsewhere for awhile. To incorporate the phasing into the formula for the capital contribution requires that the number of payments divided by their present value be represented. The most general expression for this concept is:

$$\frac{n+1}{\sum_{i=0}^n 1 / (1+R)^i}$$

Where:

n = Number of years over which payments are made

i = Year

R = Rate of return expected

Combining this expression with the previous formula for calculating

the capital contribution yields a new formula:

$$(4) \quad C_j = \left[\frac{n+1}{\sum_{i=0}^n 1 / (1+R)^i} \right] \left[\frac{Br E}{(1+R)} + \sum_{i=2}^4 \frac{Br(D_{1,j} - A_1 - Cd) + Cd}{(1+R)^i} - \frac{S_j}{(1+R)^5} \right]$$

Where:

C_j = Capital contribution in the jth iteration

n = Number of phased payments (assumed 1 year apart)

i = Year

R = Rate of return expected

Br = Income tax bracket

E = Expensed items during construction period

- $D_{i,j}$ = Depreciation taken in the i th year and j th iteration
 A_i = Amortization in the i th year
 Cd = Cash dividend
 S_j = Amount of depreciation allocated to sinking fund in the 5th year and the j th iteration

The final sophistication to be added is the step-up of the depreciable basis owing to the equity invested by the limited partners in excess of the equity implied by FHA. The depreciable basis to be written off over five years for a taxpayer also serving as the developer would be the total development cost of the project, i.e. the mortgage plus the implied equity, less the non-depreciable land and slowly depreciable shell. In this case the cost of the shell is assumed to be negligible. The equity required of an outside investor is considerably in excess of that which is required by FHA. This excess equity or developer's fee can be depreciated over 5 years. The additional depreciation adds to the capital contribution which an investor is willing to make. The additional capital contribution can also be depreciated over 5 years, leading to an infinite series. Symbolically:

$$(5) \quad C_0 = \Delta Db_0 \rightarrow \Delta C_0 = \Delta Db_1 \rightarrow \dots \Delta C_{j-1} = \Delta Db_j \rightarrow C_j = \Delta Db_{j+1} \rightarrow \dots$$

Where:

- C_0 = Capital contribution initially
 ΔC_j = Change in the capital contribution in the j th iteration
 ΔDb_j = Change in the depreciable basis in the j th iteration

Going back to the original formulae:

$$(2) \quad S_j = \frac{T_s B_c}{(1.04)^{15}} - \sum_{i=6}^{20} \frac{Cd - Br (Cd + A_i - D_{i,j})}{(1.04)^{i-5}}$$

$$(4) \quad C_j = \left[\sum_{i=0}^n \frac{1}{(1+R)^i} \right] \left[\frac{Br E}{(1+R)} + \sum_{i=2}^5 \frac{Br(D_{i,j} - A_i - Cd) + Cd}{(1+R)^i} - \frac{S_j}{(1+R)^5} \right]$$

By definition:

$$(6) \quad \Delta C_j = C_{j+1} - C_j$$

Substituting equation 4 into equation 6:

$$(7) \quad \Delta C_j = \frac{n+1}{\sum_{i=0}^n \frac{1}{(1+R)^i}} \left[\sum_{i=2}^5 \frac{\text{Br}(D_{1,j+1} - D_{1,j})}{(1+R)^i} - \frac{(S_{j+1} - S_j)}{(1+R)^5} \right]$$

Substituting from equation 2 for S_{j+1} and S_j :

$$(8) \quad \Delta C_j = \frac{n+1}{\sum_{i=0}^n \frac{1}{(1+R)^i}} \left[\sum_{i=2}^5 \frac{\text{Br}(D_{1,j+1} - D_{1,j})}{(1+R)^i} + \frac{\sum_{i=6}^{20} \text{Br}(D_{1,j+1} - D_{1,j})/1.04^{i-5} (Ts_{j+1} - Ts_j) Bc/1.04^{15}}{(1+R)^5} \right]$$

Substituting $\Delta D_{1,j}$ for $D_{1,j+1} - D_{1,j}$ and ΔTs_j for $Ts_{j+1} - Ts_j$ yields:

$$(9) \quad C_j = \frac{n+1}{\sum_{i=0}^n \frac{1}{(1+R)^i}} \left[\sum_{i=2}^5 \frac{\text{Br } D_{1,j}}{(1+R)^i} + \frac{\sum_{i=6}^{20} (\text{Br} \Delta D_{1,j}/1.04^{i-5}) - (\Delta Ts_j Bc/1.04^{15})}{(1+R)^5} \right]$$

If the depreciable basis, Db , is less than or equal to \$15,000 per dwelling unit, then for i greater than 6 and for any value of j , $\Delta D_{1,j} = 0$ and $\Delta Ts_j = 0$.

