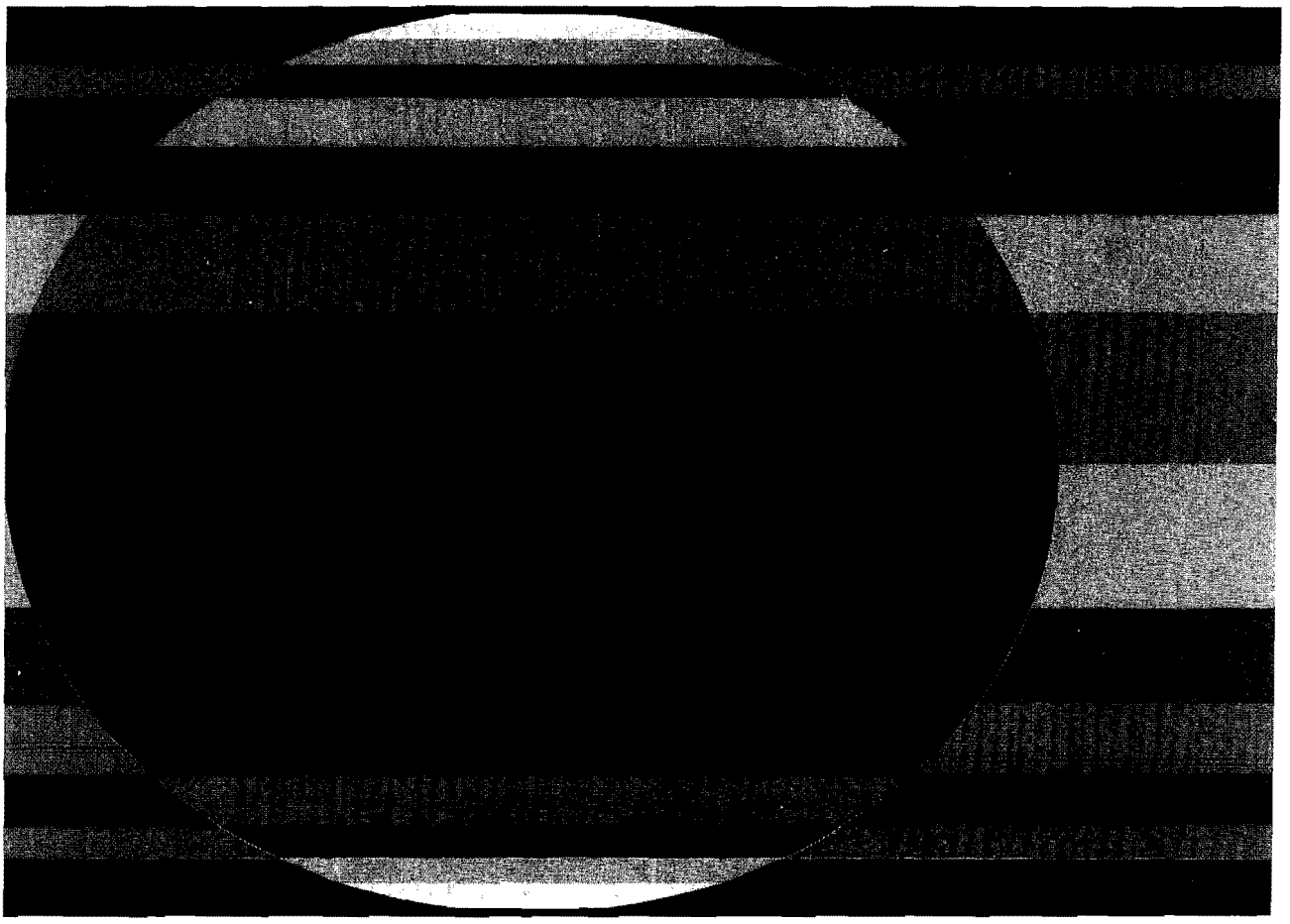
BACKGROUND PAPER

Real Estate Tax Shelter Subsidies and Direct Subsidy Alternatives

May 1977



Congress of the United States
Congressional Budget Office
Washington, D.C.

REAL ESTATE TAX SHELTER SUBSIDIES

AND DIRECT SUBSIDY ALTERNATIVES

The Congress of the United States
Congressional Budget Office

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PREFACE

The Tax Reform Act of 1976 (Public Law 94-455) imposed a number of significant new limits on real estate and other tax shelters. Because of a concern that these changes could have an adverse effect on the production of new low- and moderate-income rental housing, this form of housing was exempted from the most important new limit for five years, until 1982. This was done at the urging of the Department of Housing and Urban Development in order to give the Congress and the Executive time to consider and implement alternative methods of subsidizing low-and moderate-income rental housing.

Real Estate Tax Shelter Subsidies and Direct Subsidy Alternatives is intended to assist in this process by analyzing a number of alternative subsidies that could substitute in whole or in part for the existing tax shelter subsidies. The study was prepared in response to a June 8, 1976, request from Chairman William Proxmire of the Senate Committee on Banking, Housing and Urban Affairs, Chairman Henry S. Reuss of the House Committee on Banking, Finance and Urban Afairs, and then-Chairman Brock Adams of the House Committee on the Budget. (The letter of request is reprinted in Appendix A of the report.) In accordance with the Congressional Budget Office's mandate to provide nonpartisan analysis of issues before the Congress, the study contains no recommendations.

James M. Verdier of the Tax Analysis Division prepared the report, with the assistance of Roger C. Faxon of the Budget Analysis Division. A number of people within CBO provided valuable comments and suggestions, including Charles Davenport, Neil S. Mayer, David S. Mundel, David Rowe, and Philip A. Sampson.

Many people outside of CBO gave generously of their time and assistance during preparation of the report. Robert H. Kuehn, Jr. in particular provided invaluable guidance and assistance throughout the entire process. Others who contributed valuable comments on the various drafts include Gerard M. Brannon, William D. Comings, Jr., David Einhorn, Jane G. Gravelle, Francis J. Grey, George Gross, William G. Hamm, Jerome Kurtz, Robert L. Kuttner, Bruce S. Lane, Paul R. McDaniel, Duane T. McGough, Roger Schwarz, Emil M. Sunley, Jr., Stanley S. Surrey, Ira Tannenbaum, Thomas Tweel, John C. Weicher, Irving H. Welfeld, James W. Wetzler, and Harold Wolman. The report was edited by Patricia H. Johnston, and Linda Anderson and Shirley Hornbuckle typed it for publication.

Alice M. Rivlin
Director

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SUMMARY

WHY CONSIDER ALTERNATIVE SUBSIDIES?

The Tax Reform Act of 1976 imposed significant new limits on real estate and other tax shelters. These new limits are only the most recent in a series of Congressional and administrative attempts, going back more than a decade, to scale down the benefits of real estate tax shelters.

Real estate tax shelters are not an entirely deliberate Congressional creation. They evolved primarily from the use of various tax provisions by private individuals in ways not foreseen by the Congress. As awareness grew of the use being made of these provisions, repeated attempts were made to cut back or eliminate the tax shelters that resulted. The process has been a continuing one, and is unlikely to end with the Tax Reform Act of 1976, in which real estate tax shelters are generally thought to have fared better than other forms of tax shelter. As a result, they remain unusually vulnerable to future legislative and administrative limitations.

If the Congress determines that continued government assistance for real estate construction is needed, it may therefore be useful to consider alternative forms of subsidy that would be less vulnerable to criticism and future change than existing tax shelter subsidies. The potential difficulties are particularly acute in the case of low- and moderate-income rental housing. There tax shelter subsidies must normally be combined with other direct grant and loan subsidies before any significant amount of new construction will be undertaken at all. Removal or reduction of any one of the subsidies could make new construction of this form of rental housing uneconomical.

This special vulnerability of low- and moderate-income, government-subsidized rental housing was acknowledged in the Tax Reform Act of 1976, which exempted this form of rental housing from the most important new limit on real estate tax shelters for five years, until 1982. This was done at the urging of the Department of Housing and Urban Development (HUD), in order to give the Congress and the Executive time to consider and implement alternative methods of subsidizing low- and moderate-income rental housing.

Given the time usually required to get new programs in place and fully operating, the Congress may have only about two years in which to consider and enact an alternative subsidy if one is determined to be needed. This report is designed to help in that process by analyzing a number of possible alternative subsidies.

WHO GETS WHAT FROM REAL ESTATE TAX SHELTER SUBSIDIES?

The primary function of real estate tax shelters is to provide developers and builders of rental property with part of the money they need "up front" to finance new building construction. Tax shelters provide a 10- to 20-year stream of tax savings which the builder/developer can sell to wealthy outside investors. The money they pay him is used, along with a mortgage loan, to finance construction of the building. In effect, therefore, real estate tax shelters are simply a device to provide a government subsidy for building construction.

Only about half of what the tax shelter subsidy costs the government in lost revenue, however, ever reaches builders and developers. The remainder goes in the form of payments to the outside investors for the use of their money, and in fees to the syndicators, lawyers, and accountants who are needed to put together and sell the tax shelter package.

In addition, less than two-thirds of the estimated $1.3 billion a year the government loses in tax revenue from real estate tax shelters is used to subsidize construction of rental housing. The remainder subsidizes the construction of office buildings, shopping centers, and other commercial buildings. And of the total subsidy, only about 11 percent is used to assist low- and moderate-income rental housing construction. The rest of the rental housing share provides subsidies for middle- and upper-income rental housing.

In devising alternatives to real estate tax shelter subsidies, therefore, there are two possible sources of savings. If an alternative subsidy can be provided more directly to builders and developers of rental property, the extra costs resulting from payments to outside investors and fees to tax shelter syndicators could be avoided. In addition, if it is determined that less subsidy is needed for office buildings, shopping centers, and upper-income rental housing, tax shelters for those forms of construction could be scaled down or eliminated. The revenue saved could then be used for other purposes, including increases in the level of subsidies for low- and moderate-income rental housing.

ALTERNATIVE SUBSIDIES FOR RENTAL HOUSING

The alternative subsidies discussed in this report are primarily for rental housing, with special emphasis on low- and moderate-income rental housing. It would be possible in most cases, however, to use the same subsidy mechanisms to subsidize commercial real estate construction as well.

Six criteria are used to evaluate the alternative subsidies: cost, efficiency, ease of administration, incentives for good management and maintenance, tax equity and neutrality, and visibility and controllability.

Direct HUD Construction Grants to Builder/Developers

Under this subsidy option, HUD would provide a direct grant to the builder/developer equal to a percentage of the cost of the building. The grant could be set at a level that would provide the builder/developer with at least as much money up front as he now gets from the tax shelter subsidy. The government would save the extra costs now incurred in the tax shelter subsidy system for payments to outside investors and fees to syndicators.

If the grant were made automatically available to any builder/developer of rental housing, as the tax shelter subsidy is, it should be relatively easy to administer. If eligibility for the grant were subject to various limits and restrictions, however, administration would be more difficult. But that is true of any of the subsidies discussed in the report.

Eligibility may be limited simply to keep the costs down. It could also be limited to focus the subsidy more precisely on meeting certain housing policy goals. Only rental housing built for those with low and moderate incomes might be eligible, for example, or only housing built in particular areas. In that event, a direct construction grant from HUD could have administrative advantages over a tax subsidy from the Internal Revenue Service (IRS). A tax subsidy would require joint HUD-IRS administration or cooperation to accommodate it to both housing policy and tax policy goals. This could result in conflicting eligibility requirements and multiple reviews, adding both complexity and delay to the process.

A direct construction grant would have low incentives for good management and maintenance, since the builder/developer could get

the grant for building the project, and then walk away from it. Management and maintenance incentives could be improved under this option, however, by paying the grant in installments over a number of years.

A direct construction grant as a replacement for real estate shelters would increase tax equity among individuals, since it would make it harder for wealthy individuals to use shelters to reduce their tax payments below those of others with the same or lower incomes. Tax neutrality would also be impoved if the special tax advantages investments in real estate now have over other forms of investment were reduced.

In contrast to tax shelter subsidies, which have low visibility in the federal budget and are generally not subject to regular review and control, a direct construction grant would be highly visible and thus subject to more careful and thorough review by the Congress and the Executive. This could be considered a disadvantage by some, however, since it could make the subsidy less certain and more vulnerable to cutbacks and restrictions.

Refundable Investment Tax Credit for Builder/Developers

A refundable investment tax credit would work almost exactly like a direct construction grant from HUD, except that it would be provided by IRS through the tax system.

Under this option, the builder/developer would be entitled to a tax credit equal to a percentage of the initial cost of the building. In a building costing $1 million, for example, a 10 percent credit would be worth $100,000. The builder/developer could subtract that amount directly from the amount of taxes he would otherwise have to pay. If his tax liability were not as large as the amount of the credit, the refundable feature of the credit would require the IRS simply to write him a check for the difference. If the builder/developer's tax liability in the year of construction was $25,000, for example, a refundable investment tax credit of $100,000 would completely wipe out that liability, and also entitle him to a check from the IRS for the remaining $75,000. It would therefore be unnecessary for him to sell tax losses he could not use to others. He would get his money directly and automatically from the Treasury, rather than from the proceeds of a tax shelter syndication to outside investors.

If it were decided to make the alternative subsidy available across-the-board to builder/developers of all rental housing, or if

only a few simple eligibility requirements were imposed, the refundable investment tax credit could have an administrative advantage over a direct construction grant from HUD. As long as no coordination with HUD was necessary to accommodate housing policy goals, a refundable credit could be provided easily through the IRS' existing tax refund system.

Nonrefundable Investment Tax Credit for Builder/Developers

This option would work the same as the refundable investment tax credit, except that the builder/developer could not get a credit in any year larger than the amount of his tax liability in that year. In the previous example, where the builder/developer's tax liability was $25,000 for the year, he could only get that much of his $100,000 credit in that year. However, if the credit were set up in the same way as the present 10 percent investment tax credit for machinery and equipment, he could use the remaining $75,000 to offset his tax liability in prior or future years.

The builder/developer might also be able to use syndication or a similar device to sell outside investors the right to the unused $75,000. This could be simpler and less costly to both him and the government than syndication of tax shelter savings. Credits are simpler and easier to understand than the complicated deductions, deferrals, recaptures, and minimum and maximum taxes involved in syndicating tax shelter savings, so the job of explaining the potential tax savings to outside investors would be easier. Credits could also be sold to a wider range of investors, not just the 1 percent of taxpayers with marginal tax brackets above 50 percent who are now the only ones who can profitably invest in tax shelters.

The government could also save money with an investment tax credit, since the extra subsidy costs which now go in the form of windfall tax savings to outside investors in high marginal brackets above 50 percent would not be incurred. Credits are worth the same amount in tax savings to investors in all tax brackets, rather than being worth progressively more as the investor's top marginal tax bracket increases. A $500 tax credit would save $500 in taxes for anyone in any tax bracket who had a tax liability of $500 or more, with no extra windfall to those in higher tax brackets. A $1,000 tax shelter deduction, on the other hand, saves an investor in the 50 percent bracket only $500 in taxes, while it saves the 70 percent bracket investor $700.

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Interest Subsidies For Builder/Developers

Only a portion of the money the builder/developer needs to construct new rental housing comes from the sale of tax shelter savings to outside investors. By far the largest portion comes from the mortgage loan. A reduction in interest on the mortgage loan could have the same value to the builder/developer and to outside investors as the tax shelter savings. A lower mortgage interest rate would reduce the project's future expenses and increase the future cash distributions. Outside investors should be willing to pay the builder/developer for those future increased cash distributions, just as they pay now for future tax shelter savings. A reduction in the mortgage interest rate of an appropriate amount could, therefore, make up for removal of the tax shelter subsidy.

The mortgage interest rate could be reduced in either of two ways: direct interest reduction payments to the building owner or the mortgage lender, or direct government loans at interest rates below the market rate. Both of these devices are currently used to some extent to subsidize rental housing construction, and their use could be expanded.

Interest subsidies may provide somewhat more of an incentive for good management and maintenance than pure construction subsidies. The reason is that payment of the subsidy is spread out over the life of the project, rather than being provided all at once up front. Building owners would therefore have a greater interest in the long-term viability of the project. It would also be easier to make continued payment of the subsidy contingent on continued good management and maintenance.

Like tax shelter subsidies, interest subsidies have low visibility in the federal budget, generally are not subject to regular review and control, and tend to be provided in complicated and circuitous ways that make their size and impact difficult to measure.

Section 8 New Construction Program

Section 8 is HUD's main subsidy program for low- and moderate-income rental housing. Under this program, HUD contracts to make subsidy payments to owners or landlords of rental housing units on behalf of low- and moderate-income tenants. The tenant pays the landlord up to 25 percent of his income in rent, and HUD then pays

the landlord the difference between that amount and the fair market rent for the unit.

Section 8 is actually two separate programs. One provides rent subsidy payments for low- and moderate-income tenants in existing housing, while the other is aimed at stimulating new construction. In the new construction program, HUD contracts with builder/developers to make rent subsidy payments to them on behalf of eligible renters for up to 30 years (40 years if the project is financed by state or local housing agencies).

At some point in the future, it is possible that a well-run Section 8 new construction program could substitute at least in part for tax shelter subsidies in low- and moderate-income rental housing. For now, however, the Section 8 program has an important advantage that can make it a valuable complement to the pure construction subsidy alternatives to tax shelters. Because it is tied to rents and is spread out over 30 to 40 years, and because its continuation can be made contingent on the subsidized units being kept in good condition, it can provide very significant incentives for good management and maintenance. It can, therefore, be combined with a construction subsidy in a way that leaves each project with a set of complementary and mutually reinforcing subsidies. The builder/developer's up-front construction money could come from a direct grant or an investment tax credit, while the incentives for good management could come from the Section 8 subsidies.

Supplementary Incentives And Subsidies For Management and Maintenance

While the incentives for good management and maintenance are generally low in real estate tax shelters -- as they are with all the construction subsidy alternatives discussed -- tax shelters do provide at least a negative incentive for good management and maintenance. If the project is managed and maintained so poorly that it goes into foreclosure in the first 10 to 20 years of its life, the "recapture" provisions of the tax laws can reduce or eliminate many of the tax shelter savings investors anticipated. The direct construction grant and investment tax credit options could be structured to contain a similar incentive by requiring repayment of part of the subsidy if the mortgage is foreclosed. If this repayment requirement were gradually phased out over a period of 10 to 20 years, it could approximately duplicate the incentives provided in tax shelters by the recapture provisions.

TABLE S-1. SUMMARY OF ALTERNATIVES TO REAL ESTATE TAX SHELTER SUBSIDIES, USING VARIOUS CRITERIA FOR EVALUATION

Alternative Subsidies	Cost a/	Efficiency (Percent of Subsidy Reaching Builder/Developer)	Ease of Administration
Continue Tax Shelters for All Rental Housing	$0.85	40-60	Depends on limits and restrictions on eligibility; possible additional problems from joint HUD-IRS administration.
Direct HUD Construction Grants	$0.4-0.6	90-100 b/	Depends on limits and restrictions on eligibility; no problems with joint HUD-IRS administration.
Refundable Investment Tax Credit	$0.4-0.6	90-100 b/	Depends on limits and restrictions on eligibility; possible additional problems from joint HUD-IRS administration.
Nonrefundable Investment Tax Credit	$0.4-0.6	70 -100 b/	Depends on limits and restrictions on eligibility; possible additional problems from joint HUD-IRS administration.
Interest Subsidies	$0.4-0.6	70-100 b/	Depends on limits and restrictions on eligibility; no problems with joint HUD-IRS administration.
Section 8 New Construction Program	$0.4-0.6	Uncertain	Same as present; no problems with joint HUD-IRS administration unless combined with a tax subsidy.

a/ Revenue loss or budget outlay in billions of dollars. The amount shown is the approximate amount needed to provide builder/developers of rental housing with the same amount of subsidy now being received from tax shelters.

b/ The builder/developer's share of the total subsidy will be less than 100 percent in these alternatives if interests in the project and the subsidy must be sold or syndicated to outside investors.

(continued)

(Table S-1, continued)

Alternative Subsidies	Incentives for Good Management and Maintenance	Tax Equity and Neutrality	Visibility and Controllability
Continue Tax Shelters for All Rental Housing	Low to Moderate	Low	Low
Direct HUD Construction Grants	Low to Moderate	High	High
Refundable Investment Tax Credit	Low to Moderate	Improved	Medium
Nonrefundable Investment Tax Credit	Low to Moderate	Improved	Medium
Interest Subsidies	Possibly Higher	High	Low
Section 8 New Construction Program	High	High	High

Management incentives might also be improved if higher management fees were provided. This may be especially important in the case of low- and moderate-income subsidized projects, which may involve additional management expenses in selecting and certifying eligible tenants, collecting rents, and so forth.

Low- and moderate-income rental housing projects may also involve additional maintenance cost, which might be covered by an operating expense subsidy. However, it is difficult to devise an operating subsidy formula that covers the additional operating expenses that may be unique to low- and moderate-income projects, without at the same time rewarding instances of poor and inefficient management. The experience with operating subsidies in public housing has not been entirely satisfactory. It may be useful to gain more experience with operating subsidies there before extending a similar system to low- and moderate-income rental housing.

CHAPTER I INTRODUCTION: WHY CONSIDER ALTERNATIVE SUBSIDIES?

In the Tax Reform Act of 1976, Congress imposed significant new limits on real estate and other tax shelters. 1/ These new limits are only the most recent in a series of Congressional and administrative attempts, going back more than a decade, to scale down the benefits of real estate tax shelters.

Beginning in 1964 and continuing in 1969 and 1976, the Congress imposed increasingly tighter direct and indirect limits on real estate tax shelter investments. At the same time, the Internal Revenue Service (IRS) sought to limit real estate and other tax shelters through administrative rulings and tighter enforcement.

This pattern of gradual tightening is due in large measure to the fact that real estate tax shelters are not an entirely deliberate Congressional or administrative creation. To a large extent they just grew, as private individuals began to use various provisions of the tax law and administrative rulings to shelter income from tax in ways not foreseen by the Congress or the IRS. As awareness of the use being made of these provisions increased, the Congress and the IRS made repeated efforts to cut back or eliminate the tax shelters that resulted. The process has been a continuing one, and is unlikely to end with the Tax Reform Act of 1976. This is particularly true of real estate tax shelters, which are generally thought to have fared better under that act than other forms of tax shelter.

Real estate tax shelters now stand out as one of the few significant tax shelters left. But if the past is a guide, visibility can mean vulnerability. Real estate tax shelter subsidies rest on a complex and delicate structure of administrative rulings and tax laws. Seemingly small changes can undermine or even collapse the entire structure. Just recently, the IRS hurriedly withdrew proposed regulations dealing with the classification of organizations for tax purposes as partnerships or corporations amid protests that the regulations would remove one of the crucial

1/ Public Law 94-455 (October 4, 1976), Titles II and III.

supports for real estate tax shelters, and bring construction of low- and moderate-income rental housing to a halt. 2/

While this vulnerability to small changes is true of real estate tax shelters generally, it is an especially serious problem for low- and moderate-income rental housing. There the complex structure of tax shelter subsidies must normally be combined with an equally complex set of direct grant and loan subsidies before any significant amount of new construction will be undertaken. Removal or reduction of any one of the subsidies could make a project uneconomical.

This special vulnerability of low- and moderate-income, government-subsidized rental housing was acknowledged in the Tax Reform Act of 1976, which exempted this form of rental housing from the most important new limit on real estate tax shelters for five years, until 1982. This was done at the urging of the Department of Housing and Urban Development (HUD), which argued that the five-year "grace period" was needed to give the Congress and the Administration time to consider and implement alternative methods of subsidizing this type of rental housing. Given the time usually required to get new subsidy programs in place and fully operating, the Congress may have only about two years in which to consider and enact an alternative subsidy for low- and moderate-income rental housing, if one is determined to be needed.

