SHELTERING SUBSIDIES

by Paul Zane Pilzer

In light of some of the tax reform proposals for 1985 and their potential impact on real estate investment, the Deficit Reduction Act of 1984 seems insignificant. The federal government is moving dangerously toward taking all tax incentives out of real estate investment. It seems to feel that the syndication industry has taken unfair advantage of existing government tax policy designed to encourage investment in real property. If the government is successful, we may find out too late that the existing unmodified tax incentives accorded real estate investment more than paid their own way in the economy and performed vital social functions, such as providing affordable housing.

Existing Incentives. Unlike some types of equipment tax shelters with substantial investment tax credits, there is no such thing as a permanent real estate tax shelter. Rather, real estate offers at best a temporary tax shelter or umbrella, an umbrella the investor must one day step away from regardless of the economic success of the investment. Every dollar taken as a tax deduction from a real estate investment must eventually be taken as taxable income when the investor (regardless of profitability) sells, transfers, or loses the investment. In the meantime, the investor benefits from the ability to defer current taxes interest-free and potentially convert some ordinary income to capital gain income which is currently taxed at lower rates.

Existing policy regarding an individual investor contemplating a tax-originated real estate investment is illustrated by the following government soliloquy:

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"Look, Mr. Investor, you made an extra $50,000 this year of which I'm going to take my $25,000 (50 percent federal tax bracket). If you invest in a 2-to-1 write-off tax shelter, however, I'll make you the following deal. First, put $25,000 cash in the tax shelter investment and *temporarily* reduce your tax due this year by $25,000. During the next few years, I'll examine your real estate tax shelter. (I'm too busy now.) I'll look carefully at the economic viability of the project and if I think (with the benefit of hindsight) that it wasn't economically viable, I'll retroactively disallow your tax deductions. You'll then pay the $25,000 in taxes you would have paid without the tax shelter plus penalties, and you'll probably also lose your $25,000 investment. Separately, I'll look carefully at the structure of the partnership and although you're not a lawyer, I'll hold you 100 percent liable for the strength of the legal partnership tax structure. Additionally, although you're not a tax accountant, I'll also hold you 100 percent liable for your accountant's interpretation of my complex tax rules. Furthermore, I'm likely to change these rules at any time and disallow your deductions retroactively (without "grandfathering" your investment). When you sell, lose, or transfer this investment, even at a substantial cash loss, I'll guarantee that every dollar you have taken as a tax deduction I'm going to tax you for as income. I might let some of it be capital gain income (which I tax at lower rates) instead of ordinary income. But I should also warn you that I frequently change my mind about taxing capital gain income at lower rates without considering your existing investments."

As illustrated above, a taxpayer currently in the 50 percent bracket can decide whether to pay a cer-

tain sum of income taxes to the government, or defer tax payment by investing in a real estate limited partnership with a 2-to-1 write-off. The investor runs the risk of having to pay both individual income taxes and the investment cost (double liability) if the real estate partnership is not properly structured from a legal and accounting standpoint, or if the underlying real estate project is not commercially successful.

Unknown to many legislators, the federal government, through the investment in a tax shelter, is subsidizing real estate and piggybacking onto the expertise of the private sector to administer distribution of the subsidy. The local private investor who selects a specific investment is certainly better qualified to choose among worthwhile competitive projects than the federal bureaucracy, particularly when the private investor/syndicator has so much at risk to make the investment succeed. Real estate tax incentives also induce investors to take significant long-term risks with their capital and invest in projects that generally benefit the entire community. Furthermore, civic interests are already served by regulations that allow even greater tax advantages for investment in socially (if not economically) desirable areas, such as low-income housing projects or historic rehabilitations.

Misreading the Social Role. An illustration of how misguided some legislators have become on this issue can be found in a Congressional Report by the Joint Committee on Taxation to the Committee on Ways and Means dated February 17, 1984. This report, which preceded the Deficit Reduction Act of 1984, contained an elaborate but severely misguided explanation and discussion of the undesirability of real estate tax shelters. For example, in discussing the "Economic Effects of Tax Shelters," the report stated that the "Accelerated Cost Recovery System (ACRS) increased the value of depreciation deductions on rental housing purchased after 1981" and "this contributed to a construction boom which glutted the real estate market in several southwestern cities." The report went on to state, "rents fell in response to this oversupply" and concluded that the economic effect was to "transfer wealth from existing investors to new investors" as existing apartment owners bore some of the reduction in rents. The report missed entirely the major economic public policy effect of this example; specifically that wealthy tax-shelter-oriented investors caused a severe reduction in the rents that were paid by middle- and lower-income consumers who rent multifamily housing. The report totally missed this conclusion and merely examined the impact of real estate tax shelters on existing owners of commercial real estate.

Regulation Q Replaced. From 1933 to 1979 the federal government promoted a massive subsidy of residential housing at the expense of the nation's savers. Regulation Q empowered the federal fiscal regulatory agencies to set the maximum interest rate on consumer savings, and other government regulations mandated that these inexpensively obtained funds be invested in single-family and multifamily housing. One economic effect of this government mandated subsidy was a growth in the nation's physical plant (towns and cities), causing a rapid geographic diversification unprecedented in world history. The social effect of this mandated subsidy in recent inflationary times was a transfer of real wealth from our older citizens (typically net "savers") to the younger population. In effect, the government coerced each family to assist its younger members (whether it had children or not) in starting out on their own. The social merits of such an intergenerational transfer of wealth are open to debate, but its impact on new housing and urban development was readily apparent from 1933 to 1979.