Thus equation 9 simplifies to:

$$(10) \quad \Delta C_j = \frac{n+1}{\sum_{i=0}^n \frac{1}{(1+R)^i}} \left[\sum_{i=2}^5 \frac{\text{Br } \Delta D_{1,j}}{(1+R)^i} + \frac{\text{Br } \Delta D_{6,j}/1.04}{(1+R)^5} \right]$$

Again if Db is less than or equal to \$15,000 per unit, in years 2 through 6,

$\Delta D_{1,j} = 0.2 \Delta Db_j$. Thus:

$$(11) \quad C_j = \frac{n+1}{\sum_{i=0}^n \frac{1}{(1+R)^i}} \left[\sum_{i=2}^5 \frac{\text{Br}(0.2) \Delta Db_j/1.04}{(1+R)^i} \right]$$

As seen in equation 5, beginning with ΔDb_1 , $\Delta Db_j = \Delta C_{j-1}$.

Thus:

$$(12) \quad \Delta C = \sum_{j=1}^n \left[\frac{n+1}{\sum_{i=0}^n \frac{1}{(1+R)^i}} \left[\sum_{i=2}^5 \frac{\text{Br}(0.2) \Delta C_{j-1}}{(1+R)^i} + \frac{\text{Br}(0.2) \Delta C_{j-1}/1.04}{(1+R)^5} \right] \right]$$

Where:

- ΔC = Step-up in the capital contribution (up to \$15,000 of depreciable basis)
- j = Iteration of the step-up
- i = Year
- n = Number of years of phasing
- Br = Income tax bracket
- R = Rate of return expected

Once Db , the depreciable basis, is greater than \$15,000 per unit, equations 10 and 11 do not apply and equation 9 must be used. Assuming that the depreciable life of the improvement is 20 years, further simplifications can be made. Using the double declining balance method of depreciation yields annual depreciation equal to 10 percent per year of the as-yet underpreciated amount. After the 10th year, however, straight-line depreciation of the balance yields larger amounts of depreciation. Thus, a switch-over to straight-line is made at that point. The change in the tax on sale is affected by only the depreciation not taken. This depreciation is simply the depreciation available in what would be the 21st year of the project (20th year of the depreciation schedule). Computing these changes yields a substitute equation for equation 9 for Db greater than \$15,000 per unit.

$$(13) \quad \Delta C'_j = \frac{n+1}{\sum_{i=0}^n 1/(1+R)^i} \left[\sum_{i=2}^5 \frac{Br \Delta D_{i,j}}{(1+R)^i} + \frac{.248 \Delta Db_j - (-.006 \Delta Db_j)}{(1+R)^5} \right]$$

Substituting ΔC_{j-1} for ΔDb_j (from equation 5); simplifying, and summing an infinite number of iterations gives:

$$(14) \quad \Delta C' = \sum_{j=1}^{\infty} \left[\frac{n+1}{\sum_{i=0}^n 1/(1+R)^i} \right] \left[\sum_{i=2}^5 \frac{Br \Delta D_{i,j}}{(1+R)^i} + \frac{.254 \Delta C_{j-1}}{(1+R)^5} \right]$$

Where:

- $\Delta C'$ = Step-up in the capital contribution (beyond \$15,000 of depreciable basis)
- j = Iteration of the step-up
- i = Year
- n = Number of years of phawing
- Br = Income tax bracket
- R = Rate of return expected

The final capital contribution can be expressed as:

$$(15) \quad C = C_0 + \sum_{j=1}^{\infty} \Delta C_j + \Delta C'$$

The formulae which are important are 2,4,12,14, and 15

Calculation of the Capital Contribution

The capital contribution for the Newcastle case can be readily calculated from the formulae, and the income-expense analysis (pp.43-44 , supra.)