If the Congress wishes to continue providing a subsidy for other forms of real estate construction, such as middle- and upper-income rental housing, office buildings, and shopping centers, it may be useful to consider alternatives to tax shelter subsidies in those cases as well. It may be possible to devise a form of subsidy that is less vulnerable to criticism and to future legislative and administrative changes than the present tax shelter subsidy has been.

The analysis which follows is designed to help in this process. In accordance with the letter requesting this study from the Senate Committee on Banking, Housing and Urban Affairs, the House Committee on Banking, Finance and Urban Affairs, and the House Committee on the Budget, reprinted in Appendix A, the analysis focuses especially on alternative subsidies for low- and moderate-income rental housing.

2/ For an account, see "Simon Vetoes New Curbs on Tax Shelters," Washington Post, January 6, 1977, p. 1.

CHAPTER II TAX SHELTER SUBSIDIES FOR REAL ESTATE

In order to evaluate existing real estate tax shelter subsidies and the possible alternatives, it is important to understand first how the existing subsidies operate, who benefits from them, and how they developed.

A SIMPLIFIED REAL ESTATE TAX SHELTER IN OPERATION

Real estate tax shelters can be quite complex. They involve a number of different provisions of the tax code and a number of different participants playing different roles. The description of a sample project that follows has been simplified in order to bring the main elements into sharper focus. More details on the sample project and on the assumptions underlying the calculations in this chapter are set out in Appendix B. 3/

Financing a Rental Housing Project

The project to be built is an apartment building. The total cost of development, including land and construction costs, is $1,000,000. The builder/developer 4/ is able to obtain a 40-year loan for 90 percent of that cost ($900,000) from a private lender (bank, savings and loan association, insurance company, etc.) or from a state housing agency. 5/ The builder/developer must come up

3/ The sample project is based on pro-forma assumptions and a computer model developed for CBO by Robert H. Kuehn, Jr., of the Housing Economics consulting firm in Cambridge, Massachusetts. The calculations in this chapter have been prepared with the assistance of Mr. Kuehn and this computer model.

4/ While the builder and the developer of a real estate project are often different people, the roles are combined frequently enough that it is customary to refer to them together. The custom will be followed in this report unless there is some reason to make a distinction.

5/ FHA mortgage insurance would be needed to obtain these terms from a private lender. The 7½ percent interest rate which is assumed is based on current FNMA/GNMA Tandem Plan Financing or State Housing Agency Financing using tax-exempt bonds.

with the additional $100,000 on his own. If possible, he would like to raise more than that in order to increase his profit.

In order to obtain the $900,000 loan plus the additional $100,000-plus he needs, the builder/developer has the following potential sources of income which he can borrow against or sell interests in:

- Cash return from rents on the completed project. In a middle-or upper-income rental housing project, the potential return from rents is a major inducement for potential lenders and investors. In a project intended for low- and moderate-income renters, however, the rents tenants can afford to pay will be low. In addition, HUD and state housing agencies frequently limit the cash distribution from rents in subsidized low- and moderate-income projects. Some additional inducements are therefore necessary.

- Possible increase in the project's value. If the project increases in value over time, it can be sold or refinanced at a profit. This is another major inducement for potential lenders and investors. In the past, investors tended to discount the possibility that low-and moderate-income projects would increase in value, since locations were often less desirable, amenities fewer, and rent increases harder to obtain. In recent years, subsidized projects have been built in better locations with competitive amenities, and subsidy programs have been designed to make it easier to obtain rent increases. Whether investor perceptions have changed accordingly is not certain.

- Subsidies from HUD and state or local housing agencies. Low-and moderate-income rental housing construction is subsidized by a wide variety of federal, state, and local programs. These subsidies, many of which are often combined in a single project, include contracts for future rent payments on behalf of lower-income tenants, interest subsidies, reductions in local real estate taxes, and direct and guaranteed loans. In the case of low- and moderate-income rental housing, however, these subsidies may not be enough to make up fully for the lower return on rents and the smaller likelihood of future increases in the project's value.

- Special tax advantages that, in combination, will permit income to be sheltered and tax payments avoided or defer-

red. These tax advantages can be quite valuable, but the builder/developer is rarely able to use them himself. The main reason is that the tax advantages take the form of tax losses which can be used to offset or shelter other income, and the builder/develper usually does not have enough outside income to use the losses. In addition, the tax losses are spread out over time, and the builder/developer needs the money right away. He therefore sells interests in the project and the right to these losses to wealthy outside investors. The money the builder/developer receives from selling the right to these tax losses is what provides him with the remainder of the capital he needs to make the project a viable one. In low-and moderate-income projects, a large share of the total return comes from the sale of tax losses and from the various government subsidies. In higher-income projects, a greater share comes from rents and future increases in the project's value.

Selling the Tax Benefits

The tax benefits from real estate tax shelters are spread out over a period of years. While many of the benefits are concentrated in the first five to ten years of the project's life, the stream of benefits continues to flow over a period of 15 to 20 years.

In trying to determine how much he can sell the tax shelter benefits for, the builder/developer tries to calculate what this stream of tax benefits would be worth to an outside investor if he had to pay for all of them today. He asks, in other words, what the "present value" of a 20-year stream of tax shelter benefits would be to a potential outside investor. To determine this, he must discount the tax benefits to be received in each year according to a formula that takes account of the fact that $100 received in year 20 is much less valuable to an investor than $100 received in year five.

The discount rate used in this calculation will take into account the rate of return the outside investor could earn on alternative investments, and the risk that the project might not be as successful or the tax benefits as great as expected. Taking these factors together, a builder/developer will commonly assume that the average outside investor's discount rate is about 20 percent.

But an additional factor must also be taken into account. The losses or deductions from the tax shelter will be worth more to an investor in the top 70 percent marginal tax bracket than to one in

the 50 percent marginal bracket. Each $1,000 in annual losses or deductions from the tax shelter will save a 70 percent bracket taxpayer $700 a year in taxes, while it will save the 50 percent bracket taxpayer only $500 a year in taxes. If the builder/developer could sell all the tax losses to 70 percent bracket taxpayers, he could get more for them, since they are worth more in tax savings to these top-bracket investors. But there are usually not enough 70 percent bracket investors to go around. In most cases, the builder/developer will have to sell the tax losses at a price low enough to attract a 50 percent bracket taxpayer. 6/ This means that the builder/developer will get less for his tax losses, and that any investors with marginal tax brackets over 50 percent will get a windfall benefit that increases in size as their top marginal tax bracket increases.

6/ Tax shelters are rarely, if ever, a profitable investment for taxpayers with marginal brackets below 50 percent. The following table shows the number of taxpayers with top marginal tax brackets of 50 percent or higher for 1973, the latest year for which these statistics are available. The total number of returns filed in that year was 64,673,050.

Top Marginal Bracket	Number of Returns	Percent of Total returns filed
50%	205,918	0.32%
51-59%	247,459	0.38
60%	29,501	0.05
61-69%	68,480	0.11
70%	17,491	0.03
Total	568,849	0.88%

Source: U.S. Internal Revenue Service, Statistics of Income, 1973, Income Tax Returns (November 1976), Publication 79 (11-76), Table 3.14, p. 111.

The top left portion of Table 1 shows the present value of the 20-year stream of total benefits in this sample project to outside investors with marginal tax brackets of 50, 60, and 70 percent. Column (1), entitled "Tax Shelter Savings," separates out the tax savings that result from the special advantages of tax shelters. 7/ As indicated, the builder/developer probably will not be able to sell this future stream of tax savings for much more than $71,800, the amount they are worth to a 50 percent bracket taxpayer.

In this sample project, however, he has other benefits he can also sell to outside investors. There are the additional tax savings resulting from straight-line depreciation, reduced by whatever capital gains tax must be paid when the project is sold in year 20. As shown in column (2), the net value of these "Other Tax Savings" is $29,200 to an investor in the 50 percent bracket. There are also the after-tax "Cash Distributions from Rents" over 20 years, which have a present value of $39,000 for investors in all tax brackets (column (3)).

Taking all these benefits into account, outside investors in real estate tax shelter projects are usually willing to pay from 15 to 20 percent of the mortgage amount ($900,000 in this project) for a 95 percent interest in the project and its tax and cash benefits. In this sample project, it is assumed that the outside investors are willing to pay $140,000 or 15.6 percent of the mortgage. As column (4) shows, the present value of the anticipated 20-year stream of benefits to outside investors with marginal tax brackets above 50 percent is much greater than the $140,000 they are required to put into the project. They may therefore receive substantial extra benefits solely because of their higher tax bracket.

The Revenue Loss to the Treasury

While the 20-year stream of benefits from the tax shelter savings represents a gain to the builder/developer and the outside

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7/ These special tax shelter savings include those which result from (1) using accelerated rather than straight-line depreciation, (2) deducting construction period interest and taxes immediately rather than writing them off over the life of the building, and (3) paying tax on the gain on the sale in year 20 at capital gain rates (no recapture of depreciation) rather than ordinary income rates (full recapture). These tax provisions are described in more detail later in this chapter.

TABLE 1. DISCOUNTED PRESENT VALUE OF 20 YEARS OF PROJECT BENEFITS AND TREASURY REVENUE LOSSES

SAMPLE PROJECT BENEFITS OVER 20 YEARS
PRESENT VALUE DISCOUNTED AT 20 PERCENT

Investor Tax Bracket	Present Value to Outside Investors (95 Percent Share)				Present Value to Builder/Developer d/ (5 Percent Share)			
	Tax Shelter Savings a/ (1)	Other Tax Savings b/ (2)	Cash Distributions from Rents c/ (3)	Total (4)	Tax Shelter Savings a/ (5)	Other Tax Savings b/ (6)	Cash Distributions from Rents c/ (7)	Total (8)
50%	$ 71,800	$ 29,200	$ 39,000	$140,000	$ 3,800	$ 1,500	$ 2,100	$ 7,400
60%	86,200	35,800	39,000	161,000	4,500	1,900	2,100	8,500
70%	100,600	42,100	39,000	181,700	5,300	2,200	2,100	9,600

REVENUE LOSS TO TREASURY OVER 20 YEARS FROM TAX
SHELTER SAVINGS (COLUMNS (1) AND (5) ABOVE)
PRESENT VALUE DISCOUNTED AT 7.5 PERCENT

Investor Tax Bracket	Revenue Loss from Investor and Builder/ Developer Tax Shelter Savings a/
50%	$ 121,400
60%	145,700
70%	170,000

Source: Sample Tax Shelter Project. See Appendix B, pp. 119-120 for more details.

a/ Includes tax savings from (1) using accelerated rather than straight-line depreciation, (2) deducting construction period interest and taxes immediately rather than writing them off over the life of the building, and (3) paying tax on the gain on sale in year 20 at capital gain rates (no recapture of depreciation) rather than ordinary income rates (full recapture).

b/ Tax savings from deductions for straight-line depreciation, reduced by the present value of the tax paid on the gain on sale at capital gain rates. A small adjustment has been made in this column to reconcile the 20.4 percent return used for syndication pricing purposes with the 20 percent present value discount rate used in this table.

c/ These are after-tax or "tax-free" benefits. They have been internally sheltered from tax by losses which would otherwise be reflected above as "Other Tax Savings" (columns (2) and (6)).

d/ The builder/developer is assumed to be in the same tax bracket as the investors.

investors, it represents a revenue loss to the Treasury. The present value of this revenue loss or "tax expenditure" from the Treasury's point of view can be calculated in the same way as the tax benefit to the outside investors and the builder/developer.

For this purpose, it is useful to separate out just the revenue loss that results from the special advantages of tax shelters. This subsidy element is the portion of the outside investor and builder/developer benefits shown as "Tax Shelter Savings" in columns (1) and (5) in the top part of Table 1. 8/

When these "Tax Shelter Savings" are looked at from the Treasury's point of view as revenue losses, a different discount rate should be used. The Treasury's borrowing and lending rate is lower than that of private investors, and its future risks are less. It is assumed here, therefore, that the Treasury will discount the 20-year stream of revenue losses at a rate of only about 7.5 percent.

In addition, the Treasury must measure its revenue losses on the basis of what the average tax shelter investor's marginal tax bracket is, since that is the best approximation of the Treasury's actual loss. The fact that the builder/developer must sell these tax losses for only what the 50 percent bracket taxpayer will pay is irrelevant to the Treasury if the average tax shelter investor is in a higher bracket.

The bottom portion of Table 1 shows the present value of the 20-year stream of revenue losses resulting from the "Tax Shelter Savings" from the Treasury's point of view, assuming an average tax shelter investor with a marginal tax bracket of 50, 60, or 70 percent.

It is probably reasonable to assume that the average tax shelter

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8/ The builder/developer's five percent share of the "Tax Shelter Savings" is added in, since this is part of the revenue the Treasury loses. The builder/developer is assumed here to be in the same tax bracket as the investors.

shelter investor is in about the 60 percent marginal tax bracket. 9/ If so, the present value of the Treasury's 20-year tax shelter subsidy for this sample project would be $145,700.

Distribution of the Treasury Tax Shelter Subsidy

How is the $145,700 Treasury tax shelter subsidy resulting from the "Tax Shelter Savings" distributed among the various participants in the sample tax shelter project? As noted earlier, the most the builder/developer is likely to be able to sell this 20-year subsidy for is about $71,800, the amount a 50 percent bracket investor would pay. However, a syndicator is usually necessary to bring the builder/developer and the outside investor together. The syndicator will usually charge a fee of from 15 to 20 percent of the amount raised. 10/ Subtracting 15 percent from $71,800 leaves the builder/developer with $61,000, and the syndicator with $10,800. The builder/developer also gets his own 5 percent share of the tax shelter savings. This would come to about $3,800 if he were in the 50 percent bracket, bringing his total share to $64,800.

The Treasury's total 20-year subsidy is therefore distributed in the following way in this sample project:

	Subsidy Share	Percent of Total Subsidy
Builder/developer	$ 64,800	44.5%
Syndicator	10,800	7.4
Outside investors	70,100	48.1
Total	$145,700	100.0%

9/ A recent survey of a limited number of real estate tax shelter investors showed 50 percent of the investors with tax brackets below 60 percent, and 50 percent with top brackets of 60 percent or higher. Touche Ross & Co., The Impact and Effects of Section 167(k) on the Rehabilitation of Multifamily Property, prepared for the U.S. Department of Housing and Urban Development (1974), Vol. 1, p. 102.

10/ This fee includes packaging fees, brokerage commissions, legal and accounting fees, etc.

There are two main reasons why such a large share of the Treasury's tax shelter subsidy must be paid to outside investors. First, as noted earlier, investors in real estate tax shelters usually perceive their investments as quite risky, and therefore apply a high discount rate to the projected future benefits. They often know little about real estate in general, or about the particular project. This uncertainty about the unknown, when added to the inherent risks of real estate development, tends to push up their discount rate. In addition, they may lose many of the tax benefits they anticipate if the project is foreclosed, or if their top marginal tax bracket declines significantly below 50 percent in future years. This pushes up their discount rate on the tax benefits. Since there are so few investors with top marginal tax brackets high enough to make them potential candidates for tax shelter investments, and since they have a number of other opportunities for tax-reducing investments (tax-exempt bonds, for example) they are usually able to obtain the high discount rate they seek on real estate tax shelter investments. For all these reasons, the Treasury must in effect pay them more to induce them to risk their money than it would cost the Treasury itself to invest directly in the project. This difference in the discount rates (20 percent for the investors vs. 7.5 percent for the Treasury) accounts for about three-fourths of the Treasury's tax shelter subsidy payment to the outside investors in this sample project.

The other factor which accounts for the large Treasury subsidy payment in this example benefits only outside investors with marginal tax brackets above 50 percent. As noted earlier, the builder/developer can usually charge only what a 50 percent bracket investor would pay for these tax shelter savings, so anyone with a tax bracket higher than that gets a windfall. In the distribution table just shown, the outside investors were assumed to be in the 60 percent tax bracket, the approximate average for real estate tax shelter investors. The investors thereby receive a significant windfall, one which would be even larger for investors in the 70 percent bracket. 11/

The distribution of the subsidy among the various participants will vary somewhat from one project to another. The percentage going

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11/ Page 120 in Appendix B illustrates the impact of different marginal tax brackets and different discount rates on the present value of the tax shelter savings which constitute the Treasury's subsidy payment to the outside investors.

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to outside investors as a payment for the use of their money will vary depending on their marginal tax backets and the discount rates they require, with high-bracket investors generally getting a larger payment. The share going to the builder/developer will be higher if he has an especially good reputation, or if the project is an especially promising one. The syndicator's share will be smaller in a private syndication with only a few local investors than it would be in a public syndication with many investors in different parts of the country.

While the exact distribution of the Treasury subsidy in each project will be determined by the interaction of these different factors in the tax shelter marketplace, the general pattern is essentially the same in most cases. The builder/developer gets about 40-60 percent of the total subsidy, the outside investors get around 40 to 60 percent, and the syndicators get around 5 to 20 percent. The next section describes what these various participants do in exchange for the Treasury subsidy.

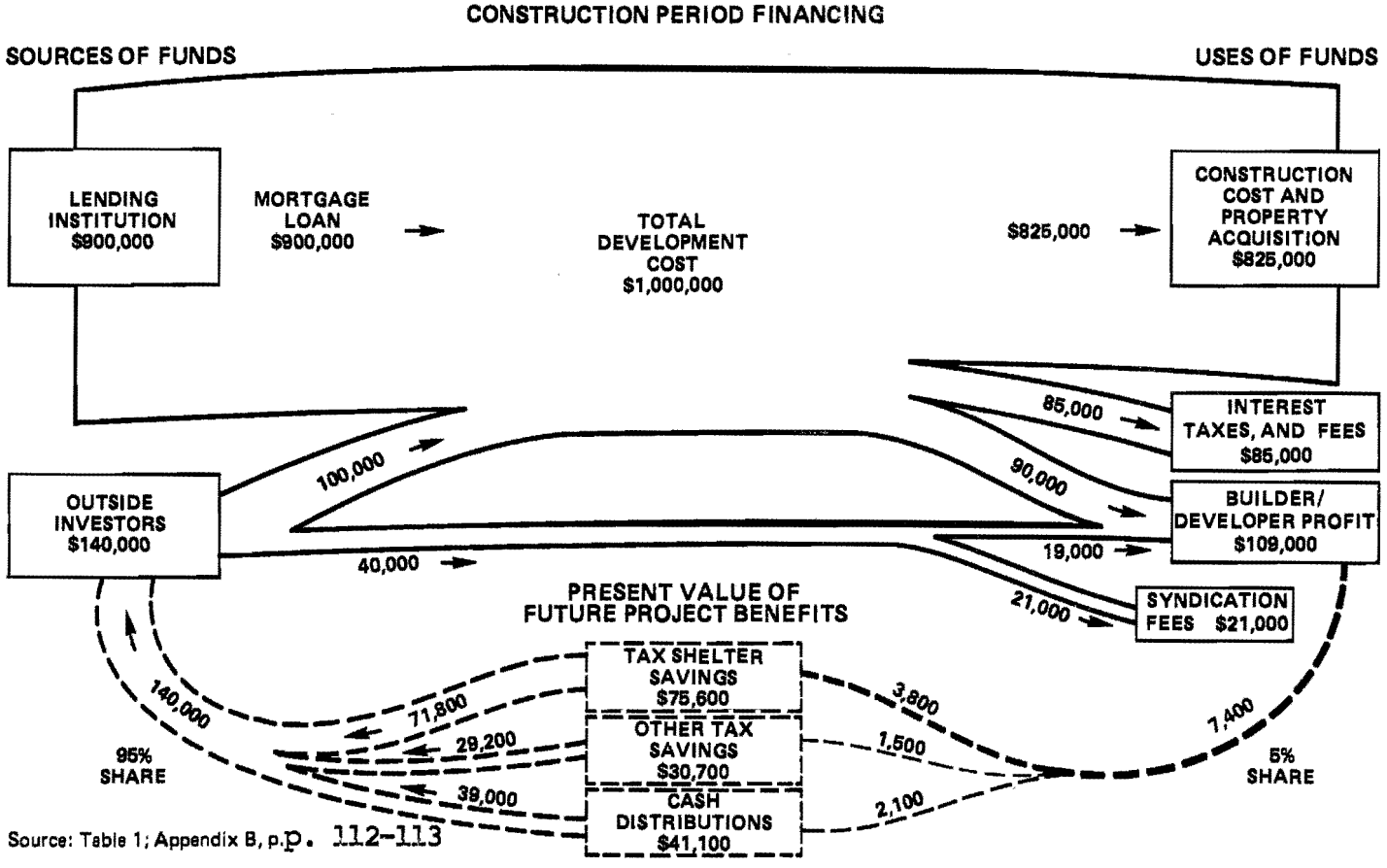
As a summary of the preceding discussion and in preparation for the discussion of the roles of the different participants, Figure 1 illustrates the flow of funds during the construction period and the distribution of the future project benefits in the sample tax shelter project. It shows where the total funds needed for development of the project come from, who receives them, and what they are used for. More details on the assumptions used in the sample project and in Figure 1 can be found on pages 112 and 113 of Appendix B.

Who Does What in A Real Estate Tax Shelter?

The real estate tax shelter subsidy system requires the involvement of people in four different roles. Frequently, as in the case of a builder/developer, one individual will play more than one role. But the roles are separate ones, and they involve different risks, rewards, and incentives.

The Developer. The developer pulls together the land, financing, local clearances, and subsidies from HUD and other sources. He handles the planning, brings together the other participants, and oversees most phases of the development process. The developer is the "prime mover" in the project, and the one who bears most of the risks in the early stages of the process. His rewards may come in part from various fees and charges in the development stage of the project, but his primary reward comes from the sale of interests in the project and its future tax benefits and

Figure 1. **Flow of Funds in Sample Tax Shelter Project; Actual Construction Period Financing Shown in Unbroken Lines, Present Value of Future Project Benefits Over 20 Years Shown in Broken Lines (50 Percent Bracket Taxpayer, 20 Percent Discount Rate)**



Source: Table 1; Appendix B, p.p. 112-113

rents to outside investors. If he retains an ownership share (as he was assumed to do in the sample project), there are also potential future returns to him from tax benefits and rents and from sale or refinancing of the project if it increases in value.

The Builder. The developer is often also the builder, but the builder's role is a separate one. The builder's main interest is in building the project, getting his payment for it, and then getting out so that he can invest his capital and resources in another project. His main risk is that cost overruns and delays will eat up his profit on the project. The builder, along with the developer, plays a central role in the project. It could not be built without their efforts.

The Syndicator. The developer may also handle the syndication, but this too is a separate role. The syndicator gets his return from the syndication fees he receives from the developer and/or from outside investors. His main interest is in continuing and expanding his syndication business. This requires that he bring in outside equity capital for the developer quickly and efficiently, and that the outside investors he brings in get the financial return they expect. His main risk is that he will be unable to satisfy the expectations of the developer or the outside investors, and thereby lose future syndication business. The syndicator may well perform a useful screening role by providing a sophisticated analysis of the economic viability of the project, and an evaluation of the reputation and ability of the developer and builder. The syndicator can only do this adequately, however, if he is acting solely as an agent of the outside investors. If he has ties to the builder/developer, as is often the case, the syndicator's analysis and evaluation will be less useful to the outside investors. Even syndicators who are independent of the builder/developer may not do an adequate job of screening projects and builder/developers. Some syndicators are better than others. Syndicators are also not the only ones who could perform this screening role. It could also be done by private lenders, state housing agencies, or HUD.

Outside Investors. The outside investors contribute a relatively small but important share of the total capital needed for the project, ranging from 10 percent or less in some projects, up to as much as 30 percent or more in others. They are interested primarily in getting as large and as early a return on their investment as they can. In a low- and moderate-income rental housing project, they expect their main return to come from the tax benefits; little or no return is expected from rents or from appreciation in the value of

the property. Investors in upper-income rental housing, by contrast, expect more of their return to come from rents and appreciation, with less coming from the tax benefits.