In October 1979, Federal Reserve Chairman Paul Volcker unleashed the "Saturday Night Special" in New Orleans that jolted the financial community into realizing what was happening. The ensuing deregulatory environment and proliferation of new consumer savings products put an end to the consumer supply of inexpensive housing funds. As the American dream of owning a single-family home slipped further away from the emerging baby-boom families, the demand for the alternative (multifamily) product escalated.

Consumer expenses on residential (single-family and multifamily) housing are based primarily on the costs of interest on existing debt. Additionally, most consumer multifamily housing in developing (Sun Belt) cities is of the garden-type "stick" construction that has a relatively short (five-to-ten-years) economic life before replacement costs exceed operating costs.

These factors combined in early 1981 to contribute to a potential massive housing shortage as the supply of existing housing with low-rate debt declined and existing units approached economic obsolescence. The high cost of consumer home mortgages in 1979–1981 brought most new residential construction to a standstill and hindered existing homeowners from being able to sell their houses regardless of demand.

In 1981, the accelerated cost recovery system greatly increased the value of depreciation deductions on non-owner-occupied housing purchased after 1981. This led to the creation (or emergence) of a new financial industry that filled the critical demand for reasonable residential financing. The real estate syndication industry emerged as the provider of affordable residential financing by packaging existing expensive debt with the new tax benefits. The social impact of this development has been a new voluntary transfer of consumer wealth from older, upper-income investors desiring tax savings and inflation protection to younger, lower- and middle-income families requiring affordable multifamily housing.

The actual transfer mechanism occurs as follows: A typical new residential project constructed during the past four years yields approximately a 9–10 percent annual return on a free-and-clear basis. Yet residential multifamily financing costs are approximately 13–14 percent per annum. Projects are being built throughout the United States by having a tax shelter investor agree to supply the negative carry (4 percent gap per annum) for the initial (usually three to five) years of the property. The tax shelter investor receives a tax deduction for the 4 percent gap invested annually to meet the financing costs and an additional tax deduction for the increased depreciation expense (typically 4–5 percent of total financing/project cost). These two tax deductions total 8–9 percent per annum, giving the investor a 2-to-1 to 2.25-to-1 tax deduction on 4 percent (of total costs) per annum cash investment.

Taking Risks. The tax shelter investor incurs substantial risks, however. First, and foremost, the investor is betting on continued inflation to increase the net operating income from the project to the level of the financing expenses by the end of the three-to-five-year pay-in period. If this does not occur, the investor may have to feed the investment indefinitely. As illustrated earlier, investors do not "use the government's money" to make investments; they merely borrow, interest-free, from the government, but the loan must be repaid regardless of the success of the project.

It is interesting to note that due to the highly competitive development, financial, and syndication markets, apartment rents have risen just to the point where the tax-oriented equity investor receives zero cash flow for several years, paralleling one term of the "interest-free loan" received from the government to make the investment. Note also the contrast between the risk/reward ratio of today's tax shelter equity investor and the traditional "hard" equity investor who typically put in 25 percent of the project cost up front. The traditional investor usually received an initial cash flow return and subordinated his investment to only a 75 percent of cost loan, instead of the 100 percent of cost loan required to facilitate today's deep-shelter deals.

Operating a residential housing project is a risk-laden business; even a temporary slip in management can be catastrophic due to the short-term nature of residential leases and the 75–100 percent of value debt burden. If tax-oriented investors were not available, rents would have to rise to where the property's initial net operating income approached the current cost of financing, or 13–14 percent of total project cost. This would cause rents throughout the United States to rise to approximately 150 percent of their current levels.

Single-Family Housing. Another recent creative development of the syndicators is to make these benefits available to many first-time single-family home buyers as well as renters. A first-time home buyer is usually not in a high-enough tax bracket to maximize the value of the single-family home interest and property tax deductions (depreciation deductions are not allowed for owner-occupied housing). Additionally, many potential first-time home buyers cannot qualify for mortgages at today's 13–14 percent level. Throughout the country, the syndication industry is stepping in to fill this need for affordable single-family home financing and efficiently transfer the tax benefits of ownership to investors in higher tax brackets.

These programs have names such as "Enter" or "Home by Five" and work as follows: When the

potential homeowner finds a house, the tax-oriented syndication group buys the house and leases it for five years to the potential homeowner. The syndication group borrows 100 percent of the home's cost at approximately 13–14 percent. The homeowner pays rent of 9–10 percent and receives an option to purchase the home in five years at an indexed or below-appraisal price. Most important, the homeowner only has to initially qualify for financing at the 9–10 percent level instead of 13–14 percent. The tax-oriented syndication investor supplies the 4 percent per annum gap for five years and receives tax deductions of 8–9 percent as illustrated in the earlier apartment example. Note both the shifting of the tax benefits to parties who can utilize them better as well as the creation of previously nonexistent depreciation deductions.

In these new cases as well as in existing tax-shelter-oriented investment, the government is subsidizing consumer housing costs and using the upper-income private sector to administer distribution of the subsidy. The private sector undertakes substantial risks in selecting and operating the subsidy properties commensurate with the potential rewards if the projects chosen are successful.

Conclusion. In summary, current legal, tax, and accounting regulations are structured to serve the community and protect both the government and the public from abusive tax shelters. What may be needed is greater enforcement of current regulations, not new laws which would circumvent the vital private sector role provided by the real estate tax shelter industry.

If anything, the government should seek to increase the role of the private sector in administering socially desirable real estate subsidy programs. One way would be to extend the extra tax benefits that are available to low-income and historic rehabilitation projects to include commercial projects which provide local employment in designated low-income areas. Another would be to return to the tax advantages on new construction that were available prior to the Tax Reform Act of 1976, thus stimulating new construction even more than ordinary real estate investment. ■