First the amount needed to be allocated to the sinking fund in the fifth year before the step-up must be calculated: (based on equation 2)

$$(16) S_0 = \frac{Ts Bc}{(1.04)^{15}} - \sum_{i=6}^{20} \frac{Cd-Br(Cd + A_1 - D_{i,j})}{(1.04)^{i-5}}$$

Evaluating the tax on sale:

$$(17) \frac{Ts Bc}{(1.04)^{15}} = \frac{1,081,000(0.30)}{1/.555} = 324,340 \times .555 = 180,000$$

The after-tax cash flows come from the income-expense analysis. Discounted to the fifth year and summed they equal \$116,870.

$$(18) \sum_{i=6}^{20} \frac{Cd - Br(Cd + A_1 - D_{i,o})}{(1.04)^{i-5}} = 116,870$$

Year	After-tax Cash Flow		Discount		Discounted Value
6	126630	x	.962	-	122110
7	1320	x	.925	-	1220
8	1090	x	.889	-	970
9	850	x	.855	-	720
10	580	x	.822	-	480
11	290	x	.790	-	230
12	(10)	x	.760	-	(10)
13	(350)	x	.731	-	(260)
14	(710)	x	.703	-	(500)
15	(1100)	x	.676	-	(750)
16	(1530)	x	.650	-	(990)
17	(1980)	x	.625	-	(1240)
18	(2470)	x	.601	-	(1490)
19	(3010)	x	.577	-	(1740)
20	(3580)	x	.555	-	(1980)

116,870

The amount allocated to the sinking fund in the fifth year (from equation 16) is given by:

$$(19) S_0 = 180,000 - 116,870 = 63,130$$

Knowing S_0 , the initial value for the capital contribution can be calculated:

$$(20) C_0 = \frac{n+1}{\sum_{i=0}^n 1/(1+R)^i} \left[\frac{Br E}{(1+R)} + \sum_{i=2}^5 \frac{Br (D_{1,0} - A_i - Cd) + Cd}{(1+R)^i} \right]$$

The phasing factor is computed:

$$(21) \frac{n+1}{\sum_{i=0}^n 1/(1+R)^i} = \frac{2+1}{\sum_{i=0}^2 1/1.25^i} = \frac{3}{2.44} = 1.23$$

The present value of the expenses during the construction period is:

$$(22) \frac{Br E}{(1+R)} = \frac{0.50(130,000)}{1.25} = \frac{65,000}{1.25} = 52,000$$

The present value of the after-tax cash flow becomes:

$$(23) \sum_{i=2}^4 \frac{Br (0.2) Db_0 - A_i - Cd}{(1+R)^i} + Cd = 238,100$$

Year	$Br(D_{1,0} - A_i - Cd)$ After-tax cash flow	$1/(1+R)^i$ Discount	Present Value
2	$0.50 (125,100 - 3,880 - 8,350) + 8,350$	x .640	= 81,490
3	$0.50 (125,100 - 4,190 - 8,350) + 8,350$	x .512	= 65,110
4	$0.50 (125,100 - 4,530 - 8,350) + 8,350$	x .410	= 52,070
5	$0.50 (125,100 - 4,890 - 8,350) + 8,350$	x .328	= 39,430
			<hr/> 238,100

The portion of the after-tax cash flows in the 5th year allocated to the sinking fund:

$$(24) \frac{S_0}{(1+R)^5} = \frac{63,130}{1/.328} = 20,850$$

Combining all of the terms (from equation 20):

$$C_0 = 1.23(52,000 + 238,100 - 20,710) = 332,350$$

The step-up in the capital contribution,

$$(25) \quad C_j = \frac{n+1}{\sum_{i=0}^n 1/(1+R)^i} \left[\sum_{i=2}^5 \frac{Br(0.2) \Delta C_{j-1}}{(1+R)^i} + \frac{Br(0.2) \Delta C_{j-1}/1.04}{(1+R)^5} \right]$$