One of the outside investors' main risks, especially in low- and moderate-income projects with high tax benefits, is that the project will go into foreclosure before the tax savings are fully realized, or while they are still subject to "recapture" under the tax laws. 12/ The outside investors may therefore apply some pressure for good management and maintenance of the completed project -- at least management and maintenance good enough to keep the project from going into foreclosure.

Some outside investors may have a degree of knowledge and sophistication about real estate investment which can be useful for screening purposes. This is more likely if the syndication is a small one (5-10 outside investors) in which the syndicator, developer, and investors know each other and live in the same area. More frequently, however, the outside investors are doctors, lawyers, dentists, or other professionals with little knowledge of or background in real estate. They are simply buying tax losses. Often they live in another part of the country, and are in no position to judge the ability of the developer and builder, or the potential viability of the project. They are wholly dependent on the syndicator for these judgments. 13/

THE COMPONENTS OF REAL ESTATE TAX SHELTERS

Real estate tax shelters have two main goals: to defer the payment of taxes for as long as possible, and to "convert" ordinary income -- which is taxed at rates as high as 70 percent -- into capital gain income which is taxed at substantially lower rates. Deferral or postponement of tax payments can be quite valuable, because it in effect provides the taxpayer with an interest-free loan from the government. If payment can be deferred for nine years, and if the taxpayer can invest his money at 8 percent, deferral will permit the taxpayer to double his money over that period. Looked at

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12/ The concept and application of recapture is discussed in the next section.

13/ For a description of some of the problems that may arise under these circumstances, see "Doctors and Deals," a five- part series appearing in the Washington Post from February 6-10, 1977.

in another way, an investor could break even if he paid $50 today for the right to postpone a $100 tax bill for nine years. This is a measure of the present value of the nine-year deferral. 14/

Accelerated Depreciation and Expensing of Construction Period Interest and Taxes

The two main features of real estate tax shelters which permit deferral of tax payments are:

- o depreciation deductions in the early years of a building's life which substantially exceed real economic depreciation; and
- o immediate deduction of the interest and property tax costs incurred during the construction period, rather than writing these costs off over the life of the building.

Because of the special rules governing limited partnerships, the value of these deductions is substantially enhanced when a large share of the total development cost is financed with borrowed money.

Special Limited Partnership Rules

Special tax rules permit outside investors in a limited partnership to take deductions for tax purposes which may substantially exceed the amount of money they have invested in the partnership. The outside investors' deductions are limited only by their "basis," which in a limited partnership can include not only the amount the outside investors have contributed to the partnership, but also the money the partnership has borrowed, but which no one is personally liable to repay. Take for example the $1,000,000 project discussed earlier, in which $900,000 was borrowed and $140,000 was received from outside investors or limited partners. A limited partner who contributed 10 percent of the equity

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14/ This is another application of the concept that was used to measure the present value of the 20-year stream of tax shelter benefits to outside investors and the Treasury in the preceding section. Tax shelters provide a series of annual deferrals, however, not just a one-time deferral extending over a number of years.

capital ($14,000) would be able to add 10 percent of the borrowed money ($90,000) to his $14,000 equity share, thereby greatly increasing the ceiling on his tax deductions. In this sample project, the total accumulated tax losses or deductions by the end of the fifth year for the project as a whole come to about $270,000. The 10 percent limited partner is able to deduct a full 10 percent share of that ($27,000), which is nearly twice as much as his $14,000 investment in the project. If the outside investor is in a 60 percent tax bracket, he will save $16,200 in taxes as a result of these deductions (60% x $27,000), thereby getting more than his total cash investment back in only five years.

Converting Ordinary Income Into Capital Gains and Provisions for Recapture

Real estate tax shelters also provide investors an opportunity to convert ordinary income into more favorably taxed capital gain income. The high early-year depreciation deductions which permit deferral of taxation are also an important ingredient in the alchemy which converts ordinary income into capital gains. It works like this. As the depreciation deductions are taken each year, they reduce the taxes due on ordinary income, which is taxed at rates up to 70 percent. These depreciation deductions are also subtracted from the initial cost of the property (its "basis" in tax terms), so that when the property is sold its "adjusted basis" (initial cost minus accumulated depreciation deductions) is likely to be lower than the sale price. The difference between the sale price and the adjusted basis is the gain on the sale, and it is subject to tax. But should it be taxed at the ordinary income rates, or at only half those rates as a capital gain? If the gain on the sale is taxed as a capital gain, it would mean that the deductions which earlier reduced the taxes on ordinary income have now produced more favorably treated capital gain income, in effect converting ordinary income into capital gains.

In the case of machinery and equipment, this result is avoided by requiring that the entire difference between the adjusted basis and the sale price be taxed as ordinary income, up to the amount of the depreciation deductions previously taken. This "recaptures" the earlier tax break. 15/ In the case of buildings, however, the only

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15/ The taxpayer still gets the advantage of deferring the higher "ordinary income" tax until the property is sold.

part of the earlier accelerated depreciation tax break that is recaptured (taxed as ordinary income) is the amount which exceeds straight-line depreciation. The difference between the sale price and the adjusted basis using straight-line depreciation is taxed at the lower capital gains rates. Only the extra difference due to accelerated depreciation -- the "excess" depreciation -- is recaptured by being taxed as ordinary income.

Recapture is a complicated concept. Because it may be an important incentive for good management and long-term ownership in real estate tax shelter projects, it is, however, worth taking some time to see how it works. Table 2 illustrates the two different recapture rules -- the "full recapture" rule which applies to machinery and equipment, and the "excess depreciation recapture" rule which applies to buildings -- under a variety of different circumstances. All the examples assume a project with an initial cost of $1,000,000, a 40-year useful life, and a sale in the 20th year. 16/

The top set of examples all assume a sale price in year 20 of $750,000, which is about what the balance on the mortgage would be at that point. The adjusted basis in the year of sale would be $500,000 using straight-line depreciation, and $300,000 using accelerated depreciation. Under the current law for buildings, in which only the "excess" depreciation is recaptured by being taxed on sale as ordinary income, there would be no recapture if straight-line depreciation were used. If accelerated depreciation were used, $200,000 of the gain would be subject to recapture. Under the full recapture rule which now applies only to machinery and equipment, the full $250,000 gain using straight-line depreciation would be recaptured, as would the full $450,000 gain using accelerated depreciation.

The amount recaptured never exceeds the total amount of the depreciation deductions previously taken. If the gain on the sale exceeds the accumulated depreciation deductions, that extra amount of gain is taxed as a capital gain rather than as ordinary income.

16/ The project used to illustrate recapture is different from the sample project used for the other calculations in this chapter. The sample project has a number of features -- different useful lives for some of the depreciable components, e.g. -- that would have required special adjustment for this illustration.

TABLE 2. ILLUSTRATION OF RECAPTURE RULES, ASSUMING $1,000,000 ORIGINAL COST, 40 YEAR USEFUL LIFE, SALE IN YEAR 20

	$750,000 Sale Price			
	Straight-line Depreciation		Accelerated Depreciation a/	
	Excess Depreciation Recapture	Full Recapture	Excess Depreciation Recapture	Full Recapture
Sale Price in Year 20	750,000	750,000	750,000	750,000
Adjusted Basis (original cost minus accumulated depreciation deductions)	-500,000	-500,000	-300,000	-300,000
Gain on Sale	250,000	250,000	450,000	450,000
Amount Recaptured (taxed at ordinary income rates)	0	250,000	200,000 b/	450,000
Tax on Sale: c/				
At Ordinary Income Rate (50%)	0	125,000 d/	100,000 e/	225,000 f/
At Capital Gain Rate (25%)	62,000 g/	0	62,500 g/	0
Total Tax on Sale	62,500	125,000	162,500	225,000

	$1,500,000 Sale Price			
	Straight-line Depreciation		Accelerated Depreciation a/	
	Excess Depreciation Recapture	Full Recapture	Excess Depreciation Recapture	Full Recapture
Sale Price in Year 20	1,500,000	1,500,000	1,500,000	1,500,000
Adjusted Basis (original cost minus accumulated depreciation deductions	-500,000	-500,000	-300,000	-300,000
Gain on Sale	1,000,000	1,000,000	1,200,000	1,200,000
Amount Recaptured (taxed at ordinary income rates)	0	500,000	200,000 b/	700,000 h/
Tax on Sale: c/				
At Ordinary Income Rate (50%)	0	250,000 i/	100,000 j/	350,000 k/
At Capital Gain Rate (25%)	250,000 l/	125,000 m/	250,000 n/	125,000 m/
Total Tax on Sale	250,000	375,000	350,000	475,000

(continued)

(Table 2. continued)

a/ 200 percent declining balance or sum of the years' digits. Note that the accelerated depreciation amounts are rounded. The actual adjusted basis in Year 20 would be $358,400 under 200 percent declining balance depreciation, and $256,200 under sum of the years' digits.

b/ Depreciation in excess of straight-line.

c/ Assumes taxpayer in 50 percent marginal tax bracket, with 25 percent capital gain rate.

d/ 50% x 250,000

e/ 50% x 200,000

f/ 50% x 450,000

g/ 25% x 250,000

h/ Total accumulated depreciation

i/ 50% x 500,000

j/ 50% x 200,000

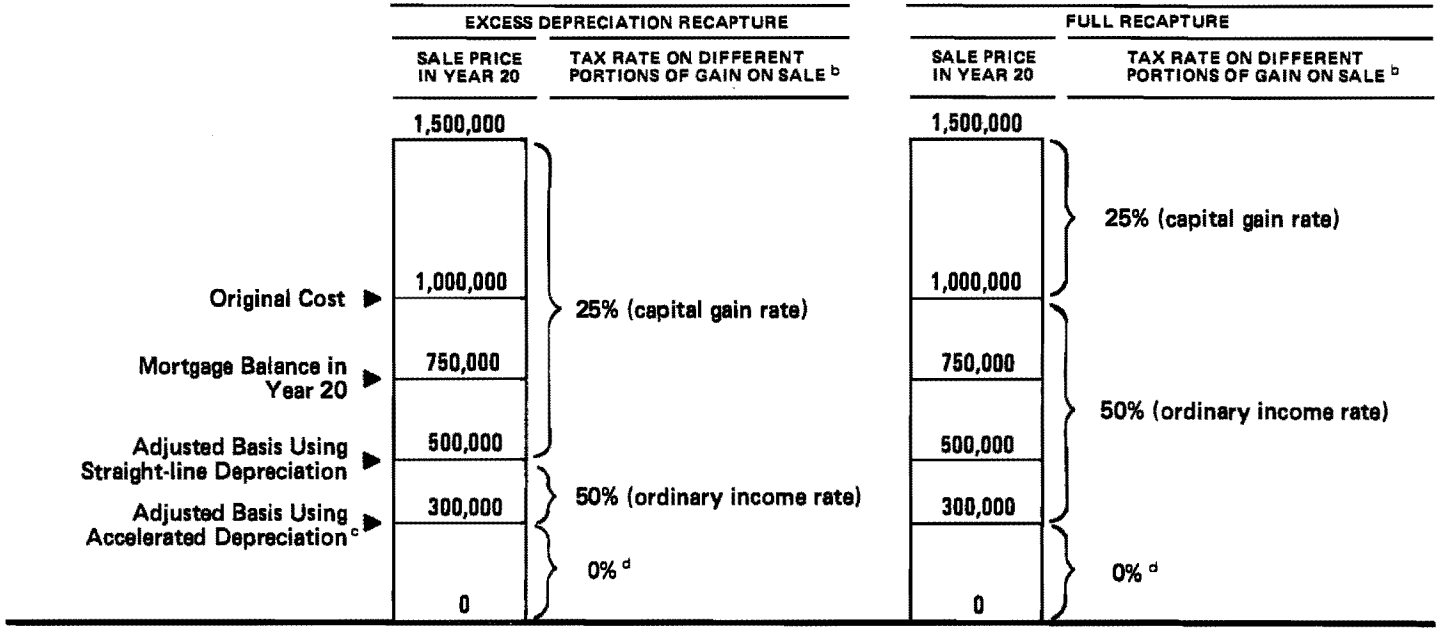
k/ 50% x 700,000

l/ 25% x 1,000,000

m/ 25% x 500,000

n/ 25% x 1,000,000

Figure 2. Portion of Gain on Sale[a] Taxed at Ordinary Income and Capital Gains Rates Under Excess Depreciation Recapture and Full Recapture Rules ($1,000,000 Original Cost, 40-year Useful Life, Sale in Year 20)



[a] Gain on sale equals the difference between the sale price and the adjusted basis. The adjusted basis is the amount left after subtracting from the original cost the depreciation deductions that have been taken up to the time of sale.

[b] Assumes taxpayer in 50 percent marginal tax bracket, with 25 percent capital gain rate.

[c] 200 percent declining balance or sum of the years' digits. Note that the accelerated depreciation amounts are rounded. The actual adjusted basis in year 20 would be $358,400 under 200 percent declining balance depreciation, and $256,200 under sum of the years' digits.

[d] No tax is due if the sale price is less than the adjusted basis, since there has been no gain.

This is illustrated by the lower set of examples in Table 2, where the sale price after 20 years is $1,500,000. The gain on the sale is then $1,000,000 when straight-line depreciation is used, and $1,200,000 when accelerated depreciation is used. The total amount recaptured never exceeds $700,000, the total accumulated depreciation using accelerated depreciation, even when the full recapture rule is applied.

Figure 2 illustrates the operation of the recapture rules in another way, by showing visually the different tax rates which apply to different portions of the gain on sale under various assumptions about the sale price and the form of depreciation used.

HOW REAL ESTATE TAX SHELTERS DEVELOPED

Real estate tax shelters are not an entirely deliberate Congressional creation. In large measure they just grew, developing out of a mix of court cases, IRS regulations, changes in the housing and tax laws, and the ingenuity and imagination of lawyers, accountants, and entrepreneurs. The Congress has reacted by steadily scaling back the tax advantages of real estate tax shelters, sometimes leaving rental housing with comparatively greater advantages, but almost always moving in the direction of tighter rules.

Accelerated Depreciation

Accelerated depreciation for buildings and other real property was added to the tax code in 1954, at a time when the main focus was on accelerated depreciation for machinery and equipment. The argument made at the time was that machinery and equipment generally wore out faster than straight-line depreciation would allow, so that some form of accelerated depreciation was appropriate. No consideration was given at the time to the question of whether buildings and other real property also depreciated at a rate faster than straight-line. 17/ Recent evidence in fact suggests that buldings depreciate more slowly than the straight-line rate, so that

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17/ Congressional Research Service, Study of Legislative History of the Rapid Depreciation Provision (1974), reprinted in Congressional Record, daily ed., March 1, 1974, pp. E1052-E1053.

even straight-line depreciation may be too much in the early years. 18/ Nonetheless, almost as an afterthought, accelerated depreciation was allowed for buildings as well as machinery and equipment in 1954.

In the Tax Reform Act of 1969, Congress reduced substantially the accelerated depreciation allowed for used buildings and newly constructed commercial buildings. Accelerated depreciation was continued at its pre-1969 level for newly constructed rental housing, however, giving this form of construction a comparative tax advantage over office buildings, shopping centers, and other commercial buildings.

Table 3 illustrates the effects of the different forms of depreciation applicable to newly constructed commercial buildings and rental housing under the Tax Reform Act of 1969. Assuming a building with a 40-year useful life, the 150 percent declining balance method allowed for commercial buildings permits 31.8 percent of the building's initial cost to be written off over the first 10 years of the building's life, compared to only 25 percent under the straight-line method. The two faster methods allowed for newly constructed rental housing -- 200 percent declining balance and sum of the years digits -- permit over 40 percent of the building's initial cost to be written off in the first ten years.

The Tax Reform Act of 1969 also added a new provision permitting certain amounts spent to rehabilitate low-income rental housing to be written off or amortized on a straight-line basis over a period of only five years. This provision, Section 167(k) of the tax code, is in effect a form of super-accelerated depreciation that concentrates an even greater share of the total tax benefits in the early years of the project. 19/ Section 167(k) was explicitly

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18/ Paul Taubman and Robert Rasche, "Subsidies, Tax Law, and Real Estate Investment," in Joint Economic Committee, The Economics of Federal Subsidy Programs, Part 3, Tax Subsidies (1972), pp. 343-369; Charles R. Hulten and Frank C. Wykoff, "The Taxation of Income From Structures," (paper prepared for Conference on Research in Income and Wealth, sponsored by the National Bureau of Economic Research, Inc., New York, N.Y., October 14, 15, 1976; processed).

19/ For an evaluation of Section 167(k), see the study by Touche Ross & Co. cited in Footnote 9, above.

TABLE 3. TOTAL ACCUMULATED DEPRECIATION DEDUCTIONS AS A PERCENT OF INITIAL BUILDING COST UNDER VARIOUS FORMS OF DEPRECIATION, TAX REFORM ACT OF 1969 (CURRENT LAW) (40-Year Life, No Salvage Value)

End of Year	Straight-Line a/	150% Declining Balance b/	200% Declining Balance c/	Sum of the Years' Digits c/
1	2.5	3.75	5.0	4.88
5	12.5	17.40	22.6	23.20
10	25.0	31.80	40.1	43.30
15	37.5	43.70	53.7	60.40
20	50.0	54.90	64.2	74.40
25	62.5	66.20	73.1	85.40
30	75.0	77.40	82.1	93.30
35	87.5	88.70	91.0	98.20
40	100.0	100.00	100.0	100.00

a/ This method requires the initial cost of an asset to be written off in equal annual installments over the life of the asset. It is the only method permitted for used commercial buldings and used rental housing with a remaining life of less than 20 years. If used rental housing has a remaining life of 20 years or more, the 125 percent declining balance method (not shown here) may be used.

b/ This is the maximum depreciation rate allowed for newly constructed commercial buildings. It permits depreciation at a rate equal to 1.5 times the straight-line rate.

c/ These are the maximum depreciation rates allowed for newly contructed rental housing. The 200 percent declining balance method allows depreciation at a rate equal to twice the straight-line rate. The sum of the years' digits method is calculated differently, but the results are approximately the same.

intended to provide a subsidy for low-income housing rehabilitation, and represented a departure from the pattern of gradually tighter real estate tax shelter rules.

The Tax Reform Act of 1969 also included a new Minimum Tax on various kinds of "tax preference" income, including accelerated depreciation. This reduced somewhat the benefits of accelerated depreciation for some investors with large amounts of tax-sheltered income.

Construction Period Interest and Taxes

The other main feature of real estate tax shelters -- the opportunity to deduct construction period interest and taxes right away rather than over the life of the building -- was never designed by the Congress to be a real estate construction subsidy. Interest and property taxes incurred as part of the cost of doing business have always been deductible. The issue in the case of building construction is when they should be deducted. If they are viewed as a current cost of doing business, it is appropriate to deduct them right away; if they are viewed as part of the cost of the building, they should be added to that cost ("capitalized") and written off over the life of the building. 20/ During earlier periods, when interest costs were relatively low and only a relatively small part of the cost of construction was borrowed, the issue of how construction period interest and taxes should be treated was not too significant. Now, however, construction period interest and tax deductions can amount to as much as 10 to 15 percent of the total cost of the building and 50 percent or more of the total deductions taken over the first three years. These deductions have therefore become a very substantial "front-end" subsidy for real estate construction, even though they were not originally intended to serve that purpose.

Limited Partnership Rules

Virtually all real estate tax shelters are set up as limited partnerships. This permits the outside investors to share fully in

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20/ "Costs to be associated with future revenue or otherwise to be associated with future accounting periods are deferred to future periods as assets." American Institute of Certified Public Accountants, Statement of the Accounting Principles Board (New York, October 1970), Paragraph 155, pp. 60-61.

the partnership's tax deductions, while limiting their personal liability for any actual partnership losses only to the amount of their cash contribution.

The use of limited partnerships as a vehicle for real estate tax shelters developed gradually over more than 20 years as court cases, IRS regulations, and changes in the housing laws each added necessary elements.

One of the most crucial elements grew out of a 1947 Supreme Court case, Crane v. Commissioner of Internal Revenue, 21/ and subsequent IRS regulations interpreting it. 22/ The Crane rule is the one which permits limited partners to increase the ceiling on the total amount they can deduct by adding to their cash investment a proportionate share of the money the partnership has borrowed, but which no partner is personally obligated to repay. Ironically, taxpayer Beulah Crane was arguing for a rule that could have limited the total deductions to the amount of the cash paid in or "at risk," while the IRS was arguing against it. The IRS won, but the decision and the regulations interpreting it paved the way for the later development of limited partnership tax shelters.

Another important development came in 1960, when the IRS issued regulations 23/ aimed at making it harder for doctors, lawyers, dentists, and other professionals to set up professional corporations in order to obtain the advantages of tax-deductible pension and retirement plans, which at that time were limited to corporations. 24/ The regulations did this by classifying

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21/ 331 U.S. 1 (1947).

22/ IRC Regs. Sec. 1.752-1(e).

23/ The so-called "Kintner" regulations, IRC Regs. Sec. 301.7701-2.

24/ The need for professionals to incorporate to obtain these tax benefits was reduced by passage of the Self-Employed Individuals Retirement Act of 1962 (P.L. 87-792), which permitted professionals and other self-employed persons to set up tax-deductible pension or retirement plans (so-called H.R. 10 or "Keogh" plans). The tax deductible contributions permitted for these plans were increased by the Employee Retirement Income Security Act of 1974 (P.L. 93-406, Sec. 2001(a)).

organizations that were on the borderline between a corporation and a partnership as partnerships for tax purposes. However, these regulations also had the effect of making it easier to set up limited partnership tax shelters by lessening the danger that they would be classified as corporations and thereby denied their right to pass through tax losses to outside investors. The Treasury recently proposed changing these 1960 regulations in a way that would have classified many real estate limited partnership tax shelters as corporations. 25/ The proposed regulations were withdrawn the same day after a flood of protests from housing groups. 26/

In both the Crane case and the 1960 regulations, the IRS focused most of its attention on other issues, not anticipating that the groundwork for limited partnership tax shelters was being laid.

In the early 1960s, however, the Federal Housing Administration (FHA) -- under prodding from housing developers -- moved more purposefully. The FHA and housing developers saw in limited partnership tax shelters a way of encouraging the construction of FHA-sponsored rental housing. Prior to that time, only corporations could own FHA-sponsored rental housing, which meant that the tax losses could not be passed on to outside investors but could only be taken by the corporation itself. In the Housing Acts of 1961 and 1964, changes were made to permit partnerships to own and operate FHA-sponsored rental housing, opening the way for limited partnership tax shelters. 27/

When the Housing and Urban Development Act of 1968 added a new program of interest subsidies for rental housing construction (Section 236), 28/ and the Tax Reform Act of 1969 changed the

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25/ Federal Register, Vol. 42, No. 3 (January 5, 1977), pp. 1038-1044.

26/ Federal Register, Vol. 42, No. 5 (January 7, 1977), p. 1489. For an account of the controversy, see "Simon Vetoes New Curbs on Tax Shelters," Washington Post, January 6, 1977, p. 1.

27/ P.L. 87-70, Sec. 607(1); P.L. 88-560, Sec. 114(a). For a brief account, see Leonard L. Silverstein, "Federal Tax Policy for Tax Shelters," National Tax Journal, Vol. XXVI, No. 3 (September 1973), p. 348.

28/ Housing and Urban Development Act of 1968, P.L. 90-448, Sec. 201(a).

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depreciation and recapture rules to give a comparative advantage to rental housing, the stage was set for a boom in real estate tax shelters through limited partnership syndications in the early 1970s. 29/

Recapture

The recapture rules which limit the opportunity to convert ordinary income into capital gains were established in 1962 for machinery and equipment, and in 1964 for buildings and other real property. The recapture rule for buildings only applied to depreciation in excess of straight-line, however, and the recapture requirement was gradually phased out so that no recapture applied after the building was held for 10 years.

The Tax Reform Act of 1969 tightened the recapture rules for buildings by eliminating the phase-out for commercial buildings, and stretching the phase-out to 16 2/3 years for rental housing. The shorter phase-out after 10 years was kept for low- and moderate-income, government-assisted rental housing. In all cases, however, recapture applied only to depreciation in excess of straight-line.

As with the depreciation changes in the 1969 Act, the changes in the recapture rules resulted in more favorable treatment for rental housing than for commercial buildings. The recapture changes established the additional precedent of giving even more favorable tax treatment to low-and moderate-income rental housing built with government assistance.

CHANGES IN THE TAX REFORM ACT OF 1976

The Tax Reform Act of 1976 continued the process of scaling back the preferential tax treatment of real estate construction. A

29/ Publicly syndicated real estate tax shelters registered with the National Association of Securities Dealers, Inc. rose from 54 with a total dollar value of $256 million in 1970 to 207 with a total dollar value of $788 million in 1972. See Tax Revision Issues-1976, Tax Shelter Investments, prepared for the use of the Committee on Finance by the Staff of the Joint Committee on Internal Revenue Taxation (April 14, 1976), pp. 16-17. Private syndications, which make up a large share of the total, are not included in these listings.

new rule was adopted requiring construction period interest and taxes to be capitalized (added to the cost of the building) and written off over a period of time -- four years to begin with, gradually increasing to ten years. Again, however, rental housing received more favorable treatment, with the start of the phase-in delayed to 1978. Low-income, government-assisted rental housing received the most favorable treatment of all, with the start of the phase-in delayed to 1982. 30/

No changes were made in the accelerated depreciation rules, so the 1969 Tax Reform Act provisions illustrated in Table 3 continue to apply. However, important changes were made in both the Minimum Tax and Maximum Tax rules which will reduce the advantage of accelerated depreciation for investors with significant amounts of tax-sheltered income. The Minimum and Maximum Tax changes will also substantially increase the capital gains tax on the sale of real property for most investors. 31/

The Section 167(k) five-year amortization subsidy for low-income housing rehabilitation was extended for two more years, until January 1, 1978. 32/ In another departure from the pattern of tightening the tax treatment of real estate, a number of new tax advantages were established for the rehabilitation of certain historic structures certified by the Secretary of the Interior. 33/

30/ P.L. 94-455, Sec. 201. The Act uses the term "low-income housing" to describe the rental housing eligible for this special delayed phase-in and less stringent recapture treatment. It includes all rental housing built with the assistance of federal, state, or local housing subsidy programs to serve families and individuals with incomes similar to those in the HUD Section 8 program -- about 80 percent of the median income. It therefore includes housing built for moderate- as well as low-income tenants. When referring specifically to the 1976 Act, this report will use the term "low-income housing;" in other cases the term "low- and moderate-income rental housing" will normally be used.

31/ Secs. 301, 302.

32/ Sec. 203.

33/ Sec. 2124.

The recapture rules were also tightened again. For all real property except low-income rental housing, all depreciation deductions in excess of straight-line will be recaptured when the property is sold, no matter how long it has been held. For low-income rental housing, recapture is phased out after the project has been held for 16 2/3 years, instead of ten years as before. 34/

Finally, for all tax shelters except real estate, the Crane rule for limited partnerships is superseded by a new "at risk" rule. Under the new rule, limited partners may not take losses in excess of the amount they have "at risk," that is, the amount they have actually put into the project plus whatever else they are personally obligated to repay. Real estate tax shelters are explicitly exempted from this new "at risk" rule, however. 35/

Table 4 summarizes the major tax shelter provisions applicable to different forms of real estate construction after the Tax Reform Act of 1976. 36/

POSSIBLE FUTURE TAX CHANGES

The tax treatment of real estate is still in flux. If the pattern of the past is continued, there are likely to be further reductions in the tax preferences for real estate, although rental housing may continue to receive comparatively more favorable treatment. This would mean movement toward:

- o straight-line (or even slower) depreciation for all forms of real estate;
- o a requirement that construction period interest and taxes be written off over the full life of the building, not just ten years;

34/ Sec. 202.

35/ Secs. 204, 213(e).

36/ For a detailed description of the changes made by the 1976 Act, see Bruce S. Lane, "The Tax Reform Act of 1976: What It Means for Real Estate Limited Partnerships," Journal of Real Estate Taxation, Vol. 4, No. 3 (Spring 1977).

TABLE 4. TAX SHELTER PROVISIONS APPLICABLE TO DIFFERENT FORMS OF NEW REAL ESTATE CONSTRUCTION AFTER THE TAX REFORM ACT OF 1976

Tax Shelter Provision	Commercial Buildings	Rental Housing	Low-Income Rental Housing
Depreciation	150% declining balance a/	200% declining balance or sum of the years' digits b/	200% declining balance or sum of the years' digits b/
Construction Period Interest and Taxes	Capitalize and amortize over 4-10 years, beginning in 1976	Capitalize and amortize over 4-10 years, beginning in 1978	Capitalize and amortize over 4-10 years, beginning in 1982
Recapture	Recapture of all "excess" depreciation c/	Recapture of all "excess" depreciation c/	Recapture of all "excess" depreciation on sale in the first 8-1/3 years, then a gradual phaseout, with no recapture after 16-2/3 years c/
"At Risk" Rule	Not applicable	Not applicable	Not applicable

a/ This method permits depreciation at a rate equal to 1.5 times the straight-line rate. Straight-line depreciation requires the initial cost of an asset to be written off in equal annual installments over the useful life of the asset. Accelerated methods of depreciation allow deductions higher than straight-line in the early years, and lower than straight-line in later years.

b/ The 200 percent declining balance method allows depreciation at a rate equal to twice the straight-line rate. The sum of the years' digits method gives approximately the same results as 200 percent declining balance depreciation.

c/ The recapture rule for buildings only requires the recapture of "excess" depreciation, that is, depreciation in excess of straight-line. The recapture rule for machinery and equipment requires the recapture of all previous depreciation, up to an amount equal to the gain on the sale of the property.

- o full recapture of all depreciation (not just the excess over straight-line); and

- o extension of the new "at risk" rule to real estate.

In order to give some idea of the relative importance of various tax shelter provisions to outside investors and to measure the impact of various possible future tax changes, the sample tax shelter syndication in this chapter was run on a computer model with a number of variations in the tax treatment. Table 5 shows the results. (More details are shown in Appendix B.)

The first measure used is the discounted internal rate of return over 20 years for an investor in the 60 percent bracket who invests $140,000. In the Base Case, which is the tax treatment under present law, the discounted rate of return is 26.0 percent. If the investor is subject to the Minimum Tax on the excess depreciation taken during the project's first 20 years, his rate of return drops to 22.6 percent. If he is also subject to the Minimum Tax on his gain on the sale in the 20th year, his return drops to 22.4 percent.

The new rule for construction period interest and taxes which, when fully in effect, will require these costs to be amortized over 10 years reduces the rate of return from 26.0 percent to 20.9 percent. Requiring construction period interest and taxes to be capitalized and written off over the entire life of the building would reduce the rate of return to 19.0 percent.

Requiring straight-line depreciation, but making no other changes in the Base Case tax treatment, would reduce the rate of return to 13.5 percent. The full recapture rule with no other changes would reduce the rate of return to 25.6 percent, and the "at risk" rule standing alone would reduce it to 8.8 percent.

If capitalization of construction period interest and taxes and straight-line depreciation were combined, the rate of return would be 9.1 percent. If full recapture were added, it would drop to 6.1 percent.

As another measure of the impact of these various tax changes, the discounted present value of the 20-year stream of tax shelter savings to both the investor and the builder/developer has also been

calculated. 37/ This calculation shows that the present value of this 20-year stream of tax shelter savings is $90,760 under the Base Case, using a 20 percent discount rate. If construction period interest and taxes must be capitalized, the present value drops to $57,970. Straight-line depreciation with no other change reduces the present value to $38,280. The full recapture rule standing alone reduces the present value to $87,100. If all three of these requirements are combined, by definition the present value of the tax shelter savings drops to zero. The outside investor's only return will then come from the cash distributions from rents and from the other tax savings (straight-line depreciation, reduced by the capital gains tax on sale) not included in the tax shelter as defined here. Application of the "at risk" rule to this sample project, with no other change, would reduce the present value of the investor's tax shelter savings to $76,610.

The column that discounts the tax benefits at a 7.5 percent rate gives a measure of the present value of the 20-year stream of tax shelter revenue losses to the Treasury, using its lower discount rate.

It should be kept in mind that this is just one sample project. Different assumptions from the ones used here could result in very different outcomes. If the assumed sale price was substantially higher or lower, for example, the impact of full recapture of depreciation would be much different.

In addition, as discussed earlier in this chapter, the tax shelter subsidy is only one source of the total return to the investor and the builder/developer in real estate projects. In some projects, such as upper-income rental housing and commercial office buildings and shopping centers, higher rents may make up for reductions in the tax shelter subsidy. In other cases, alternative forms of subsidy might be devised to take the place of some or all of the tax shelter subsidy. These possibilities are discussed in Chapters III and V.

37/ This includes tax savings from (1) using accelerated rather than straight-line depreciation, (2) deducting construction period interest and taxes immediately rather than writing them off over the life of the building, and (3) paying tax on the gain on sale in year 20 at capital gain rates (no recapture of depreciation) rather than ordinary income rates (full recapture). The present value of other tax savings and cash distributions from rents is not included.

TABLE 5. IMPACT OF VARIOUS TAX PROVISIONS ON RETURN TO INVESTORS AND ON PRESENT VALUE OF TAX SHELTER SAVINGS TO INVESTORS AND BUILDER/DEVELOPER (Based on Sample Project, Investor and Builder/Developer in 60 Percent Tax Bracket, 40-Year Life, Sale in Year 20)

Tax Treatment a/	Discounted Internal Rate of Return to Investors on Initial Investment of $140,000 b/	Present Value of Tax Shelter Savings c/ to Investors and Builder/Developer — Discount Rate 20%	Discount Rate 7.5%
A. Base Case d/	26.0%	$ 90,760	$145,720
B. Minimum Tax: e/			
1. Excess Depreciation	22.6	77,160	124,020
2. Excess Depreciation Plus Capital Gain on Sale	22.4	72,240	115,760
C. Construction Period Interest and Taxes:			
1. Amortized over 10 yrs. f/	20.9	72,860	136,320
2. Capitalized and Depreciated	19.0	57,970	113,980
D. Straight-line Depreciation	13.5	38,280	56,550
E. Recapture:			
1. Excess Depreciation Recapture g/	25.8	89,380	133,250
2. Full Recapture	25.6	87,100	112,700
F. "At Risk" Limitation	8.8	76,610	106,960
G. Combination of C-2 & D	9.1	2,020	18,840
H. Combination of C-2, D, & E-2	6.1	0	0

Source: Appendix B, pp. 119-140.

a/ Each tax change shown in B. through F. has been applied separately to the Base Case. Only G. and H. show the cumulative impact of more than one change.

b/ Includes all project benefits (tax shelter savings, other tax savings, and cash distributions from rents). Investor share only (95 percent).

c/ Includes tax savings from (1) using accelerated rather than straight-line depreciation, (2) deducting construction period interest and taxes immediately rather than writing them off over the life of the building, and (3) paying tax on the gain on sale in year 20 at capital gain rates (no recapture of depreciation) rather than ordinary income rates (full recapture). Both investor tax savings (95 percent) and builder/developer tax savings (5 percent) are included. The builder/developer is assumed to be in the same tax bracket as the investors. Does not include present value of "Cash Distributions from Rents" or "Other Tax Savings" shown in Table 1.

d/ Present law for low-income rental housing (calendar year 1977).

e/ Present law.

f/ Tax Reform Act of 1976 rule when fully phased in (beginning in 1982 for commercial buildings, 1984 for rental housing, and 1988 for low-income rental housing.

g/ Present law for commercial buildings, and for rental housing other than low-income.

CHAPTER III SUBSIDIES FOR REAL ESTATE CONSTRUCTION: DISTRIBUTION AND ECONOMIC IMPACT

TAX SHELTER SUBSIDIES FOR REAL ESTATE CONSTRUCTION

The various tax provisions that are combined into real estate tax shelters will provide an estimated $1.3 billion in subsidies for past and current real estate construction in fiscal year 1978. 38/ As shown in Table 6, 35 percent of this subsidy goes to assist the construction of commercial buildings -- office buildings, shopping centers, and the like. Another 54 percent goes to assist the construction of middle- and upper-income rental housing, mostly apartment buildings. 39/ Only about 11 percent of the total goes to assist low-income rental housing. 40/

Low-Income Rental Housing Share

There are two reasons for the small share of real estate tax shelter subsidies currently going to low-income rental housing. First, until the Tax Reform Act of 1976, low-income rental housing did not receive substantially more favorable tax shelter benefits than other forms of rental housing. The major deductions -- those

38/ The revenue loss is measured on the assumption that a different law, without these provisions, had always been in effect. It is, therefore, a measure of the current cost of tax-sheltered real estate construction from prior years, plus the revenue losses resulting from new construction in the current year. Approximately $0.3 billion of the $1.3 billion total is attributable to new construction in fiscal year 1978.

39/ Middle- and upper-income rental housing includes all private rental housing built without the assistance of HUD, state, or local housing subsidies.

40/ Low-income rental housing is defined for purposes of this section in the same way it is defined in Sections 201 and 202 of the Tax Reform Act of 1976. It, therefore, includes all private low- and moderate-income rental housing built with the assistance of HUD, state, or local housing subsidies.

TABLE 6. DISTRIBUTION OF REAL ESTATE TAX SHELTER SUBSIDIES AMONG FORMS OF RENTAL PROPERTY, FISCAL YEAR 1978, IN MILLIONS OF DOLLARS

Tax Shelter Component	Cost in Lost Revenues a/			
	Commercial Buildings	Middle and Upper Income Rental Housing b/	Low-Income c/ Rental Housing	Total
Construction Period Interest and Taxes	90	80	10	180
Depreciation in Excess of Straight Line	140	430	95	665
Capital Gains d/	220	190	30	440
Housing Rehabilitation: 5-year Amortization	___	___	15	15
Total	450	700	150	1300
Percent of Total	34.6%	53.8%	11.5%	100%

Source: Congressional Budget Office, Five Year Budget Projections: Fiscal Years 1978-1982, Supplement on Tax Expenditures (April 1977), pp.7-11. Distribution among forms of real estate based on estimates by CBO and staff of the Joint Committee on Taxation.

a/ The revenue loss is measured on the assumption that a different law, without the tax shelter provisions, had always been in effect. It is, therefore, a measure of the current cost of tax-sheltered real estate from prior years, plus the revenue losses resulting from new construction in the current year. Approximately $0.3 billion of the total $1.3 billion revenue loss is attributable to new construction in fiscal year 1978.

b/ Includes all private rental housing built without the assistance of HUD, state, or local housing subsidies.

c/ "Low-income housing," as defined by Sections 201 and 202 of the Tax Reform Act of 1976 (P.L. 94-455). This includes all private rental housing built with the assistance of HUD, state, or local housing subsidies.

d/ Includes approximately $50 million of unrecaptured depreciation (revenue loss from not taxing the full amount of the gain on sale resulting from all previous depreciation deductions as ordinary income). Of this amount, approximately $20 million is attributable to commercial buildings, $25 million to middle- and upper-income rental housing, and $5 million to low-income rental housing. Because of data limitations, this estimate for unrecaptured depreciation should be viewed as very rough and tentative.

for construction period interest and taxes and accelerated depreciation -- were the same for both low-income and upper-income rental housing. Low-income rental housing did receive some additional benefits in the Tax Reform Act of 1969 from the more rapid phase out of the recapture requirement and the Section 167(k) rehabilitation subsidy, but these are much less important overall than the major deductions. At least until the effects of the Tax Reform Act of 1976 begin to be reflected in the totals, therefore, the low-income share of the total rental housing tax shelter subsidy will not be substantially larger than the low-income share of total rental housing starts.

This brings in the second determinant of the low-income share of total tax shelter subsidies -- HUD and state housing agency subsidies. Without these subsidies, virtually no new low- and moderate-income rental housing will be constructed. It is simply uneconomical for builder/developers and investors to undertake it. As shown in Table 7, the HUD-subsidized share of total multifamily rental housing starts over the last 11 years has averaged just under 13 percent, with the highest percentage coming in 1970, when it reached nearly 30 percent. It is now about 13 percent. Because of the somewhat more favorable tax treatment low-income housing receives, the low-income share of the tax shelter subsidies for rental housing is a little larger than that -- about 18 percent. As shown in Table 6, however, the low-income share of all real estate tax shelter subsidies is only about 11 percent, since rental housing gets only about two-thirds of these subsidies, with the rest going to commercial buildings.

Other Tax Subsidies for Housing

While they are not discussed in this report, a number of provisions in the tax code which are not part of the tax shelter system also subsidize the construction of both rental and owner-occupied housing. By far the largest tax subsidies for housing are the deductions for mortgage interest and property taxes on owner-occupied homes. Taken together, these two provisions represent a fiscal year 1978 tax expenditure of $10.2 billion for the construction and ownership of new and existing homes. 41/ The deferral of

41/ Special Analyses, Budget of the United States Government, Fiscal Year 1978, Special Analysis F, "Tax Expenditures, p. 139.

TABLE 7. SUBSIDIZED PRIVATE MULTIFAMILY HOUSING STARTS, 1965-1976, IN THOUSANDS OF UNITS

Year	Total Private Multifamily a/ Starts	Subsidized Private Multifamily a/ Starts	
		Total b/	Percent of Total Private Multifamily Starts
1965	423	16	3.8%
1966	325	18	5.5
1967	376	32	8.5
1968	527	70	13.3
1969	571	72	12.6
1970	536	158	29.5
1971	781	150	19.2
1972	906	115	12.7
1973	795	64	8.1
1974	382	27	7.1
1975	204	22	10.8
1976	291	37	12.7
Annual Average	510	65	12.7%

Source: U.S. Department of Housing and Urban Development, HUD-Subsidized Housing Production, 1962-1975, unpublished tables prepared by Housing-FHA, Office of Management, MIS Division; and U.S. Bureau of the Census, Housing Starts, C20-76-12 (February 1977), Table 2, p. 4.

a/ In structures with 5 units or more.

b/ Includes Sections 221(d)(3), 236, 202, and 8, uninsured state projects, and rent supplement starts not included under other programs.

capital gain on home sales provides another incentive to home ownership, estimated at $0.9 billion in fiscal year 1978. 42/ The excess bad debt reserves of savings and loan associations and mutual savings banks also provide an indirect subsidy for homeownership, amounting to a tax expenditure of $0.5 billion in fiscal year 1978. 43/

Low-income public housing construction is supported by a fiscal year 1978 tax expenditure of $0.4 billion for tax-exempt local housing authority bonds. 44/ Low- and moderate-income private rental housing built with the assistance of state housing agencies is subsidized by $0.2 billion in fiscal year 1978 tax expenditures for the tax-exempt bonds issued by those agencies. 45/

DIRECT OUTLAY AND CREDIT ASSISTANCE SUBSIDIES FOR REAL ESTATE CONSTRUCTION

As shown in Table 8, the federal government will provide an estimated $4.0 billion in direct outlay and credit assistance subsidies for rental housing in fiscal year 1978. These programs provide support for renters in existing housing as well as subsidizing the construction of new rental housing. Most of the rental housing subsidy programs are aimed at low- and moderate-income rental housing, although a substantial share of the GNMA Tandem Assistance goes to middle- and upper-middle income rental housing, as does a portion of the Section 202 Housing for the Elderly or Handicapped subsidy. 46/

42/ Ibid., Table F-1, p. 130.

43/ Ibid., Table F-1, p. 128. The tax expenditure for the excess bad debt reserves of commercial banks, amounting to $0.1 billion, is not included in the estimate in the text, since these institutions do little home mortgage lending.

44/ CBO estimate.

45/ CBO estimate.

46/ For a brief description of these programs, see Ninth Annual Report on the National Housing Goal, House Document No. 95-93 (January 19, 1977), pp. 36-37, 44.

TABLE 8. DIRECT OUTLAY AND CREDIT ASSISTANCE SUBSIDIES FOR RENTAL HOUSING, FISCAL YEAR 1978, IN MILLIONS OF DOLLARS

Rental Housing Subsidy Program	Outlays
Public Housing	$1,168
Section 8	890
Section 236	552
Rent Supplement	262
GNMA Tandem Assistance (Multifamily)	28
FHA Loans and Guarantees (Multifamily)	290
Rural Housing Insurance Fund (Multifamily)	86
Subtotal	3,276
Off-Budget: Section 202 Housing for the Elderly or Handicapped	738
Total	$4,014

Source: CBO Current Policy Estimates, April 1, 1977.

Except for limited special purpose loans to businesses in economically depressed areas by the Economic Development Administration, 47/ and loans to small businesses by the Small Business

47/ Although EDA does provide loans for building construction, its lending guidelines list among the types of projects which are "inconsistent with the objectives of EDA for business development assistance" various types of "ventures primarily for speculation" including "real estate development." U.S. Department of Commerce, Economic Development Administration, Lending Guidelines, Office of Business Development (April 5, 1971), No. 44, p.1.

Administration, 48/ there are no federal direct outlay or credit assistance subsidy programs for commercial real estate construction.

Owner-occupied housing will receive an estimated $1.3 billion in assistance in fiscal year 1978 through FHA, VA, and Farmers Home Administration mortgage insurance programs, the GNMA Tandem Plan, and the Section 235 homeownership subsidy program for low-income families. 49/ These home ownership programs subsidize both new construction and the occupancy of existing housing. With the exception of the Section 235 program, almost all of the homeownership subsidy programs are aimed at middle- to upper-middle income families and individuals.

ECONOMIC IMPACT OF TAX SHELTER SUBSIDIES FOR REAL ESTATE CONSTRUCTION

Economy-Wide Vs. Real Estate Construction Industry Impact

It is important to distinguish between the impact of real estate tax shelter subsidies on the economy as a whole, and their impact on the real estate construction industry. In terms of production, employment, and prices, the impact of real estate tax shelter subsidies on the general economy is likely to be little different from any other tax reduction of the same size. A government spending increase of the same size would have a somewhat greater

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48/ The SBA did not provide loans for commercial and residential construction for future sale until very recently. A new loan program permitting such loans to small contractors was begun in October 1976 (see 41 F.R. 47452, October 29, 1976).

49/ CBO Current Policy estimate, April 1, 1977. For a description of these programs, see Ninth Annual Report on the National Housing Goal, pp. 33-37, 41.

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impact. A change in monetary policy that resulted in lower interest rates could have a similar impact, although the kind of change required and the timing of the impact is harder to estimate.

As far as the impact on the economy as a whole is concerned, therefore, the complete removal of real estate tax shelter subsidies could be compensated for by a general tax reduction or government spending increase of approximately the same size, or by changes in monetary policy. 50/

Even with compensating general fiscal or monetary policy changes, however, it is clear that reduction or removal of real estate shelter subsidies would have a significant net impact on the real estate construction industry. There would be some reduction in production and jobs in that industry, and some increase in rents. An increase in real estate tax shelter subsidies would have the opposite effects. However, these changes would represent primarily a shifting of resources from one sector of the economy to another, not an economy-wide increase or decrease in production, jobs, or prices.

With these qualifications, some estimates can be made of the impact of real estate tax shelter subsidies on the real estate construction industry. Little empirical work has been done in this area, however, so there is a wide range of uncertainty in the estimates.