As seen in equation 21, the phasing factor,

$$(26) \quad \frac{n+1}{\sum_{i=0}^n 1/(1+R)^i} = 1.23$$

Simplifying the next term:

$$(27) \quad \sum_{i=2}^5 \frac{Br(0.2) \Delta C_{j-1}}{(1+R)^i} = .1890 \Delta C_j$$

i Year	Br(0.2) ΔC_{j-1} Change in basis		1/(1+R) ⁱ Discount		Present Value
2	0.1 ΔC_{j-1}	x	.640	=	.0640 ΔC_{j-1}
3	0.1 ΔC_{j-1}	x	.512	=	.0512 ΔC_{j-1}
4	0.1 ΔC_{j-1}	x	.410	=	.0410 ΔC_{j-1}
5	0.1 ΔC_{j-1}	x	.328	=	.0328 ΔC_{j-1}
					<hr/>
					.1890 ΔC_{j-1}

Simplifying the final term of the step-up equation:

$$(28) \quad \frac{Br(0.2) \Delta C_{j-1}/1.04}{(1+R)^5} = \frac{0.50(0.2) \Delta C_{j-1}/1.04}{1/.328} = 0.0316 \Delta C_{j-1}$$

Combining terms, the increase in the capital contribution (from equation 25):

$$(29) \quad \Delta C_j = 1.23(.1890 \Delta C_{j-1} + .0316 \Delta C_{j-1}),$$

or

$$(30) \quad \Delta C_j = 0.2713 \Delta C_{j-1}$$

From equation 5, $\Delta C_0 = \Delta D_1$. And, ΔD_1 is the initial step-up in the depreciable basis.

Originally, the depreciable basis was equal to the implied equity, plus the mortgage, less the expensed items, less the land, and less the shell costs, or \$1,251,000. The only item which changes with the step-up is the

implied equity. The initial capital contribution replaces it. Thus:

$$(31) \Delta C_0 = \Delta Db_1 = C_0 - \text{Implied equity}$$

or

$$(32) \Delta C_0 = 332,350 - 139,000 = 193,350$$

When C_0 is added to the original depreciable basis, the new depreciable basis becomes:

$$(33) C_1 = C_0 + \Delta C_0 = 1,251,000 + 193,350 = \$1,444,350$$

Since the buildings in question contain 100 dwelling units, \$1,500,000 is the maximum depreciation which can be taken to remain within the \$15,000 per unit limit imposed by Section 167(k). This limit will have to be watched.

The next step-up can be taken from equation 30.

$$(34) \Delta C_1 - 0.2713 \Delta C_0 = 0.2713(193,350) = 52,500$$

- Adding C_1 (-1,444,350) to ΔC_1 (-52,500) yields C_2 (-1,496,850) --- only \$3150 less than \$1,500,000. ΔC_2 can equal no more than \$3150. Again from equation 30:

$$(35) \Delta C_2 = 0.2713 C_1$$

But not all of ΔC_1 can be stepped using the five year write-off thus:

$$(36) \Delta C_2 = 0.2713(\Delta C_1 - \Delta C'_0) = 3150$$

Where $\Delta C'_0$ must be stepped up using double declining balance depreciation.

Substituting for ΔC_0 :

$$(37) 0.2713(52,500 - \Delta C'_0) = 3150$$

Solving for $\Delta C'_0$:

$$(38) \Delta C'_0 = 40,700$$

All further step-ups must be based on equation 14:

$$(39) C' = \sum_{j=1}^{\infty} \left[\frac{n+1}{\sum_{i=0}^n \frac{1}{(1+R)^i}} \right] \left[\sum_{i=2}^5 \frac{Br \Delta D_{i,j}}{(1+R)^i} + \frac{.254 \Delta C_{j-1}}{(1+R)^5} \right]$$

When $R = 0.25$ and $n = 2$, equation 39 simplifies to:

$$(40) \quad \Delta C' = \sum_{j=1}^{\infty} \left[1.23 (0.084 \Delta C_{j-1} + 0.083 C_{j-1}) \right]$$

or

$$(41) \quad \Delta C' = \sum_{j=1}^{\infty} 0.2054 \Delta C_{j-1}$$

Evaluating $\Delta C'$ beginning with $\Delta C_0 = 40,700$ (equation 38):

$$(42) \quad \Delta C' = 10,590$$

<u>j</u>	<u>0.2054</u>		<u>ΔC_{j-1}</u>		<u>ΔC_j</u>
1	0.2054	x	40,700	=	8,450
2	0.2054	x	8,450	=	1,710
3	0.2054	x	1,710	=	350
4	0.2054	x	350	=	70
5	0.2054	x	70	=	10
					10,590