Impact on New Construction

As shown in Table 6, the tax shelter subsidies for real estate construction in fiscal year 1978 are estimated to cost about $1.3 billion in lost revenues, of which about $0.3 billion is attributable to new construction in that year. The total value of all new construction put in place is currently estimated at about $145 billion a year. Tax shelter financing, however, is concentrated most heavily in just some portions of the real estate construction

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50/ For a general discussion of this point, see Gerard M. Brannon, "The Effects of Tax Incentives for Business Investment: A Survey of the Economic Evidence," in Joint Economic Committee, The Economics of Federal Subsidy Programs, Part 3: Tax Subsidies (July 15, 1972), pp. 253-55.

industry -- mainly those involving construction of private rental property by partnerships and other noncorporate entities. The impact of any changes would therefore be greatest in those parts of the industry, which make up less than 15 percent of the total. 51/

In order to determine how much new construction each $1 billion in tax shelter subsidies is likely to produce, a number of interacting factors must be taken into account. First, since the tax shelter subsidy equals only about 10 percent or less of the initial cost of each new subsidized building, each dollar of tax shelter subsidy is associated with nine or more additional dollars of new construction. However, most of that construction would have taken place even without the tax subsidy, so by no means all of it can be attributed to the subsidy. 52/ In addition, the subsidy is likely to lead to an increased demand for borrowed funds, both on the part of the federal government (to finance the subsidy) and on the part of private builder/developers (to finance the new construction). This is likely to push up interest rates, and that in turn will reduce the level of all new construction (including subsidized construction) below the level it might otherwise have reached.

There are no firm estimates of how these different factors, taken together, are likely to affect the final outcome in the case of subsidies for real estate construction. In the case of tax incentives for investment in plant and equipment, however, recent evidence suggests that each $1 billion in tax subsidies may result in a net increase of from $200 million to $1 billion in new investment. 53/ Whether these results can be carried over to subsidies for investment in real estate construction is uncertain.

51/ Based on U.S. Bureau of the Census, Value of New Construction Put in Place, Series C30-77-1 (March 1977), and unpublished 1974 data on total construction put in place by type of investor.

52/ This is less true of low- and moderate-income rental housing, most of which would probably not be built without both tax shelter subsidies and HUD, state, or local subsidies.

53/ Brannon, "The Effects of Tax Incentives for Business Investment," p. 262.

Impact on Employment

The Bureau of Labor Statistics estimates that each $1 billion spent on multifamily residential construction in 1975 required 43,000 jobs, while the same amount spent on office building construction required 33,000 jobs. 54/ In the private sector generally, each $1 billion of spending was estimated to require 49,000 jobs. However, these estimates are not a measure of the number of new, additional, or incremental jobs created by an additional $1 billion of spending. They are merely a measure of the number of jobs associated with $1 billion of the type of spending indicated.

The number of new or incremental jobs actually produced by a subsidy depends primarily on the state of the economy at the time and on overall government fiscal and monetary policy. As discussed earlier, the main effect of tax shelter and other subsidies for real estate construction is to shift jobs from other sectors of the economy into real estate construction rather than to increase the total number of jobs throughout the economy. They are primarily a device for job allocation, not job creation.

In addition, since there is little reason to expect that the need for new rental housing or new office buildings will coincide geographically with the need for new jobs, subsidies for the construction of new buildings are usually not the most appropriate devices for job creation. Building construction subsidies also have relatively little value as antirecession or countercyclical job-creation devices, since too much time elapses between the time the subsidy first becomes available and the time actual construction begins. The jobs are rarely available at the time they are most needed.

Impact on Rents

The impact of real estate tax shelter subsidies on rent levels is hard to measure. The movement from subsidy changes to rent changes is a multistep process, with many uncertainties about both magnitude and timing at each step.

54/ Bureau of Labor Statistics, Estimated Total Jobs per Billion Dollars of Contract Construction in 1975 Dollars by Industry and Type of Construction (April 1976), unpublished data.

If tax shelter subsidies were reduced, for example, the initial impact would be an increase in construction costs and a drop in the level of new construction below what it would otherwise have been. With a lower level of new construction each year, the total existing stock or supply of buildings then gradually drops below what it would otherwise have been. If demand for building space stays the same, rents will then be pushed upward. But rents will go up only as the total supply of buildings goes down relative to the demand. This is a gradual process, since each year's new construction is only a fraction of the total outstanding stock of buildings.

While some impact on rent levels may begin to show up a year or two after subsidy levels are changed, the full impact may not show up for as long as 10 to 20 years. The size of the impact, as well as its timing, will depend on the relative levels of supply and demand for apartments and building space in particular geographic areas. This is hard to measure, and even harder to predict. It may also vary from one area to the next.

Some attempts at measuring the impact of tax subsidy changes on rent levels have been made, however. One 1972 study looked at the impact of certain tax changes on both office buildings and apartments. 55/ This study estimated that in the long run -- after 20 years -- a change from accelerated to straight-line depreciation would result in a 6 percent reduction in the total supply of office buildings, and a 1 percent total increase in rents. 56/ For apartment buildings, it was estimated that a change from accelerated to straight-line depreciation would reduce the total supply of apartment buildings by 3 percent after 20 years, and that rents would increase by a total of 1½ percent. 57/ Alternatively, if accelerated

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55/ Paul Taubman and Robert Rasche, "Subsidies, Tax Law, and Real Estate Investment," in Joint Economic Committee, The Economics of Federal Subsidy Programs, Part 3: Tax Subsidies (July 15, 1972), pp. 343-369.

56/ Taubman and Rasche, p. 360.

57/ Taubman and Rasche, p. 361

depreciation was continued, but all depreciation was fully recaptured on sale by being taxed as ordinary income, it was estimated that the total stock of apartment buildings would decline by 7 percent after 20 years, and that rents would increase by a total of 3½ percent. 58/ The authors noted that these estimates probably represent the maximum effects of the tax changes, since other factors not taken into account in the analysis would be likely to reduce the effects shown. 59/

A more recent study just completed for HUD estimates that the changes in real estate tax shelters made by the Tax Reform Act of 1976 will result in a long-run increase in rents of 4 to 5 percent, if owners are successful in passing on the increased costs in full. 60/ The study also estimates the impact of possible additional future tax changes, again on the assumption that all increased costs are passed on in full in the form of higher rents. In the long run, the study estimates, full recapture standing alone would increase rents by 9 percent, straight-line depreciation standing alone by 5 percent, and straight-line depreciation combined with full recapture by 14 percent. 61/

It must be emphasized, however, that the estimates in both these studies are very uncertain. They are based on limited data, and many of the assumptions that were required may not be reliable.

58/ Taubman and Rasche, p. 361.

59/ Taubman and Rasche, p. 362.

60/ William B. Brueggeman, Tax Reform, Tax Incentives And Investment Returns On Rental Housing (unpublished draft report prepared for the U.S. Department of Housing and Urban Develoment, March 1977), pp. 41-42, 48.

61/ Brueggeman, Table 12, p. 71.

Perhaps the most that can be said at this point is that the impact on rents resulting from a change in tax shelter subsidy levels is likely to be fairly small, that it will show up only after the change in subsidy levels has produced a change in the total stock or supply of buildings in an area, and that rents will increase only if the demand for building space in a particular area exceeds the supply.

To the extent that rent increases do occur, there are likely to be some additional effects worth noting. Some people who are now renting, for example, would find it more advantageous to own than to rent. There would therefore be some shift in the direction of greater home ownership, and some additional conversion of existing rental housing to condominiums. There would also be some shift of new construction from rental housing to single family homes and condominiums. 62/

In addition, since any rent increases would be reflected in existing as well as newly-constructed rental housing, there would be some additional incentive for good management and maintenance and continued ownership of older buildings. The higher cash return to owners from the higher rents would make it easier to cover management and maintenance expenses, and would also tend to increase the long-term property. It is possible, of course, that the higher rents in existing properties could be used to increase short-term owner profits rather than being spent on improved management and maintenance.

62/ For a discussion of this point, see George S. Tolley and Douglas B. Diamond, Homeownership, Rental Housing and Tax Incentives (unpublished draft report prepared for the U.S. Department of Housing and Urban Development, February 1977), pp. 51-58.

CHAPTER IV CRITERIA FOR EVALUATING ALTERNATIVE SUBSIDIES

Criteria or standards are needed to decide among competing alternatives. Several criteria are used in this report so that those who consider some more important than others can give them more weight in evaluating the various alternatives.

COST

The first criterion is cost. The revenue the Treasury loses as a result of tax shelter subsidies is a cost, just as a direct grant or loan subsidy from HUD is a cost. While it is sometimes difficult to measure subsidies that come in different forms in ways that make their costs comparable, that at least is the starting point for analysis.

EFFICIENCY

A subsidy is efficient if it does what it is supposed to do at the lowest possible cost. However, there is frequently not complete agreement on what a subsidy is supposed to do. Are real estate tax shelter subsidies supposed to increase the production of apartments, office buildings, and shopping centers? Reduce rents? Increase the profits of builder/developers? Provide more construction industry jobs? Reduce taxes for high-income outside investors? Provide fees for syndicators, lawyers, and accountants?

Of course subsidies may have more than one purpose. This can make analysis of their efficiency difficult. But more importantly, the subsidy itself may be less efficient if some of the purposes work against each other. For example, if the purpose of a housing subsidy is to reduce rents for low-and moderate-income families, it may be less costly to do so by subsidizing rent payments for these families directly rather than by subsidizing the construction of new rental housing for them. Alternatively, if the purpose of the subsidy is to increase the construction of new rental housing, it may be less costly to do this by subsidizing construction of new housing for middle- and upper-income families rather than for lower-income families, since the per-unit subsidy does not have to be as large.

Combining both of these purposes in one program may result in production subsidies that are more costly than they have to be, rent subsidies which reach fewer people than they otherwise might, or both. 63/

In the analysis which follows, it will be assumed that the purpose of real estate tax shelter subsidies and the alternative subsidies that are discussed is to increase the production of new buildings. As was discussed in the last chapter, it is very difficult to determine to what extent tax shelter or other production subsidies actually increase building construction beyond what would otherwise take place. Therefore a much more limited "first-order" measure of efficiency will be used. It will simply be asked how much of the subsidy actually reaches the builder/developer without being diverted to intermediaries. It will be assumed that some portion of the subsidy reaching the builder/developer is passed on to renters in the form of lower rents, but no attempt will be made to measure how much. As was discussed in the last chapter, not enough is known about the workings of building construction subsidies and real estate markets to make any very reliable estimates of that.

EASE OF ADMINISTRATION

Ideally a subsidy would be provided simply and promptly to the intended recipients. But the more narrowly the class of recipients is defined, the harder it will be to keep administration of the subsidy simple and prompt.

Some subsidies are easy to administer. The deductions for home mortgage interest and property taxes are a good example. The homeowner simply adds these deductions to his tax return, and files it with the IRS. The subsidy comes either immediately in the form of a lower tax payment, or after a few weeks in the form of a refund. But the reason it is so quick and simple is that anyone who owns a home is entitled to get it. There is no attempt to limit eligibility.

Real estate tax shelters are a little more difficult. In order to get the subsidy, taxpayers must enter into a complex limited

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63/ For a discussion of these issues, see Congressional Budget Office, Budget Issue Paper, Housing Assistance for Low- and Moderate-Income Families (February 1977).

partnership arrangement. But if this is done properly, the subsidy from IRS is quick and automatic. Again, however, the reason it is relatively simple is that anyone who goes through the proper steps in setting up a limited partnership is entitled to the subsidy. No additional limits on eligibility are imposed.

HUD direct grant and loan subsidies have been quite difficult to administer. Elaborate advance paperwork is required, along with extensive and multiple reviews. This inevitably results in extended delays. Much of the reason for this, however, is that eligibility for HUD subsidies is narrowly limited by law, regulation, and the availability of subsidy funds. They are not open-ended "entitlement" subsidies like those of the IRS, where everyone who is eligible gets the subsidy, and hardly any limits are put on eligibility. At HUD, difficult decisions must be made about who gets how much out of limited resources, and difficult decisions usually take longer than simple ones.

Additional administrative problems may arise when a single subsidy must be jointly administered by two or more agencies, or when multiple subsidies from different sources must be combined in a single project. Different and sometimes conflicting eligibility standards may be applied, especially when the two agencies have different goals, as HUD and IRS often do. Therefore, if it is determined that a rental housing subsidy should have significant eligibility limitations in order to accomodate it to housing policy goals, it may be better to provide the subsidy through HUD rather than through the IRS, where it may have to be accommodated to tax policy goals as well.

The alternative subsidies discussed in the final chapter will be evaluated in light of their potential for administrative complexity and delay. While complexity and delay are largely a function of the limits and restrictions placed on eligibility for the subsidy, some eligibility limitations may be harder to administer than others. Where possible, this will be indicated.

INCENTIVES FOR GOOD MANAGEMENT AND MAINTENANCE

The Nation's long-established housing goal is to provide "a decent home and a suitable living environment for every American family." In the case of rental housing, this requires something more than simply constructing a building; it requires that the building be adequately managed and maintained during its useful life. That in turn requires incentives -- a system of rewards and penalties.

Incentives for good management and maintenance come mainly from two sources. The first is rent collections -- or the lack of them. The owner who keeps his building well managed and in good repair should be able to charge higher rents. The higher rents can in turn help to finance better management and maintenance. Vacancy rates are also likely to be low in well-managed and maintained buildings, further increasing rent collections.

These incentives may be less strong in low-income rental housing. The rents low-income tenants can afford to pay will normally be too low to provide an adequate incentive for good management and maintenance. Prospects that the building will increase in value over time may also be less for reasons which have little to do with management performance, such as poor location, poor design, or lack of amenities. The low return from rents in low-income projects is usually supplemented by subsidies of various kinds, but unless those subsidies are tied to management performance in the same way that rent collections are, the incentives for good management and maintenance are likely to be low. In addition, subsidy programs frequently include limits on the return developers and investors can earn from the project, which can further reduce the incentive for good management and maintenance.

Real estate tax shelter subsidies are tied to management and maintenance in only limited and indirect ways. Most of the subsidy comes automatically through the tax system, whether management and maintenance is good, bad, or indifferent. The amount of the subsidy is based almost entirely on the initial cost of the building, not on subsequent rent collections. One result of this is that builder/developers have an incentive to add as much as they can to the initial cost of the building. If the additional amounts are spent on special design features that improve the chances for ultimate sale at a profit, or which make subsequent management and maintenance easier, the tax shelter might lead at least indirectly to better management and maintenance. But there is no guarantee that the additional amounts added to the building cost will be used for this purpose. They could just as well be used to increase fees for the various participants.

Real estate tax shelter subsidies are linked at least roughly to management performance in another way. If the project is so poorly managed and maintained that it goes into default and foreclosure in the first 10 to 15 years of its life, the recapture provisions of the tax law will substantially reduce or eliminate the tax shelter benefits. Projects may go into foreclosure for reasons that have little or nothing to do with management performance,

however. In addition, the threat of foreclosure and recapture encourages only management which is just good enough to avert disaster. It is not a positive incentive for management which is much better than that.

Relatively low incentives for good management are not unique to tax shelter subsidies, however. To a large extent, the same problem will be present in any subsidy which is tied primarily to the initial cost of the building rather than to later rent collections or operating costs. Most of the alternative subsidies discussed in the final chapter have this same problem since, like the tax shelter subsidies they are designed to replace, they provide subsidies for building construction rather than for rents or operating costs. In some cases, the alternative subsidies may not even provide as much of an incentive for good management as real estate tax shelters, since they lack the recapture provisions that tax shelters have. In those cases, it may be possible to improve the prospects for good management performance by stretching the subsidy out over a longer period, combining it with other programs that have better management incentives, or providing supplementary incentives and subsidies.

It may be possible to improve the management of projects subsidized primarily by construction subsidies by increasing HUD regulation and supervision of the management of completed projects. However, this is likely to prove quite difficult if real financial incentives for good management are lacking. The problem would be analagous to that faced in HUD multifamily construction subsidy and insurance programs, where the very substantial incentives to add unnecessarily to the initial cost of the building must be suppressed by an elaborate and burdensome review process aimed at keeping those incentives from being acted upon. It may be more productive to change the incentives than to increase regulation and supervision.

TAX EQUITY AND NEUTRALITY

Tax laws are judged by standards of equity and neutrality. Tax equity requires that those who are in the same position be treated the same for tax purposes. Real estate tax shelters represent a departure from tax equity, since they permit some individuals with very high incomes to pay less in taxes than others with the same or even lower incomes.

The standard of tax neutrality requires that the tax system, to the extent possible, refrain from biasing economic decisions one way or the other. Under this standard, economic decisions should be made for economic reasons, not tax reasons.

Real estate tax shelters also represent a departure from the principle of tax neutrality, since they permit one industry to be treated more favorably for tax purposes than others. Resources are diverted into real estate construction that, on purely economic grounds, would have gone elsewhere.

There are of course many departures from neutrality in the tax system. In most cases they represent an effort to use the tax system to provide a subsidy, rather than an effort to reach a proper definition of income for tax purposes. To the extent that tax provisions are intended to provide a subsidy, the standard of tax neutrality is less applicable. Subsidies, after all, are supposed to be unneutral. The question then is whether the tax system is the most appropriate mechanism for providing the subsidy, and whether the subsidy itself is efficient, equitable, and effective.

VISIBILITY AND CONTROLLABILITY

Some subsidies are more visible and controllable than others. Most direct grant programs are highly visible in the federal budget, and are subject to regular review and control through the congressional authorization, appropriaton, and budget processes. Tax subsidies have become more visible now that the government is required to publish an annual tax expenditure budget, 64/ but a process for regular review and control of tax subsidies has yet to be fully developed. Real estate tax shelter subsidies are less visible than most other tax subsidies, since they are made up of a number of different tax expenditures rather than just one. Some interest

64/ The first tax expenditure budget was published in 1968. See U.S. Department of the Treasury, Annual Report of The Secretary of the Treasury for Fiscal Year 1968, pp. 326-340. The Congressional Budget Act of 1974, P.L. 93-344 (July 12, 1974) requires that the President's budget include a list of tax expenditures (Sec. 601). The most recent tax expenditure budget appears in Special Analyses, Budget of the U.S. Government, Fiscal Year 1978, pp. 128-130, Table F-1.

subsidy and loan programs have very low visibility and controllability. 65/

Determining the size and impact of subsidies is made more difficult if they are provided in indirect and circuitous ways, and pass through a number of intermediaries. Real estate tax shelter subsidies and many interest subsidy and loan programs share these characteristics.

High visibility and controllability may or may not be considered desirable characteristics. For those whose main concern is maintaining control over the budget, they are obviously desirable. For the beneficiaries of subsidies, however, visibility and controllability may be much less desirable. Visible subsidies can be vulnerable subsidies. If the beneficiaries of a subsidy are not confident that a strong consensus supports it, they may seek to lower its visibility by making it complicated and indirect. Visibility is also reduced if support is provided through multiple subsidies of different types. No one of the subsidies then looks especially large. Reduced visibility makes periodic review and control of the subsidy much less likely.

65/ For a discussion of some of these issues, see Allen Schick, "Congressional Control of Expenditures," prepared for the House Committee on the Budget, 95th Cong., 2nd Sess. (January 1977).

CHAPTER V ALTERNATIVE SUBSIDIES FOR RENTAL HOUSING

This chapter discusses six different alternative subsidies for rental housing construction in terms of the criteria developed in the preceding chapter. Supplementary subsidies or incentives for housing management and maintenance and for screening of projects and builder/developers are also discussed. Table 10 at the end of the chapter summarizes the discussion.

SUBSIDIES FOR COMMERCIAL REAL ESTATE AND UPPER-INCOME RENTAL HOUSING

The alternative subsidies discussed below are all subsidies for rental housing, and special emphasis is placed on low- and moderate-income rental housing. In the letter requesting this study, reprinted in Appendix A, the committees expressed special concern over the impact of possible tax changes on low- and moderate-income rental housing, and asked that the study focus on "alternative housing subsidy options." HUD also emphasized the special needs of low-income rental housing in urging that the new limits on real estate tax shelters in the Tax Reform Act of 1976 include a five-year exemption for this type of housing.

If subsidies are considered desirable for commercial real estate and upper-income rental housing, the present tax shelter subsidies could be continued. Alternatively, some of the rental housing subsidy mechanisms discussed below, such as an investment tax credit, could be used to subsidize commercial real estate or upper-income rental housing, although the level of the subsidy might be lower in those cases. Since these forms of real estate construction tend to compete with low- and moderate-income rental housing for equity capital and other resources, continuation of subsidies for commercial and upper-income residential real estate could require higher subsidies for low- and moderate-income rental housing than would otherwise be necessary. The elimination of tax shelter subsidies for commercial real estate and upper-income rental housing would be likely to result in a combination of reduced construction and increased rents for those types of buildings. If this option is chosen, a gradual phase out of the subsidies over a period of time might be considered to ease the transition.

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CONTINUATION OF EXISTING TAX SHELTER SUBSIDIES FOR RENTAL HOUSING

One option that could be considered is the continuation of existing tax shelter subsidies for rental housing, with perhaps some limitation on the incomes of those eligible to live in the housing built with the subsidy.

Cost

As indicated in Chapter III, tax shelter subsidies for rental housing will cost an estimated $850 million in lost revenue in fiscal year 1978, with about $150 million of that going to low-income, government-subsidized rental housing. The cost of the subsidy could be reduced by limiting it to rental housing constructed for those with incomes below a specified level. If the median income level is chosen, by definition 50 percent of all households would be eligible. The 1975 median income levels for families of different sizes are:

Family Size	1975 Median Income
1	$ 4,882
2	11,040
3	14,025
4	15,848
5	16,466
6	16,134
7 or more	14,529

Source: U.S. Bureau of the Census, Current Population Reports, Consumer Income, Series P-60, No. 103 (September 1976), pp. 2, 9.

If a lower income level is desired, the limit for the HUD Section 8 program could be used. This limits eligibility to those with incomes up to 80 percent of the median income. This would include approximately 40 percent of all households, and 55 percent of all renters. 66/ The definition of "low-income housing" in the Tax Reform Act of 1976 incorporates the Section 8 eligibilty limits. 67/ Income limits could of course also be set above median income levels.

66/ Congressional Budget Office, Housing Assistance for Low and Moderate Income Families, Budget Issue Paper, February 1977, Table 1, p. 4.

67/ 26 USC 189(e)(5); 26 USC 1250(a)(1)(B)(ii).

The cost of continuing tax shelter subsidies for rental housing would depend primarily on whether income eligibility levels were set, and the level at which they were set. If eligibility is limited to rental housing built for those with low and moderate incomes (using, for example, the Section 8 definition), the cost would also depend on the level of activity and funding for HUD, state, and local housing subsidy programs, since low- and moderate-income rental housing usually cannot be constructed without the assistance of those subsidies.

Efficiency

As discussed in Chapter II, only about 40 to 60 percent of the revenue the government loses on real estate tax shelter subsidies reaches the builder/ developer. The remainder goes for fees to syndicators, and as a payment to outside investors for the use of their money. This aspect of the tax shelter subsidy system would continue basically unchanged if the subsidy were limited to rental housing. However, the resulting reduction in the total supply of tax shelter opportunities might increase the bargaining power of rental housing builder/developers, making it possible for them to obtain a higher share of the total subsidy for themselves. This could reduce the inefficiency somewhat.

Ease of Administration

As a practical matter, benefits from the administrative simplicity and speed of tax shelter subsidies are confined largely to those who build middle- to upper-income rental housing. For those building low-to-moderate-income rental housing, where tax shelter subsidies must usually be combined with HUD, state, or local housing subsidies, the administrative advantages of tax shelter subsidies are often swallowed up by the complexities and delays which accompany the other subsidies.

Indeed, when tax shelter subsidies and other subsidies must be combined in a single project, the administrative difficulties are likely to be multiplied. Additional and sometimes conflicting requirements may be placed on builder/ developers. Two or more bureaucracies must be dealt with instead of one.

There are a number of examples of the problems that can result from combining tax and nontax subsidies in the history of the Section

167(k) tax subsidy for low-income housing rehabilitation, which is almost invariably combined with HUD subsidies. To begin with, the initial regulations proposed for Section 167(k) by the IRS in 1970 used a different definition of "low-and moderate-income" from the one being used by HUD for its subsidy programs. 68/ This problem was eventually resolved in the final regulations by allowing use of either the HUD or the IRS definition, 68a/ but other problems have cropped up.

On November 15, 1976, the IRS issued a Revenue Ruling denying the tax benefits of Section 167(k) to a partnership because the form submitted with its tax return certifying tenant income was the HUD form rather than the one prescribed by the IRS. 69/ The only difference between the two forms was that IRS required theirs to be notarized, while HUD did not. The HUD form did impose criminal penalties for false statements, however.

The IRS Section 167(k) regulations also conflict somewhat with the HUD Section 8 regulations for Substantial Rehabilitation. In order to encourage economic integration, the HUD Section 8 regulations establish a preference for projects in which low-income units represent 20 percent or less of the units to be rehabilitated. 70/ The IRS Section 167(k) regulations, however, provide an incentive for projects in which all, or almost all, of the units are reserved for low-income occupants. They do this by permitting rehabilitation expenditures for common areas like stairways, hallways, and parking lots to be proportionally allocated to low-income units, but not to others. If the building contains some units for other than low-income families, therefore, only part of the common area rehabilitation expenditures can benefit from the special five-year write-off under Section 167(k). 71/

68/ For a discussion, see John D. Heinberg and Emil M. Sunley, Jr., "Tax Incentives for Rehabilitating Rental Housing," in George Sternlieb, and Virginia Paulus, eds., Housing 1971-1972 (1974), pp. 475-477.

68a/ Income Tax Regulations, Section 1.167(k) - 3(b)(3).

69/ Revenue Ruling 76-439, November 15, 1976.

70/ HUD Regulations, Section 881.104(a).

71/ Income Tax Regulations, Section 1.167(k)-2(d).

A similar problem comes up in the Tax Reform Act of 1976. The act makes an entire building eligible for more favorable tax treatment as "low-income housing" if 85 percent or more of the units are reserved for lower-income families. If less than 85 percent of the units are reserved for such families, however, this extra bonus is lost and the tax benefits are calculated only on a per-unit basis. 72/ Again, however, the regulations under the HUD Section 8 housing subsidy program establish a preference for projects in which lower-income units are limited to 20 percent or less of total units. 73/

There are fewer problems of this kind in middle- and upper-income rental projects which receive only tax shelter subsidies. The reason, of course, is that there have been few attempts to limit eligibility for these subsidies, or to require that they conform to any housing policy goals. If such limits were imposed, tax shelter subsidies would be subject to many of the same administrative problems that encumber many HUD subsidy programs. If tax shelter subsidies were limited to housing built for persons with incomes below specified limits, for example, the IRS would have to check the income levels of renters in order to establish the eligibility of owners and investors for the tax shelter subsidies. This in fact is what must be done now under the Section 167(k) tax subsidy for rehabilitation, 74/ resulting in such difficulties as having one's subsidy denied for failing to submit notarized tenant income certificates.

Incentives for Good Management and Maintenance

The present tax shelter subsidies for rental housing provide only limited incentives for good management. They do provide outside investors with an incentive for management that is at least good enough to avoid foreclosure during the first 10-15 years of the project, since the tax consequences of early foreclosure are highly unpleasant for them. Many of the tax benefits they anticipated may not be realized, and those already received may be recaptured. One problem, however, is that while the tax laws provide outside investors with an incentive to see that foreclosure is avoided, state

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72/ 26 USC 1250(a)(1)(B).

73/ HUD Regulations, Section 880.104(a).

74/ Income Tax Regulations, Section 1.167(k)-3(b)(4).

limited partnership laws severely restrict their ability to act on that incentive. The Uniform Limited Partnership Act, in effect in 49 of the 50 states, provides that outside investors in a limited partnership will lose their privilege of limited liability if they take part in the control of the business. 75/ In addition, outside investors usually have little experience or expertise in real estate investment or management, they are often not adequately represented by legal counsel, and they are often poorly informed about the current status of the project. The project may well get into deep trouble before they realize it, and it may then be too late to do anything about it. 76/

A number of HUD-subsidized, low-income rental housing projects have been foreclosed or assigned to HUD in their early years, despite the seriously adverse tax consequences for the outside investors. In the first eight years of the HUD Section 236 low-and moderate-income rental housing program, through January 31, 1977, 223 out of 2,821 limited partnership (limited dividend) projects (7.9 percent) were assigned or foreclosed. 77/ In addition a great many others have been in default for varying lengths of time.

The builder/developer, who normally shares a small part of the ownership with the outside investors (usually no more than 5 percent), also has some incentive to provide good management. Primarily, he has his own reputation to protect. His ability to attract equity capital from outside investors for future projects, and his eligibility for HUD subsidies on future projects, 78/ depends

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75/ Uniform Limited Partnership Act, Section 7. Only Louisiana has not adopted the Uniform Limited Partnership Act.

76/ For some examples, see "Doctors and Deals," a five-part series appearing in the Washington Post from February 6-10, 1977.

77/ Unpublished data from Department of Housing and Urban Development, Management Information Systems Division.

78/ Builder/developers seeking HUD subsidies are required to submit a "Previous Participation Certificate" (FHA Form 2530) indicating whether any previous HUD or FHA-insured project in which they were involved was ever in default or received mortgage relief.

in large measure on how successful he is in developing projects and maintaining them well enough to protect the investments of his outside investors.

There is in fact some evidence that good management and maintenance is more likely in those projects where the builder/developer retains a long-term ownership interest in the project, and either handles the management himself or subcontracts it. A 1973 study by Touche Ross & Company found that the tax shelter subsidy system provides an incentive for stable ownership for a period of 15 to 20 years, since sale or foreclosure before that time would have adverse tax consequences which would substantially reduce the rate of return of outside owner/investors. 79/ A responsible builder/developer therefore would want to keep the project adequately managed and maintained for at least that long in order to enable the outside owner/investors to maximize the return on their investment. After 20 years, however, the Touche Ross study found that relatively little incentive for continued ownership would remain, and after 30 years there would be no incentive at all to continue ownership or avoid foreclosure.

The builder/developer will often manage a completed rental housing project himself, or subcontract the management to a management firm. In many projects, these management fees may be a source of profit and an incentive to good management. In low- and moderate-income projects, however, the management fees may not be adequate to cover the costs of the extra management effort that is needed. HUD regulations permit management fees in subsidized projects to be "somewhat" higher than those in other projects, 80/ but this may not be enough to make up for the additional problems and

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79/ Touche Ross and Company, Tax Incentives and the Long-Term Ownership of Section 236 Projects, prepared for the Department of Housing and Urban Development (September 1973), NTIS No. PB 233 333, pp. 3-5, 34-41.

80/ U.S. Department of Housing and Urban Development, Compensation for Management Services in Multifamily Housing Projects With Insured or HUD-Held Mortgages, Handbook No. 4381.5 (July 1974), p. 6.

costs involved in managing low-income rental housing projects. This problem is further discussed later in this chapter in the section on supplementary incentives and subsidies for management and maintenance.

The builder/developer also stands to benefit if the project can be sold after 10 or 20 years for a price greater than the amount remaining on the mortgage. This prospect of gain from an increase in value will normally be realized only if the project is well managed and maintained. In the case of low- and moderate-income rental housing, however, owners in the past generally have not anticipated any significant increase in value. The property was often not in a good location, design may have been poor or amenities inadequate, and there was usually little prospect of charging the substantially higher rents needed to enhance the sale value of the property. This may change if low- and moderate-income projects are built in better locations, with better design and amenities, and if rent increases become easier to obtain. In that event, the incentives for good management and maintenance in these projects should be enhanced.

There is little data available that would show conclusively whether projects financed through tax shelter subsidies have better or worse management than projects financed in other ways. A 1974 Urban Institute study of 60 low- and moderate-income housing developments indicated that management performance tended to be lower in developments financed through tax shelter subsidies. The study emphasized, however, that there were examples of high, low, and medium management peformance in all three forms of ownership studied (cooperatives, nonprofits, and limited dividends financed through tax shelters). "No one form of ownership assures good performance by management," the study concluded. 81/

Tax Equity and Neutrality

The option of continuing existing tax shelter subsidies for rental housing ranks low on tax equity grounds. Individuals with very high incomes would continue to be able to pay a smaller share of their income in taxes than others by investing in rental housing tax

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81/ Morton Isler, Robert Sadacca, and Margaret Drury, Keys To Successful Housing Management (Washington, D.C., The Urban Institute, 1974), p. 13.

shelters. Since rental housing tax shelters could become more visible as one of the last remaining tax shelters, public discontent with these departures from tax equity might be even greater than before, leading to further efforts to reduce or eliminate them.

Continuing the tax shelter subsidy system for rental housing would also be a departure from the principle of tax neutrality, since it would single out one sector of the economy for especially favorable tax treatment. However, if this departure from neutrality represented an explicit decision to subsidize rental housing construction, made after full consideration of alternative subsidy options, it might be less subject to criticism.

Visibility and Controllability

Even with the annual publication of a tax expenditure budget, real estate tax shelter subsidies have relatively low visibility in the federal budget. As illustrated in Table 6 in Chapter III, real estate tax shelters are actually a combination of a number of different tax expenditure items. To make it even more difficult to compile a total for real estate tax shelters, only a portion of some of the tax expenditure items, such as capital gains and construction period interest and taxes, is part of the tax shelter subsidy system.

Since the tax expenditure concept itself is still relatively new, tax subsidies in general tend not to receive the kind of periodic close scrutiny and review that other forms of subsidy must undergo. The problem is even greater when, as in the case of real estate tax shelters, the subsidy is made up of a number of different tax provisions. These provisions are usually not considered together as parts of a single subsidy program, so it has been difficult to weigh their cost and effectiveness against alternative forms of subsidy. In addition, the real estate tax shelter subsidy operates in such a complicated and indirect fashion, with so many different participants, that it is very difficult to identify its actual size and impact.

DIRECT HUD CONSTRUCTION GRANTS TO BUILDER/DEVELOPERS

The present tax shelter subsidies for rental housing could be replaced by a direct grant from HUD to builder/developers equal to a

percentage of the initial cost of the project. In the sample rental housing project discussed in Chapter II, for example, the builder/developer actually received only $64,800 as his share of the subsidy resulting from the "tax shelter savings" on the $1,000,000 project. 82/ In that project, therefore, the tax shelter subsidy could be replaced by a direct construction grant from HUD equal to 6.48 percent of the cost of the project, and the builder/developer would be no worse off (6.48% x $1,000,0000 = $64,800). 83/ The portion of his up-front equity capital which now comes from selling the right to the future tax shelter savings to outside investors would instead come directly from HUD. 84/

Cost

The cost of the direct construction grant option would depend on the level at which it was set, and on the eligibility limits which accompanied it.

In order to determine the proper level for a direct construction grant, a range of rental housing projects would have to be examined to determine how much of the tax shelter subsidy builder/developers in those projects now receive. However, since the federal government under this direct grant system would save the

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82/ See text table on page 10 showing the distribution of the Treasury subsidy resulting from the "tax shelter savings" among the different participants in the sample project.

83/ Since the $64,800 the builder/developer receives from the tax shelter subsidy is tax-free, a direct construction grant from HUD of $64,800 would also have to be tax-free to provide an equivalent benefit. Alternatively, the HUD grant could be made larger to make up for the tax that would be due on it.

84/ The builder/developer would continue to be able to obtain additional equity capital under this option by selling to outside investors the right to the project benefits shown as "other tax savings" and "cash distributions from rents" in Table 1 on page 8.

revenue it now loses from the portion of the tax shelter subsidy which goes to syndicators and outside investors, the government could afford to err on the high side in setting the level of the direct construction grant and still come out ahead.

In the sample project discussed in Chapter II, for example, the builder/developer's share of the tax shelter subsidy came to only $64,800, while the present value to the government of the 20 years of lost revenues came to $145,700. In that project, if the government provided instead a direct construction grant equal to 10 percent of the $1,000,000 cost of the project, or $100,000, the builder/developer would get an extra $35,200 in up-front equity capital, and both he and the government would be better off as a result of eliminating the middlemen.

The total cost of a direct construction grant option would also depend on the eligibility limits that were applied to it. The grant might be limited to low- and moderate-income rental housing, for example, or a higher grant might be provided for that type of housing. Higher grants might also be provided for projects built in certain areas, or for projects with higher risks.

As an illustration of the possible total costs, a direct grant equal to 10 percent of the initial cost of all new multifamily construction would cost about $600-800 million a year at the present relatively low levels of multifamily construction. If multifamily construction returned to the higher levels reached during 1971-74, the cost could reach $1.5 to $2.0 billion per year. 85/

Limiting the direct construction grant to low- and moderate-income rental housing would reduce the total cost by at least 50 percent, and probably more, depending on the exact income levels set. In the case of low- and moderate-income housing, the total cost of the grant might also depend on the availability of other HUD, state, or local housing subsidies, since low- and moderate-income projects might not be started at all without those additional subsidies.

85/ U.S. Bureau of the Census, Value of New Construction Put in Place, C30-77-1 (March 1977). Estimate based on value of new residential buildings with two or more units, Table 2, p. 4.

Taking all of these possibilities into account, the cost of the direct grant option might range from $250 million (7 percent grant, low- and moderate-income housing only, present construction levels) to $2.0 billion (10 percent grant, all rental housing, higher construction levels).

Efficiency

Unlike the tax shelter subsidy, the entire amount of the direct construction grant would go to the builder/developer. No amounts would be diverted for syndication fees or for payments to outside investors for the use of their money.

Ease of Administration

If the construction grant were automatically available to the builder/developer of any rental housing project, administration could be quite simple and prompt. If the grant were available only for rental housing built for persons below specified income levels, or in specified geographic areas, administration would be more difficult. More complex paperwork would be needed to establish eligibility for the subsidy, and more time would be needed to review the paperwork. If the percentage amount of the grant varied from one project to another, based on tenant income levels, location, risk, or some other standard, additional complexity and delay would again result.

If eligibility limitations were imposed to tailor the subsidy to meet housing policy goals, the HUD direct construction grant could have administrative advantages over tax subsidies. With the subsidy coming directly from HUD, joint HUD-IRS administration or cooperation would not be needed, and the possibility of conflicting or multiple eligibility limitations and administrative reviews would be reduced.

The basic issue would remain, however. The more limited and targeted the direct construction grant is, the more difficult and costly it becomes to administer. On the other hand, the fewer the restrictions put on eligibility, the more the direct grant option would cost in total. There is an obvious trade-off, with no obviously correct solution.

Incentives for Good Management and Maintenance

A direct up-front construction grant would in itself provide little or no incentive for continuing good management and maintenance. The builder/developer could get the grant for building the project, and then walk away from it. However, if payment of the grant were spread out in installments over five or ten years, there would be a significant incentive for continued interest in the project and its management and maintenance. The builder/developer might of course sell the right to these future construction grant payments to outside investors in order to obtain the cash he needs up front to finance construction. In that case the outside investors would take over the incentive for management and maintenance as well as the right to the grant payments.

As an alternative or supplement to paying the construction grant in installments over a number of years, the grant could be paid up front, but with a requirement that some portion of it be repaid if the project is foreclosed. This repayment requirement could be structured so that it worked in approximately the same way as the recapture requirements of the tax law, with the repayment requirement gradually phasing out over a period of 15 to 20 years. This would at least preserve the management incentives of the present recapture rules.

Apart from the construction grant, the owners of rental housing projects would continue to have the same incentives for good management and maintenance they have now. The amount they can charge in rents and the likelihood of an increase in the project's value both depend significantly on good management and maintenance.

The incentives from rent collections and possible increases in value may be somewhat less in low- and moderate-income projects if rent collections are not permitted to increase enough to reward good management adequately, or if good management is not fully reflected in increases in the project's value. Possible solutions to these problems will be discussed later in this chapter in the section on supplementary incentives and subsidies for management and maintenance.

Tax Equity and Neutrality

By making it possible to eliminate tax shelter subsidies, the direct construction grant option would substantially improve individual tax equity, since high-income indivduals would have fewer

opportunities to escape full taxation. Replacement of tax shelter subsidies with a direct construction grant would also improve tax neutrality, since the special tax advantage investments in real estate now have would be reduced.

Visibility and Controllability

Direct construction grants for rental housing would be highly visible in the federal budget. The amount spent each year would be readily identifiable. In contrast to tax shelter subsidies, the full amount of the subsidy would be provided through a single program, rather than being collected from assorted different provisions of the tax law. Delivery of the subsidy would be simple and direct; its magnitude and impact would not be disguised by a circuitous and indirect delivery system.

As indicated in Chapter IV, this high visibility may be considered either an advantage or a disadvantage, depending on one's view of the importance of budgetary control, the value of the activity being subsidized, and the degree of possible opposition to the subsidy.

REFUNDABLE INVESTMENT TAX CREDIT FOR BUILDER/DEVELOPERS

If it is considered preferable to continue providing a subsidy for rental housing construction through the tax system, a refundable investment tax credit could be substituted for the existing tax shelter subsidy. This would be practically identical to the direct construction grant discussed in the previous section, except that it would be provided by IRS rather than HUD.

Under this option, the builder/developer of new rental housing would be entitled to a tax credit equal to a percentage of the initial cost of the building. In a building costing $1 million, for example, a 10 percent credit would be worth $100,000. The builder/developer could subtract that amount directly from the amount of taxes he would otherwise have to pay. If his tax liability were not as large as the amount of the credit, the refundable feature of the credit would require the federal government simply to write him a check for the difference. If the builder/developer's tax liability in the year of construction was $30,000, for example, a refundable investment tax credit of $100,000 would completely wipe out that liability, and also entitle him to a check from the federal government for the remaining $70,000. It would therefore be

unnecessary for the builder/developer to sell tax losses he could not use to others. He would get his money directly and automatically from the Treasury, rather than from the proceeds of a syndication to outside investors.

Cost

The refundable investment tax credit option and the direct construction grant option discussed in the preceding section are different only in form. The costs of each option would therefore be the same as long as the levels and eligibility restrictions were the same. The only difference is that the costs of the tax credit would come in the form of revenue losses, while the costs of the grant would come in the form of direct outlays.

Efficiency

Like the direct grant option, the refundable investment tax credit would eliminate the extra subsidy costs for syndication fees and payments to outside investors for the use of their money. The entire amount of the subsidy would go directly to the builder/developer.

Ease of Administration

The consideration here are similar in many respects to those in the case of the direct construction grant from HUD. An across-the-board refundable investment tax credit for all forms of new rental housing construction would be easiest to administer, with administration becoming increasingly more complex and time-consuming as more limits or restrictions are placed on eligiblity. At the same time, these limits on eligibility would reduce the total revenue loss from the credit.

If the refundable investment tax credit is limited or targeted in order to meet housing policy goals, however, some form of cooperation or joint administration by both HUD and IRS would be necessary. If the experience with the Section 167(k) tax subsidy for low-income housing rehabilitation is a guide, this could lead to administrative complications and delays.

It may be, therefore, that the refundable investment tax credit is a better option if the subsidy is to be provided across-the-board with few eligibility limitations, while the HUD direct construction grant may be better if significant eligibility limitations are to be applied, especially if those limitations are related to housing policy goals.

Incentives for Good Management and Maintenance

Again, the considerations here are the same as in the case of the HUD direct construction grant. The refundable investment tax credit to the builder/developer would in itself provide no incentive for good management and maintenance. It would, therefore, be important to consider paying the credit in installments over a period of years, and/or establishing a gradually diminishing repayment requirement that worked in approximately the same way as the recapture provisions of the present tax law.

Tax Equity and Neutrality

From the standpoint of tax equity among individual taxpayers, a refundable investment tax credit would be an improvement over the present tax shelter subsidies, since it could not be used by wealthy outside investors to reduce their tax liability. From the standpoint of tax equity and neutrality among different forms of business investment, however, a refundable investment tax credit for rental housing poses some new issues.

A refundable credit -- one that is paid whether or not the recipient has a tax liability as large as the credit -- would be a new departure in business tax policy. There has been a refundable tax credit in the individual income tax since 1975, however --the earned income credit or "work bonus" for low-income workers with children. 86/ In addition, Chairman Russell B. Long of the Senate Committee on Finance recently introduced a bill to make the present investment tax credit refundable. 87/

86/ 26 USC 43.

87/ S.1270, Congressional Record, daily ed., April 7, 1977, pp. S.5770-71.

Nonetheless, if a refundable investment tax credit were limited only to rental housing, it could be argued that it conflicted with the principles of tax equity and neutrality by giving rental housing a comparative tax advantage over investments in machinery and equipment. Making the present 10 percent investment credit for machinery and equipment refundable could have significant budgetary implications, increasing the estimated $12 billion fiscal year 1978 revenue loss from the credit by another $3.5 billion. 88/ It might also be argued that tax equity and neutrality would require that the refundable investment tax credit be extended to all forms of building construction, not just rental housing. A 10 percent credit for all new private nonresidential building construction would cost from $2.5 to $3.0 billion a year in lost revenue. 89/

Another issue of neutrality and equity that should be considered is whether the credit itself should be treated as taxable income. It is the functional equivalent of a direct grant, and most government grants to business are treated as taxable income. 90/ If the credit were not taxed, it would be worth more to individuals or businesses in high tax bracekts than to those in lower brackets. A 70 percent bracket taxpayer would save $700 in taxes on a tax-free refundable credit of $1000, for example, while a 50 percent bracket taxpayer would save only $500.

Visibility and Controllability

A refundable investment tax credit would be somewhat less visible in the budget than a direct HUD construction grant, simply because tax expenditures still tend to receive less attention than

88/ Congressional Budget Office, Five Year Budget Projections: Fiscal Years 1978-82, Supplement on Tax Expenditures (April 1977), p. 10; Tax Reduction Program, 3, Business Tax Reductions, prepared for the Senate Committee on Finance by the staff of the Joint Committee on Taxation (March 11, 1977), p. 23.

89/ CBO estimate based on U.S. Bureau of the Census, Value of New Construction Put in Place, C30-77-1 (March 1977), Table 2, p. 4.

90/ Stanley S. Surrey, William C. Warren, Paul R. McDaniel, and Hugh J. Ault, Federal Income Taxation: Cases and Materials, Volume One (The Foundation Press, 1972), pp. 214-15.

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direct expenditures. In addition, if the refundable investment tax credit worked in the same way as the present investment tax credit and other tax expenditures, it would be automatically available each year to those eligible for it, without the need for a separate appropriation or any other action by Congress. In this sense, it would be the equivalent of an entitlement program. As a consequence, it would probably receive less annual attention from the Congress and the executive branch than would a direct grant program of the same kind, which would presumably require periodic reauthorization and annual appropriations.

The visibility of a refundable investment tax credit would also depend somewhat on how the refundable portion of the credit was treated in the budget documents. If the refundable portion were carried in one part of the budget as a direct outlay, and the nonrefundable portion were included in the tax expenditure budget as a tax expenditure, it would be less easy to determine the total cost of the credit each year. The Office of Management and Budget treats the present earned income credit this way, 91/ although CBO and the Congressional Budget Committees include both portions of the earned income credit in the tax expenditure budget. 92/

NONREFUNDABLE INVESTMENT TAX CREDIT FOR BUILDER/DEVELOPERS

If a refundable investment tax credit for rental housing construction is considered to be too great a departure from present tax policy, the present machinery and equipment investment tax credit could be extended to rental housing construction. Like the refundable investment tax credit just discussed, this credit could replace the existing tax shelter subsidies for rental housing, and could be set at any level and contain any eligibility limits believed necessary. Under present rules, the amount of the machinery and

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91/ See Special Analyses, Budget of the United States Government, Fiscal Year 1978, p. 129, for the nonrefundable portion of the earned income credit, and The Budget of the United States Government, Fiscal Year 1978, p. 166, for the refundable portion.

92/ Congessional Budget Office, Five-Year Budget Projections: Fiscal Years 1978-1982, Supplement on Tax Expenditures (April 1977), p. 14.

equipment credit used in any one year may not exceed $25,000 of tax liability, plus 50 percent of any liability in excess of $25,000. Unused credits may be carried back three years and forward seven years, however. 93/ If these same rules applied to an investment tax credit for rental housing construction, builder/developers in many instances would not be able to make full use of the credit. If a builder/developer were entitled to a tax credit of $100,000 in a particular year, for example, but had a tax liability for the year of only $35,000, he could only use $30,000 of the credit in that year ($25,000, plus 50 percent of the amount over $25,000). If there were carryback and carryforward provisions in the credit, however, the remaining $70,000 could be used to offset tax liability in prior or later years. The builder/developer could also, in effect, sell credits he could not fully use to outside investors through a limited partnership syndication or some other device.