Finally, evaluating the value of the capital contribution from equation 15:

$$(43) \quad C = C_0 + \sum_{j=1}^{\infty} \Delta C_j + \Delta C' = 332,350 + (52,500 + 3,150) + 10,590$$

$$(44) \quad C = 398,600$$

The final capital contribution is thus \$398,600. Each of the 3 phased payments equal \$132,900. The increase in the depreciable basis is equal to the final capital contribution minus the originally implied equity (\$398,600 - 139,000 = 259,600). The depreciable basis then equals \$1,251,000 plus \$259,600 or \$1,510,600.

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INTERVIEWS

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Other

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Donald Stull, Stull Associates, Inc.

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GLOSSARY

ADJUSTED BASIS - The original basis of a property minus the depreciation taken until that time; the book value.

AMORTIZATION - The amount of debt service which pays the principal of the mortgage. The portion of the debt service payment going toward amortization increases as the mortgage is repaid.

BASIC RENT - The amount of rent based upon the subsidized interest rate in an FHA project.

BASIS - For tax purposes the cost of a piece of property minus any amount deductible during the construction period.

BROKER - A person or firm who sells the tax shelter to the investor for the developer. The broker assumes liability for adhering to all securities regulations.

BUILDERS AND SPONSORS PROFIT AND RISK ALLOWANCE - The amount FHA allows a developer and a contractor for their services. It is equal to 10 percent of development costs other than land. The developer and contractor must establish at least a loose identity of interest to receive this much profit.

CAPITAL CONTRIBUTION - The amount which the investors pay the developer for a limited partnership interest in the project.

CAPITAL GAINS - The form of taxation levied on a property held for a long period of time. Beginning in 1972 capital gains rates are equal to one-half of the ordinary income tax rates.

CAPITALIZATION - A method of determining the value of a property based upon the cash flows it generates. The amount of the cash flows are divided by the rate of return desired to determine the value of the property in excess of the mortgage.

CLOSING COSTS - The amount of local taxes, legal fees, recording fees

and other costs paid in transferring the legal ownership of a property.

CONSTANT - The amount of the fixed annual payment on the mortgage. It is equal to the sum of the amortization and interest charges. As payments are made the percent going toward amortization increases; the percent going toward interest decreases.

COOPERATIVE - Apartments owned by the residents. Each tenant owns an undivided share of the entire project.

CRANE V. COMMISSIONER 331 U.S. 1 - Supreme Court case which held that the purchase price of a property includes any mortgages acquired or assumed.

DEBT SERVICE - The amount paid toward the mortgage including both interest and amortization.

DEPRECIATION - Income tax deduction at a fixed rate permitted the owner of a building as compensation for wear and tear or obsolescence.

DEPRECIABLE BASIS - The portion of the amount paid for a property which can be depreciated.

DEVELOPER - The person, organization, or firm which coordinates the construction or rehabilitation of real estate.

DISCOUNT RATE - The rate at which future cash flows are reduced per year to allow them to be compared directly with current cash flows.

DIVIDEND - The amount of cash paid an investor per year. It is limited to 6 percent on an FHA - insured, limited-dividend project.

DOUBLE DECLINING BALANCE METHOD - Most accelerated method allowable for computing depreciation on newly-constructed housing. Before the 1969 Tax Reform Act this was the most accelerated method on rehabilitation. It is computed by multiplying the amount not-yet depreciated times twice the rate necessary to fully depreciate the property over its useful life.

EQUITY - Amount of cash or the equivalent invested in a property.

FORECLOSURE - Repossession of a property through a court order as a result of an unpaid debt on that property.

IMPLIED EQUITY - In an FHA-insured project, the amount of cash or its equivalent its owner is assumed to have invested in it. Generally 10 percent of the total development costs.

KNETSCH V. U.S. 364 U.S. 361 - Supreme Court case which held that a transaction constructed simply for tax benefits was illegal.

LEASED HOUSING - A form of public housing in which a local housing authority leases dwelling units in private housing for occupancy by tenants eligible for public housing subsidies.

LIMITED DIVIDEND CORPORATION - A corporation which agrees to limit the amount of profit it takes on a FHA-insured project. It is entitled to a mortgage equal to 90 percent of the total development costs.