Cost

To the extent that the lack of refundability made it impossible for builder/developers to use fully all the credits to which they were entitled, a nonrefundable investment tax credit for rental housing would cost less in lost revenue than a refundable credit of the same size and with the same eligibility limitations. If the experience with the machinery and equipment investment tax credit is a reasonable guide, this reduction in the revenue loss could be on the order of around 30 percent. 94/

Efficiency

Like the refundable investment tax credit, this version would eliminate the extra subsidy costs that now exist in the form of windfall tax savings to outside investors in high marginal tax brackets above 50 percent. This would be the case even if unused credits were syndicated, since credits are worth the same amount in

93/ 26 USC 46. Public utilities, railroads, and airlines are temporarily permitted to take investment tax credits up to 100 percent of their tax liability.

94/ Approximately 30 percent of the investment credits for which corporations qualify in any one year go unused in that year, although unused credits may be carried forward to future years. Telephone conversation with Howard Nester, U.S. Department of the Treasury, April 26, 1977.

tax savings to investors in all tax brackets, rather than being worth progressively more as the investor's top marginal tax bracket increases. A $1,000 tax credit would save $1,000 in taxes for anyone in any tax bracket who had a tax liability of $1,000 or more, with no extra windfall to those in higher brackets. A $1,000 tax shelter deduction, on the other hand, saves an investor in the 50 percent bracket only $500 in taxes, while it saves the 70 percent bracket investor $700.

If unused credits were syndicated, some additional expenses would be incurred for syndication fees, and this would divert part of the subsidy from the builder/developer. However, since credits would be simpler and easier for outside investors to understand than the present tax shelter subsidies, and since they could be sold to a wider range of investors -- not just those in 50 percent or higher marginal tax brackets -- syndication costs would perhaps be lower.

In addition, like both the direct construction grant and the refundable investment tax credit, this option would provide all of the subsidy up front rather than spreading it out over 10 to 20 years as is done with tax shelter subsidies. The extra subsidy payment the government must make to outside investors in tax shelters because of the high discount rate investors apply to future tax savings could be saved under this option, since all of the tax savings would come in the first year. As discussed earlier in the section on direct construction grants, however, it may be desirable to provide the grant or credit in installments over a number of years, and/or to include some type of repayment requirement, in order to provide greater incentives for good management and maintenance. In that case, outside investors may still discount the subsidy at a fairly high rate, and less of the subsidy cost to the government would be saved. It might be worth the extra cost to the government to purchase better incentives for good management and maintenance, however.

Ease of Administration

Again, as in the case of HUD construction grants and refundable investment tax credits, credits that have limits and restrictions on eligibility would be harder to administer -- but less costly overall -- than those that are more broadly available. In addition, like the refundable investment tax credit, further administrative complexities and delays could arise if HUD-IRS cooperation or joint administration were needed to limit or target the credit in accordance with housing policy goals.

Incentives for Good Management and Maintenance

The nonrefundable investment tax credit would be the same in this respect as HUD construction grants or refundable investment credits. Since the credit itself would provide no significant incentives for good management and maintenance, consideration should be given to paying it in installments over a number of years and/or including a gradually diminishing repayment requirement.

Tax Equity and Neutrality

Replacing the existing real estate tax shelter subsidies with a nonrefundable investment tax credit would be an improvement from the standpoint of individual tax equity. With a credit, investors in all tax brackets would get the same tax saving from the same size credit, whereas in tax shelters investors in higher brackets get progressively bigger tax savings from the same deductions.

If tax shelter subsidies for all forms of real estate construction were eliminated, to be replaced by an investment tax credit limited to rental housing, some broader questions of neutrality or equity might be raised. One reason given in the past for not extending the machinery and equipment investment tax credit to buildings has been that other tax incentives in the form of accelerated depreciation, expensing of construction period interest and taxes, and limited recapture have been available for buildings. If these incentives or subsidies were removed, Congress might wish to reconsider the issue of whether the investment tax credit subsidy should be extended to all buildings.

Similarly, while the Treasury's prescribed useful lives for most depreciable assets have been significantly shortened in recent years, those for buildings have not been -- again, in large part because of the other tax advantages real estate construction has enjoyed. 95/ If these special real estate tax advantages were to be removed, the Treasury might want to consider a revision in useful lives for buildings.

95/ C. Willis Ritter and Emil M. Sunley, Jr., "Real Estate and Tax Reform: An Analysis and Evaluation of the Real Estate Provisions of the Tax Reform Act of 1969," 30 Maryland L. Rev. 5 (1970), Note 16, pp. 8-9.

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Visibility in the Federal Budget

A nonrefundable investment tax credit would have the same visibility in the budget as a refundable credit. Both would be included in the tax expenditure budget. In addition, since there is no portion of the nonrefundable credit that might be treated as an outlay for budget purposes, the problem that arises in the case of a refundable credit of having a portion of it appear in one part of the budget and another portion somewhere else would not occur.

INTEREST SUBSIDIES FOR BUILDER/DEVELOPERS

In the sample project discussed in Chapter II, the 20 years of tax shelter savings had a present value of $75,600 to the builder/developer and to outside investors in the 50 percent tax bracket. In addition, the 20 years of cash distributions from rents had a present value of $41,100, and the 20 years of "other tax savings" had a present value of $30,700. (See Table 1, p. 8.) The builder/developer obtained most of the equity capital he needed from selling the rights to these tax savings and cash distributions to outside investors.

The major source of financing in the sample project, however, was a $900,000, 40-year mortgage loan, at 7½ percent interest. If that 7½ percent interest rate were reduced to approximately 3 percent, the expenses of the project over the first 20 years would be reduced by $32,500 a year, and the after-tax cash distributions from rents could be increased by $15,500. The builder/developer should be able to sell the right to these 20 years of higher after-tax cash distributions for about $75,600, which is their present value discounted at 20 percent. This is also the present value of the tax-free tax shelter savings.

If, therefore, he can sell the right to the higher cash distributions resulting from a 4.5 percentage point decrease in the mortgage interest rate for the same price he can sell the right to the tax shelter subsidies, any subsidy device that lowered the mortgage interest rate by 4.5 percentage points could compensate for the removal of the tax shelter subsidy in this project.

It is possible that an outside investor might believe that the higher cash distributions resulting from the lower interest rate are less certain than the tax shelter savings. The very high rate of

return on equity that would result might lead to limits on future rent increases, for example. If so, he might discount these future cash distributions at a rate higher than the 20 percent assumed here. In that case, an interest rate reduction of more than 4.5 percentage points would be needed to compensate the builder/developer fully for removal of the tax shelter subsidy.

There are a number of ways in which the federal government could reduce the interest rate of mortgages for new rental housing by the required amount. The mechanisms for providing interest subsidies currently in use tend to be fairly complicated and circuitous, but they boil down to three basic approaches: interest reduction payments, direct loans, and loan guarantees.

Interest reduction payments are simply a government payment to the lender or borrower which is equivalent in amount to the desired reduction in the interest rate. On a $900,000 mortgage, for example, an interest reduction payment of $9,000 a year would be approximately the equivalent of a one percentage point reduction in the interest rate. This is the mechanism that is used in HUD's Section 236 rental housing subsidy program and the Section 235 homeownership subsidy program.

Direct loans are government loans made directly to a private borrower. They can be made at whatever interest rate is desired. This is the mechanism used in the HUD Section 202 Housing for The Elderly or Handicapped rental housing subsidy program. The GNMA Tandem Plan also works out very much like a direct loan program in the end, although the mechanism used to get there is rather circuitous.

Loan guarantees are a mechanism by which the government guarantees or insures loans made by private lenders to private borrowers. HUD has a wide range of loan guarantee or mortgage insurance programs, including the Section 203 single-family program, and multifamily insurance programs under Sections 221(d)(3), 221(d)(4), and 236. Loan guarantees can reduce the interest rates borrowers must pay only if the government's assumption of the risk of loss induces the private lender to charge a lower interest rate. The interest rate reduction resulting from federal guarantees is usually not very large. More importantly, there is little prospect for an additional interest rate reduction in rental housing projects from mortgage guarantees, since HUD guarantees for 90 to 100 percent of mortgage loans are already widely available. Any interest rate reduction from this source has, therefore, already been largely achieved. For this reason, loan guarantees are not a likely substitute for tax shelter subsidies.

Cost

The cost of an interest reduction payment is simply the amount paid out, while the cost of a direct loan is the difference between the interest rate charged on the loan and the federal government's borrowing rate.

The total cost to the government of this interest subsidy option would depend on the amount of the interest rate reduction desired, and on the limits placed on eligibility for the subsidy. The cost to the government of an interest subsidy could be less than the cost of an equivalent tax shelter subsidy, however. With an interest subsidy, the extra windfall benefits that now go to outside investors with marginal tax brackets above 50 percent in tax shelter subsidies would be eliminated.

However, the government probably would not be able to take advantage of its lower discount rate in this option. This can generally only be done when the government provides the subsidy directly rather than through outside investors or other intermediaries. Under the interest subsidy option, the builder/developer would probably have to syndicate the right to the future government interest subsidies to outside investors to get the up-front equity capital he needs. If the interest subsidy is designed to completely compensate for removal of the tax shelter subsidy, it would have to be high enough to offset the high discount rate outside investors are likely to apply to these future benefits. The cost of syndication fees would probably also be incurred in this option.

The interest rate reduction could be made larger than that assumed above, of course, in which case the builder/developer would more than break even. This would increase the cost to the government. The interest subsidy could also be limited to rental housing built for low- and moderate-income families, or built in certain areas, and this would reduce the government's cost.

Efficiency

As just noted, some portion of the interest subsidy would probably be diverted from the builder/developer to outside investors because of the likely need for syndication.

Beyond that, any further diversion of the subsidy to private lenders or other intermediaries could be eliminated if the subsidy were provided in the form of a direct low-interest loan from the government. If the GNMA Tandem Plan or some similarly circuitous mechanism were used, however, some additional portion of the subsidy could be diverted to intermediaries before reaching the builder/developer.

Channeling the interest subsidy through private lenders may be beneficial, however, provided the private lenders bear some risk of loss on the loan. In that event, they would have an incentive to screen both the project and the builder/developer more carefully, providing a potentially valuable addition to the government's own screening process. In such cases, a diversion of part of the subsidy to intermediaries may be a good investment. This issue will be discussed further later in this chapter in the section on supplementary incentives and subsidies for screening.

Ease of Administration

As in the case of the other alternatives, interest subsidies which have limits and restrictions on eligibility will be harder to administer than those which do not, although more precise targeting will reduce government costs.

If it is determined that limits and restrictions on eligibility are needed to reduce government costs, or to target the subsidy more precisely to meet housing policy goals, the interest subsidy option may be easier to administer than any of the tax subsidy options. The interest subsidy would presumably be administered by HUD alone, rather than requiring joint HUD-IRS administration or coordination. With just one agency in charge, there would be less likelihood of conflicting eligibility requirements and time-consuming multiple reviews.

Incentives for Good Management and Maintenance

The interest subsidy alternative has the potential for providing somewhat better incentives for good management and maintenance than the alternatives discussed previously. The reason is that payment of the subsidy is spread out over the life of the mortgage rather than being concentrated in the earlier years. Effective incentives could therefore be provided by making continued

payment of the subsidy contingent on continued good management and maintenance of the project.

It would be possible, of course, to provide direct HUD grants or investment tax credits in annual installments over as many as 40 years and achieve the same result. Installment payments over a shorter period are probably more likely, however. The repayment or recapture requirements discussed in connection with the earlier alternatives are also likely to be less effective incentives for good management than a subsidy that is spread out over the life of the mortgage. The threat that a subsidy not yet paid will be withheld is generally more credible than a threat to require repayment of one that is already in hand.

Tax Equity and Neutrality

If tax shelter subsidies were replaced by interest subsidies, tax equity among individuals would be improved, since wealthy individuals would have less opportunity to reduce their taxes through shelter devices. Tax neutrality would also be improved, since the special tax advantages investments in real estate construction now have would be reduced.

Visibility and Controllability

Interest subsidies and other credit assistance programs tend to have low visibility in the federal budget, and are generally less subject to regular review and control than other programs. In part this is because it is inherently very difficult to measure the cost of loan programs. With a direct government loan, the cost is not the full amount lent out, since the loan is eventually repaid. A better measure of the cost might be the difference between the interest rate charged on the loan and the government's borrowing rate, but the government borrows at many different rates at the same time and at different times. When the government guarantees loans, the amount the government might have to pay if some of the loans go bad is part of the cost, but that cost is hard to predict.

This uncertainty about how to measure the cost of loan programs, combined with apprehension that opponents of the programs may exaggerate their cost, has led to the adoption of various devices that tend to reduce the visibility of these programs in the budget even more. Some loan programs are placed off-budget by law, such as

the Section 202 Housing for the Elderly or Handicapped direct loan program. Federal Financing Bank purchases of guaranteed loans are used to turn them into off-budget direct loans. Elaborate mechanisms are set up, such as the GNMA Tandem Plan, which make it difficult to trace and measure the subsidy being provided.

The interest subsidies discussed in this section -- interest reduction payments and direct loans -- could have varying degrees of visibility and controllability, depending in part on how they are handled in the budget. However, the proper treatment of loan programs in the federal budget raises a number of complex and difficult issues which can probably only be dealt with in a much broader context than this. 96/

SECTION 8 NEW CONSTRUCTION PROGRAM

HUD's Section 8 rental housing subsidy program for low- and moderate-income families was established by the Housing and Community Development Act of 1974. 97/ Under this program, HUD contracts to make subsidy payments to landlords or owners of rental housing units on behalf of low- and moderate-income families and individuals. The tenant pays the landlord 25 percent of his income in rent, 98/ and HUD then pays the landlord the difference between that amount and the fair market rent for the unit.

96/ For a discussion of some of the issues involved, see Loan Guarantees and Off-Budget Financing. Hearing before the Subcommittee on Economic Stabilization of the Committee on Banking, Currency and Housing, the Subcommittee on Oversight of the Committee on Ways and Means, and the Tax Expenditure Task Force of the Committee on the Budget, U.S. House of Representatives, 94th Congress, 2nd Session (November 10, 1976); Special Analyses, Budget of the United States Government, Fiscal Year 1978, Special Analysis E, "Federal Credit Programs," pp. 87-118.

97/ Public Law 93-383 (August 22, 1974).

98/ The tenant payment requirement may drop to as low as 15 percent of income in unusual circumstances (large families and those with very low incomes or unusually high medical or other expenses).

Section 8 is now HUD's main subsidy program for rental housing. It is actually two separate programs. One is aimed at stimulating new construction and substantial rehabilitation; the other provides subsidies for renters in existing housing. In the new construction/substantial rehabilitation program, HUD contracts 99/ with builder/developers to make rent subsidy payments on behalf of eligible renters to them or to the later owners for up to 30 years (40 years if the project is financed by state or local housing agencies). In the existing housing program, HUD contracts with landlords or owners of existing housing to make rent subsidy payments to them on behalf of eligible renters for up to 15 years.

The following table shows the status of the Section 8 program through March 31, 1977:

TABLE 9. SECTION 8 PROGRAM, CUMULATIVE ACTIVITY FROM INCEPTION OF THE PROGRAM THROUGH MARCH 31, 1977 IN NUMBERS OF UNITS

	Fund Reservations	Starts	Completions	Occupied
New Construction	194,381	37,196	10,383	(5,330
Rehabilitation	21,527	6,862	1,223	(
Existing a/	383,843	N/A b/	N/A b/	186,899
Total	599,751	44,058	11,606	192,229

Source: U.S. Department of Housing and Urban Development, Management Information Systems Division and Office of Assisted Housing Management (unpublished data).

a/ Includes units in loan management program (FHA-insured units in danger of mortgage foreclosure).

b/ Not applicable.

99/ HUD may delegate its administrative responsibilities to state or local housing agencies, in which case these agencies would do the contracting, subject to HUD approval. See HUD Regulations, Section 880.102.

The Section 8 new construction program has been slow in getting underway. There have been signs in recent months of a step-up of activity, however, and HUD is predicting a higher level of starts in the remainder of fiscal year 1977 and in fiscal year 1978. 100/

It is uncertain whether the Section 8 new construction program could ultimately, by itself, substitute for real estate tax shelter subsidies. At the present time, builder/developers appear to require at least three layers of subsidy before Section 8 new construction will be undertaken: the Section 8 rent subsidies, interest subsidies through the GNMA Tandem Plan or tax-exempt state housing agency bonds, plus tax shelter subsidies. Removal of any one of those layers could reduce new low- and moderate-income rental housing construction activity substantially.

Whether this will change over time remains to be seen. If construction and operating costs in the Section 8 new construction program can be kept to a reasonable level, and if fair market rents are set high enough, it is possible that a higher return to investors from rents might compensate for removal of the tax shelter subsidies.

In the sample project discussed in Chapter II, the tax shelter subsidies over 20 years had a present value of $75,600, while the cash distribution from rents over 20 years had a present value of $41,100 (both discounted at 20 percent). In order for the Section 8 rent subsidy program to substitute for the tax shelter subsidy in this project, the present value of the after-tax cash distribution

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100/ U.S. Department of Housing and Urban Development, Justification for 1978 Estimates, Part 1, (March 1977), Table VII, P. B-31. For further details on the Section 8 programs see Congressional Budget Office, Budget Issue Paper, Housing Assistance for Low- and Moderate-Income Families (February 1977), pp. 25-36; Grace Milgram, The Current State of The Section 8 Housing Programs, Congressional Research Service, 77-67 E (March 1, 1977).

from rents over 20 years would have to increase by $75,600 to a total of $116,700. In the sample project, this would require a 17.1 percent increase in the annual gross rent collections. 101/

It is too early to tell whether the Section 8 program could achieve this. It will depend in part on where the fair market rent levels are set, since the amount of the subsidy is the difference between what the tenant pays and fair market rents. HUD defines fair market rents as:

> The rent, including utilities (except telephone), ranges and refrigerators, parking, and all maintenance, management and other services, which, as determined at least annually by HUD, would be required to be paid in order to obtain privately developed and owned, newly constructed rental housing of modest (nonluxury) nature with suitable amenities and should architectural design meeting the objectives of the HUD Minimum Property Standards. (Emphasis added) 102/

In high cost areas, HUD may permit the upper limit on the subsidy to be set at 10 or 20 percent above market rents. While HUD has established fair market rent levels for the Section 8 program in areas throughout the country, the ultimate impact of the resulting subsidies on the potential return to builder/developers and investors in new low- and moderate-income rental housing is still uncertain.

101/ Gross rent collections would have to increase by $30,800 a year to bring the present value of 20 years of rent collections after taxes to $75,600, using a 20 percent discount rate and assuming a 50 percent tax rate. Gross rent collections in the Sample project are $180,000 a year (see Appendix B, p. 112). Increasing those collections by $30,800 a year represents a 17.1 percent increase.

102/ HUD Regulations, Section 880.102.

There are practical upper limits on the amount of subsidy that can be provided through the Section 8 rent subsidy mechanism, even with changes in legislation. The subsidy is already permitted to go 20 percent above fair market rents in some areas. As these rent subsidy levels increase, families and individuals living in unsubsidized rental housing may perceive that the rental housing being provided to subsidized Section 8 tenants is superior to that for which they are paying full market rents out of their own pockets. Since these are the people who must be taxed to pay for the Section 8 subsidies, support for the program could be significantly eroded if the rent subsidies are pushed too high.

If there are additional costs involved in constructing and operating Section 8 projects that are not incurred in unsubsidized projects, efforts directed at reducing those costs or subsidizing them directly might be more appropriate and acceptable than increasing the level of permitted rent subsidies. If Section 8 construction costs are higher because of HUD paperwork requirements and processing delays, for example, improved administration may be what is most needed. If the higher construction costs are due to environmental requirements, Davis-Bacon prevailing wage requirements, and HUD minimum property standards, a careful balancing of the benefits and costs of those requirements may lead to some cost reductions. Operating expenses may also be higher in Section 8 projects because of extra costs that are to some extent inherent in low- and moderate-income projects -- budget counseling, extra janitorial services and day care centers in family projects, extra facilities and services in projects for the elderly, and so forth. If so, the solution may be to subsidize these costs directly rather than trying to cover them with a rent subsidy.

If some of these problems with the Section 8 program can be worked out, there is at least the possibility that, at some point in the future, a well-run program could substitute for at least part of the tax shelter subsidies.

For now, however, the Section 8 program has one significant potential advantage over the direct construction grant and investment tax credit alternatives discussed earlier. Unlike those alternatives, Section 8 is designed in such a way that it can readily provide substantial incentives for good management and maintenance. It could therefore be combined with one of the direct grant or investment credit alternatives in a way that left each project with a set of complementary and mutually reinforcing subsidies. The builder/developer's up-front equity money could come from a direct

grant or an investment tax cedit, while the incentives for good management and maintenance could come from the Section 8 rent subsidies. This will be discussed further below in the section on incentives for management and maintenance.

Cost

If Section 8 proved feasible as a substitute for rental housing tax shelter subsidies, the portion of the tax shelter subsidy costs which now go in the form of windfall benefits to investors with marginal tax brackets higher than 50 percent would be saved. As discussed in the next section, however, syndication costs would probably still be incurred, and the government in most cases would not be able to take advantage of its lower discount rate by providing the subsidy directly to the builder/developer.

If, as may be more likely, Section 8 were used to complement some other alternative subsidy such as a direct construction grant or an investment tax credit, the costs or savings involved would be attributable to the other alternative, not to Section 8.

Efficiency

While substitution of Section 8 for the tax shelter subsidies would eliminate windfall subsidy payments to high-bracket outside investors, syndication fees would still be necessary in most cases, since builder/developers would normally have to sell the right to future Section 8 subsidy payments to outside investors in order to obtain up-front equity capital. This might be less complicated and costly than selling tax benefits, however, since complex tax provisions would not have to be explained and illustrated to outside investors. In addition, the market could also be broader than it is now, when only a small number of high-bracket outside investors can invest profitably in tax shelters. Builder/developers might therefore be able to retain a larger share of the total subsidy.

Ease of Administration

As in the case of other subsidies,many of the administrative difficulties in Section 8 are a function of the limits and restrictions placed on eligibility. Ease of administration must therefore be balanced against the benefits of more refined targeting and lower overall program cost.

If it is determined that an up-front construction subsidy is needed in addition to the Section 8 rent payment subsidy, there may be an administrative advantage in providing the construction subsidy through HUD rather than through the tax system. If the construction subsidy is made available automatically to any builder/developer building a project eligible for Section 8 subsidies, it makes relatively little difference which route is chosen. But if there are separate or additional eligibility standards for the construction subsidy, there could be advantages in having it administered through HUD, since that would avoid the problems that might result from joint HUD-IRS administration.

Incentives for Good Management and Maintenance

The Section 8 program can provide more incentives for good management and maintenance than the alternative subsidies discussed previously. Since the subsidy is spread out over a period of up to 40 years, rather than being concentrated in the early years of the project, effective incentives can be provided by making continuation of the subsidy contingent on good management and maintenance of the project. The current Section 8 regulations do in fact provide that the subsidy payment may be withdrawn if the unit is not being maintained in "decent, safe, and sanitary condition." 103/ If the required annual inspections are thorough and reliable, and if HUD is prepared to enforce this sanction, the incentives for good management and maintenance could be substantial.

In addition, there may be less incentive to defer or postpone needed maintenance under the Section 8 program than under programs which provide more of the subsidy in the earlier years of the project. If the bulk of the subsidy is provided in the early years, a building can be under-maintained without significantly diminishing the subsidy, most of which will have been received before any adverse effects begin to appear. If the subsidy is spread fairly evenly over the life of the building, however, as it is in Section 8, the extra subsidy gained by postponing maintenance in the early years may be more than eaten up by higher maintenance costs later on.