LIMITED PARTNERSHIP - A legal organization consisting of one or more general partners who have total operational control and total liability concerning the affairs of the partnership, and one or more limited partners who serve as passive investors with liability limited to their investment. For tax purposes a limited partnership must be shown to lack two of the following corporate characteristics: 1) limited liability for all the partners, 2) centralization of management, 3) free transferability of interest among partners, and 4) continuity of the life of the partnership.

MARKET RENT - Rent based upon the full market interest rate.

MORTGAGE - A loan to finance the purchase of property secured by giving its holder the right to acquire the property if payments are missed.

NET AMOUNT REALIZED - In section 1039 of the Internal Revenue Code, the amount received on the disposition of a property, including the amount of any mortgage, transferred but minus the amount of any closing costs incurred.

NON-PROFIT CORPORATION - Legal organizational form chartered by a state entitled to receive mortgage insurance from FHA on 100 percent of the total development costs.

PRESENT VALUE - The amount which a cash flow is worth today after being discounted to the present.

RECAPTURE - Taxation in the year of sale of the amount of accelerated depreciation taken in prior years.

RENT SUPPLEMENTS - Title I, Housing and Urban Development Act of 1968. It subsidized the rent of a certain number of tenants residing in 221(d)3 or 236 projects who are eligible for public housing. These tenants pay 25 percent of their income for rent.

ROLLOVER - See SECTION 1039

SECTION 167(k) of the Internal Revenue Code - Allows the cost of rehabilitation for occupancy by low or moderate income families to be depreciated over five years.

✓ SECTION 221(d)3 of the National Housing Act - Provides loans to sponsors of moderate income multi-family housing developments at 3 percent interest over 40 years. It has been administratively superceded by Section 236.

SECTION 221(d)4 of the National Housing Act - Provides mortgage insurance for 90 percent of project expenses over 40 years for the development of multi-family housing. Developers must agree to limit their profits.

SECTION 236 of the National Housing Act - Provides mortgage insurance, for moderate-income multi-family developments also provides a debt service subsidy on the difference between a market interest loan over 40 years and a 1 percent loan over this term. Mortgages are 100 percent of total development costs for non-profit sponsors and 90 percent for limited dividend sponsors.

SECTION 312 of the Housing Act of 1964 - Provides direct loans from HUD for 100 percent of rehabilitation costs at 3 percent interest over 20 years. Priority is given to owner-occupants. Loans must be in code enforcement or urban renewal areas or the property and area must meet other specified criteria.

SECTION 1039 of the Internal Revenue Code - Provides that no gain be recognized for tax purposes on the disposition of a 221(d)3 or 236 project to the tenants. The net amount realized from disposition, including the mortgage, must be reinvested in a similar project. The depreciation allowed on the second project is reduced by the amount taken on the first. The process is referred to as a "rollover."

SINKING FUND - A hypothetical fund provided out of the earnings from the early years of a project which when set aside at a conservative interest rate grows to pay all the taxes occurring in the later years of the project.

STRAIGHT-LINE DEPRECIATION - A form of depreciation which allows a constant amount each year over the useful life of the project.

SYNDICATION - The process of selling limited partnership interests or other ownership interests in a housing development.

TAX CREDIT - An allowance to directly reduce the amount of taxes payable rather than simply the taxable income.

TAX PREFERENCE ITEMS - Capital gains, accelerated depreciation, and other tax deductions which subject a taxpayer to a minimum 10 percent tax on the excess of such items over \$30,000 plus the amount of the normal tax paid.

TOTAL DEVELOPMENT COST - The sum of all project expenses allowed by the FHA as the basis for a mortgage it insures.

TURNKEY - Private development of public housing. A private developer will construct the housing and "turn the key" over to local public housing authority, also known as Turnkey I. Turnkey II allows private management agents to

manage public housing. Turnkey III allows tenants to purchase the units in which they live through amortization payments and their own labor.

TURNKEY LEASING - Public housing program where private developers lease an entire project to a local housing authority for 40 years under Section 10(c) of the Housing Act of 1937.

USEFUL LIFE - The period of time over which wear and tear or obsolescence will render valueless a building or the improvements on a building. Depreciation is normally computed over this period.