Depending on how it is administered, the Section 8 program could also improve the chances that the project will increase in

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103/ HUD Regulations, Section 880.221.

value over time, which in itself is an important incentive for good management and maintenance. Whether the project increases in value will depend in general on its location, its design and amenities, how well it has been managed and maintained, the market for rental housing in the area, inflation, and a number of other factors. The Section 8 program seeks to encourage construction in good locations. 104/ The fair market rent levels are supposed to be set high enough so that "suitable amenities and sound architectural design," can be provided. 105/ The rent levels are also supposed to cover "maintenance, management and other services" comparable to those in unsubsidized projects. 106/ The availability of the Section 8 subsidy should help assure that there is a good market for units in the building, and that occupancy rates stay high. Whether these incentives for good management and maintenance actually materialize, of course, depends in large measure on how the program is administered, and that can only be determined by experience.

There is one aspect of the Section 8 subsidy program which may reduce the incentives for good management and maintenance, however. That is the provision which permits rent subsidy payments of 80 percent of the full rent for vacant units for up to 60 days, and payments equal to the debt service (mortgage principal and interest payments) attributable to the unit for another 12 months after that. 107/ To the extent that vacancies are a result of poor management and maintenance, this reduction in the penalty that must be paid for vacant units could reduce management and maintenance incentives. While this temporary payment for vacant units may be one of the important inducements for builder/developers to undertake Section 8 new construction, it may not be the most appropriate form of inducement if incentives for good management and maintenance are an important concern.

Tax Equity and Neutrality

If the Section 8 new construction program made it possible to eliminate tax shelter susbsidies, tax equity and neutrality would be improved.

104/ HUD Regulations, Section 880.112.

105/ HUD Regulations, Section 880.102.

106/ HUD Regulations, Section 880.102.

107/ HUD Regulations, Section 880.107.

Visibility and Controllability

Section 8 rent subsidy payments are highly visible in the federal budget, making it easier for the Congress and the executive branch to review and control the program.

SUPPLEMENTARY INCENTIVES AND SUBSIDIES

With the exception of the Section 8 construction program and perhaps the interest subsidy option, the alternative subsidies that have been discussed have had relatively low incentives for good management and maintenance. This final section discusses some additional incentives or subsidies for management and maintenance that could be used to supplement those alternatives where the incentives are low.

In addition, it has been suggested that syndicators and outside investors in rental housing tax shelter subsidies may perform a useful role by screening projects for their economic viability, and builder/developers for their skill and reputation. If an alternative subsidy is chosen that involves only limited private sector screening, such as a direct construction grant or a refundable investment tax credit, some effort to provide additional private sector screening may be desirable. Some possibilities are discussed below.

Management and Maintenance

Loss or Repayment of the Subsidy. One form of management and maintenance incentive touched on briefly in the discussion of several of the alternative subsidies is a negative one -- a requirement that the subsidy be withdrawn or repaid if management and maintenance is inadequate. For this incentive to work, there must be some way of measuring whether management and maintenance is adequate or not. One not very precise measure is whether the project has been foreclosed. This is how repayment of the subsidy is triggered in tax shelters, but it is not completely satisfactory. Projects may go into foreclosure for reasons other than bad management, while other projects may avoid foreclosure even though their management is poor.

As an alternative, a system of periodic inspections could be established to determine whether the property is being adequately managed and maintained. This is the system used in the Section 8

subsidy program to determine whether the unit is being kept in "decent, safe, and sanitary condition." 108/ But whether management and maintenance is adequate is often a matter of judgment on which opinions may differ. If continuation or repayment of a subsidy turns on that decision, however, an adverse decision may be challenged administratively or in court. This could diminish the strength of the incentive by making the penalty for inadequate management and maintenance less certain and more difficult to enforce.

A milder variant of this loss or repayment approach is used by the Michigan State Housing Development Authority. The authority requires builder/developers to deposit an "equity escrow" equal to five percent of the mortgage to cover possible operating deficits over the first six years of the project. If there are no deficits, the equity escrow is returned in full to the builder/developer. 109/ This gives the builder/developer an incentive to operate the project efficiently during these first six years, which can be a crucial and difficult time for many new projects. At the same time, however, it may tempt a builder/developer to forego needed additional management and maintenance expenses during this period if they would lead to an operating deficit, since the extra costs would come out of his equity escrow deposit.

Management Fees. Incentives or subsidies for management could also be provided more directly through increased management fees. Management fees are a standard part of the operating expenses in both subsidized and unsubsidized rental housing projects. They are based on a percentage of the gross rent collected each month, generally about 6 to 7 percent. 110/ This system gives the property manager an

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108/ HUD Regulations, Section 880.221.

109/ For a description of the equity escrow system, see Michigan State Housing Development Authority, The Section 8 Handbook (April 1, 1976), pp. 9-10, 12.

110/ Touche Ross & Co., The Impact and Effects of Section 167(k) on the Rehabilitation of Multifamily Property, prepared for the U.S. Department of Housing and Urban Development (1974), Volume I, p. 124.

incentive to collect rents promptly and to provide good enough management so that vacancies stay low. In addition, if management is especially good, the owner of the building may be able to charge a premium for it in the form of higher rents. When management fees are based on rent collections, managers automatically share in the rent premium they have helped to produce. This latter incentive is less likely to be present in subsidized projects, however, since HUD may not permit the rents to rise to take this factor into account.

This system of compensating management may not be adequate in low- and moderate-income subsidized projects. These projects may involve additional management expenses in selecting tenants and certifying their eligibility for subsidy payments, and there may be additional difficulties in collecting rents. HUD has sought to take account of this in its guidelines for management compensation in HUD-subsidized projects. These guidelines state that the "rate of management fee should be somewhat higher" in subsidized projects "in order to compensate the agent for the added expertise and supervision required to adequately administer these subsidies." 111/

The HUD management compensation guidelines also try to provide an additional incentive for good management by permitting a 0.25 percent per year increase in the management fee rate (up to a total of 2 percent) after each year of "superior management performance." 112/ Whether these guidelines are sufficient to provide adequate management incentives in subsidized rental housing projects depends in large measure on how they are administered by local HUD offices.

Low- and moderate-income subsidized rental housing may also have additional maintenance costs. If the project is in an area with inadequate public services and high crime rates, this may increase maintenance costs. Costs are also likely to be higher if the project

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111/ U.S. Department of Housing and Urban Development, Compensation for Management Services in Multifamily Housing Projects with Insured or HUD-Held Mortgages, Handbook No. 4381.5 (July 1974), p. 6.

112/ HUD Management Services Handbook, pp. 7-8.

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has a substantial number of large families. Extra janitorial services may be necessary, and more may have to be spent on minor repairs.

It may not be appropriate to try to cover these potential additional maintenance costs in low-and moderate-income rental housing through higher management fees. Some of these costs can be controlled by better management, and some cannot. 113/ This has led to proposals to cover unusual maintenance costs through operating subsidies.

Operating Subsidies. Operating subsidies for public housing were begun on a small scale in the Housing Act of 1961. The costs have grown substantially since then, and are expected to reach a level of $588 million in fiscal year 1978. 114/ Public housing operating subsidies have been controversial, with some arguing that they seriously erode the incentives for responsible management in public housing projects, while others have argued that they are needed to meet the built-in extra expenses of meeting the housing needs of low-income families and individuals. 115/

113/ For a discussion of these problems in public housing, see Robert Sadacca, et. al., Management Performance in Public Housing (Washington: The Urban Institute, January 1974), pp. 71-75.

114/ U.S. Department of Housing and Urban Development, Justification for 1978 Estimates, Part 1 (March 1977, p. E-1.

115/ For a discussion of public housing operating subsidies, see Housing and Development Reporter, Public Housing Management (Washington: Bureau of National Affairs (BNA), 1977) Reference File 30, pp. 30:3011-15.

Limited operating subsidies were also authorized for the Section 236 low- and moderate-income rental housing subsidy program by the Housing and Community Development Act of 1974. 116/ Section 212 of that act authorized HUD to make additional payments to the owner of Section 236 projects if the costs of utilities and local property taxes increase. The Senate version would have permitted additional payments for increased maintenance costs as well, but this was dropped in conference. 117/ HUD has refused to implement this new authority, except when ordered to do so by court decisions. HUD is currently paying about $552,000 per year in operating subsidies for utility and local property tax increases under court orders. 118/

Under the Section 8 program, increases in the rent subsidy payments over and above those which result from periodic increases in the fair market rents are permitted if HUD:

> determines such adjustments are necesssary to reflect increases in the actual and necessary expenses of owning and maintaining the units which have resulted from substantial general increases in real property taxes, utility rates, or similar costs which are not adequately compensated for by increases in fair market rent levels. 119/

This would not cover additional maintenance costs that might be unique to low- and moderate-income housing projects, however.

The difficult experience with public housing operating subsidies, and the reluctance on the part of HUD and many in the Congress to provide operating subsidies for maintenance expenses in

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116/ P.L. 93-383 (August 22, 1974), Section 212, amending Section 236 of the National Housing Act.

117/ Compilation of the Housing and Community Development Act of 1974, prepared by the Subcommittee on Housing of the Committee on Banking and Currency, House of Representatives, 93rd Congress, Second Session (October 1974), pp. 324, 600.

118/ HUD, Justification for 1978 Estimates, P. D-13.

119/ P.L. 93-383, Section 201; United States Housing Act of 1937, Section 8(c)(2)(B).

low- and moderate-income rental housing, suggest that this is an approach which should be considered with caution. It is not easy to determine what kinds of additional operating expenses may be unique to low- and moderate-income housing projects. It is harder still to devise a formula to cover them which does not at the same time reward inefficiency and waste. 120/ HUD has only recently put into effect a system which attempts to do this in public housing. 121/ Further experience with that may give a better indication of whether a similar approach can work in low-and moderate-income private rental housing.

Screening

There can be considerable value in having proposals for new rental housing construction screened by people in the private sector who have some of their own money at stake. They are likely to take a close look at the economic viability of the project, and evaluate carefully the skill and reputation of the builder/developer. HUD already does this in the case of low- and moderate-income subsidized projects, but even there it can be valuable to have someone in the private sector involved in the screening process as well. Low- and moderate-income projects will normally not be economically viable without subsidies. But with the subsidies they should be, and private screening can evaluate that. The skill and reputation of the builder/developer is of course equally critical in both subsidized and unsubsidized projects.

In tax shelter subsidies, this screening role can be played by the syndicator and, to a lesser extent, by outside investors. The syndicator has both his future earnings and his reputation riding on the success or failure of projects he is involved with. Outside investors have money at stake but, as discussed earlier, they are not usually in a position to perform the screening role adequately.

120/ For an attempt to devise such a formula for public housing, see Robert Sadacca, et. al., The Development of a Prototype Equation for Public Housing Operating Expenses (Washington: The Urban Institute, June 1975).

121/ This so-called Performance Funding System was put into effect in April 1975. For a description, see Housing and Development Reporter, Public Housing Management, REference File 30, pp. 30:3012-13.

Responsible syndicators can be effective and useful participants in the rental housing construction process if they have developed the staff and expertise to screen and evaluate new construction proposals. The National Corporation for Housing Partnerships, for example, established by the Congress in the Housing and Urban Development Act of 1968, 122/ has been the syndicator for a wide range of low- and moderate-income housing construction projects in recent years. It has developed a substantial capability for screening potential projects and builder/developers, and assisting in project development, construction and management. 123/

Syndicators could continue to play a role in most of the alternative subsidies that have been discussed, since builder/developers would usually still need to sell interests in the project and the alternative subsidy to outside investors in order to obtain up-front equity capital. Even in the case of the direct grant and the refundable investment tax credit, where the subsidy would go directly to the builder/developer, a process similar to syndication might be used if the grant or credit were paid in installments over a number of years. Builder/developers who needed their money right away might sell the right to these future subsidy payments to outside investors. If it were thought important to preserve a screening role for syndicators, therefore, it could be done under the alternative subsidies that have been discussed.

There are others in the private sector who could also perform this screening role. The primary candidate is the mortgage lender who currently provides the bulk of the financing for rental housing construction projects. Unless the private mortgage lender has insurance, the risk of project failure will fall on him. This provides a substantial incentive to screen both the project and the builder/developer carefully.

122/ P.L. 90-448, Title IX.

123/ For a current report on its activities, see National Corporation for Housing Partnerships and The National Housing Partnership, Standing Our Ground Between Programs, a Report to the President of the United States (1975).

In the case of most low- and moderate-income rental housing, however, HUD provides the private lender with full insurance against any loss on the mortgage loan. The lender therefore has little incentive to screen the project and the builder/developer, and is generally content to leave the screening to HUD. The Housing and Community Development Act of 1974 authorized HUD to develop a new co-insurance program which would shift 10 percent or more of the risk of loss to private mortgage lenders, who would in exchange receive a portion of the mortgage premiums and fees now going to HUD. 124/ This would provide private lenders with an incentive to do a more careful job of screening the project. This new co-insurance program is still in its early stages, however, so it is not certain how it will eventually work out. 125/

Life insurance companies could also screen projects and builder/developers effectively, since many of them have well-developed real estate investment departments or subsidiaries. Life insurance companies frequently provide permanent mortgage loans for new rental housing construction, and must screen and evaluate projects in connection with that. They also may make direct up-front investments of equity capital in rental housing, just as other outside investors to. In those cases, their interest in carefully screening the project can be even greater.

Insurance companies rarely make equity capital investments in low-and moderate-income rental housing, however. One reason is that much of the return to investors in that type of housing comes from tax shelter savings, which most insurance companies do not need since they already pay very low rates of tax. 126/ They are more likely to

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124/ P.L. 93-383, Section 307, adding a new Section 244 to the National Housing Act.

125/ For the most recent report on the status of this program, see U.S. Department of Housing and Urban Development, Third Annual Report to the Congress on the HUD Co-Insurance Program (March 1, 1977).

126/ Touche Ross & Co., Study on Tax Considerations in Multi-Family Housing Investment, prepared for the Department of Housing and Urban Development (1972), pp. 28-29.

invest instead in commercial buildings and upper-income rental housing projects, where the tax shelter portion of the return is relatively low, and the cash distribution from rents and the long-run increase in value is likely to be higher.

If the tax shelter subsidy for rental housing construction were replaced by an alternative that did not involve a tax subsidy, such as a direct HUD construction grant, insurance companies might be somewhat more likely to invest in low- and moderate-income rental housing, and in the process provide valuable private sector screening.

TABLE 10. SUMMARY OF ALTERNATIVES TO REAL ESTATE TAX SHELTER SUBSIDIES, USING VARIOUS CRITERIA FOR EVALUATION

Alternative Subsidies	Cost a/	Efficiency (Percent of Subsidy Reaching Builder/Developer)	Ease of Administration
Continue Tax Shelters for All Rental Housing	$0.85	40-60	Depends on limits and restrictions on eligibility; possible additional problems from joint HUD-IRS administration.
Direct HUD Construction Grants	$0.4-0.6	90-100 b/	Depends on limits and restrictions on eligibility; no problems with joint HUD-IRS administration.
Refundable Investment Tax Credit	$0.4-0.6	90-100 b/	Depends on limits and restrictions on eligibility; possible additional problems from joint HUD-IRS administration.
Nonrefundable Investment Tax Credit	$0.4-0.6	70 -100 b/	Depends on limits and restrictions on eligibility; possible additional problems from joint HUD-IRS administration.
Interest Subsidies	$0.4-0.6	70-100 b/	Depends on limits and restrictions on eligibility; no problems with joint HUD-IRS administration.
Section 8 New Construction Program	$0.4-0.6	Uncertain	Same as present; no problems with joint HUD-IRS administration unless combined with a tax subsidy.

a/ Revenue loss or budget outlay in billions of dollars. The amount shown is the approximate amount needed to provide builder/developers of rental housing with the same amount of subsidy now being received from tax shelters.

b/ The builder/developer's share of the total subsidy will be less than 100 percent in these alternatives if interests in the project and the subsidy must be sold or syndicated to outside investors.

(continued)

(Table 10, continued)

Alternative Subsidies	Incentives for Good Management and Maintenance	Tax Equity and Neutrality	Visibility and Controllability
Continue Tax Shelters for All Rental Housing	Low to Moderate	Low	Low
Direct HUD Construction Grants	Low to Moderate	High	High
Refundable Investment Tax Credit	Low to Moderate	Improved	Medium
Nonrefundable Investment Tax Credit	Low to Moderate	Improved	Medium
Interest Subsidies	Possibly Higher	High	Low
Section 8 New Construction Program	High	High	High

APPENDIX A

Letter requesting the study
from the Chairmen of the Senate
Committee on Banking, Housing
and Urban Affairs; the House
Committee on Banking, Currency
and Housing; and the House
Committee on the Budget.

Congress of the United States
House of Representatives
Washington, D.C. 20515

June 8, 1976

Alice M. Rivlin
Director
Congressional Budget Office
U.S. Congress
Washington, D.C. 20515

Dear Alice:

The Tax Reform Act of 1975, H.R. 10612, which is now pending in the Senate, contains a variety of provisions dealing with "tax shelters" in real estate and other industries. These provisions would modify a number of tax expenditures--depreciation in excess of straight line, expensing of construction period interest and taxes, 5-year amortization of housing rehabilitation expenses, and capital gains--which are often combined into real estate tax shelters.

Some concern has been expressed that these pending tax changes may have an adverse impact on the rental housing industry, and especially on low and moderate income rental housing. It has been suggested that increased direct budget outlays or credit assistance could substitute--in whole or in part--for the "tax shelter" subsidies for rental housing.

This may be a promising approach. In order to implement it, however, close coordination will be necessary among the committees with legislative jurisdiction over housing programs and taxation, including the Banking Committees and the Committee on Ways and Means, which under the Constitution must originate revenue bills. The new Budget Act directs the Budget Committee to encourage this process of coordination by giving it the duty:

> . . . to request and evaluate continuing studies of tax expenditures, to devise methods of coordinating tax expenditures, policies, and programs with direct budget outlays, and to report the results of such studies to the House on a recurring basis. (Section 101(c))

Accordingly, we believe it would be a helpful first step for the Congressional Budget Office to undertake a study of possible alternative or additional rental housing subsidies which could substitute for existing tax shelter subsidies. Such a study would <u>not</u> deal with the separate issue of subsidies for homeownership, such as the tax deductions for home mortgage interest and property taxes.

To provide background, the cost of the existing real estate tax shelter provisions should be estimated and their impact measured in terms of the goals of both housing policy and tax policy. To the extent possible, an estimate should be made of how this revenue loss or tax saving is distributed: how much goes to residential versus nonresidential construction; how much to builders/developers, syndicators, and passive investors; how much to renters in the form of lower rents; and so forth. In addition, an estimate should be made of the amount of additional construction, jobs, income, and taxes stimulated by these real estate tax subsidies.

The study should then set out a number of alternative housing subsidy options and estimate their likely cost and impact. These alternatives could include subsidies in the form of direct grants, credit assistance, or tax expenditures. They should be evaluated in light of the Nation's housing goal of "a decent home and a suitable living environment for every American family" and of the goals of economy, efficiency, and equity which are common to both housing policy and tax policy.

In conducting this study, we anticipate that you will work closely with our staffs. In addition, you should coordinate your work with the Departments of Housing and Urban Development and Treasury in order to avoid unnecessary duplication of effort and to make the fullest possible use of available governmental resources.

We hope that it will be possible to complete this study by December 31, 1976. To the extent that it is required by legislative developments, we may call upon you for interim reports prior to that date.

We believe that a joint effort of this kind can make a significant contribution to improved housing and tax policy, and we look forward to working closely with you and your staff in the months to come.

Sincerely,

William Proxmire Chairman Senate Committee on Banking, Housing and Urban Affairs	Brock Adams Chairman House Committee on the Budget	Henry S. Reuss Chairman House Committee on Banking, Currency and Housing

APPENDIX B

SAMPLE REAL ESTATE TAX SHELTER PROJECT

Details of Assumptions

Impact of Various Tax Changes on Taxpayers in 50, 60, and 70 Percent Brackets

Details of Assumptions

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ASSUMPTIONS FOR SAMPLE REAL ESTATE TAX SHELTER PROJECT

DEVELOPMENT		
Property Acquisition		$ 75,000
Construction Cost (including architectural and engineering)		750,000
Carrying Charges (12 months)		
Interest at 9% on 1/2 mtge	$ 41,000	
Financing Fee	9,000	
Taxes	10,000	
Legal & Organizational	10,000	
Miscellaneous	15,000	
Total		85,000
Developer's Profit (10% ± of above)		90,000
Total Development Cost		$ 1,000,000
Mortgage Amount (90%)		$ 900,000
OPERATING		
Gross Effective Income		$ 180,000
Operating Expenses		(60,000)
Real Estate Taxes (20% of income)		(36,000)
Net Income		$ 84,000
Debt Service (7 1/2% + 1/2%, 40 Years = 8.4 constant)		(75,600)
Cash Flow		$ 8,400

TAX TREATMENT

Non-depreciable		$ 75,000
Depreciable a/		
Construction	$ 750,000	
Legal and Miscellaneous	25,000	
Developer's Net Profit (syndication + fee less equity)	130,000	
Total		$ 905,000
Expensed		
Interest	$ 41,000	
Financing Fee	9,000	
Real Estate Taxes	10,000	
Total		$ 60,000
Total (mortgage + syndication)		$ 1,040,000

SYNDICATION

Investment:	$140,000 in three equal annual installments
Allocation:	95 percent of tax and cash benefits to investors
Sale Conditions:	$1 over mortgage in year 20

a/ SYD depreciation method; 200 month phaseout of recapture. Depreciable components:

building shell	$ 724,000	at 40 years
roof, equipment, etc.	90,500	at 20 years
appliances, finishes, cabinetry, etc.	90,500	at 10 years
Total	905,000	

COMPLETE 20-YEAR PROJECTION, IN DOLLARS

Year	Project Income	Construction Expenses	Construction Interest	Operating Expenses	Interest and MIP	Depreciation	Total Deductions	Loss (Income)	95 Percent Allocation
				INCOME AND EXPENSES					
0	0	60,000	0	0	0	0	60,000	60,000	57,000
1	180,000	0	0	96,000	71,900	60,400	228,300	48,300	45,900
2	180,000	0	0	96,000	71,600	57,400	225,000	45,000	42,800
3	180,000	0	0	96,000	71,300	54,600	221,900	41,900	39,800
4	180,000	0	0	96,000	70,800	51,500	218,300	38,300	36,400
5	180,000	0	0	96,000	70,500	48,600	215,100	35,100	33,300
6	180,000	0	0	96,000	70,100	45,600	211,700	31,700	30,100
7	180,000	0	0	96,000	69,700	42,600	208,300	28,300	26,900
8	180,000	0	0	96,000	69,100	39,600	204,700	24,700	23,500
9	180,000	0	0	96,000	68,600	36,800	201,400	21,400	20,300
10	180,000	0	0	96,000	68,100	33,700	197,800	17,800	16,900
11	180,000	0	0	96,000	67,400	30,800	194,200	14,200	13,500
12	180,000	0	0	96,000	66,800	29,500	192,300	12,300	11,700
13	180,000	0	0	96,000	66,100	28,100	190,200	10,200	9,700
14	180,000	0	0	96,000	65,400	26,800	188,200	8,200	7,800
15	180,000	0	0	96,000	64,500	25,600	186,100	6,100	5,800
16	180,000	0	0	96,000	63,700	24,300	184,000	4,000	3,800
17	180,000	0	0	96,000	62,700	22,900	181,600	1,600	1,500
18	180,000	0	0	96,000	61,700	21,600	179,300	(700)	(700)
19	180,000	0	0	96,000	60,600	20,300	176,900	(3,100)	(2,900)
20	180,000	0	0	96,000	59,400	18,900	174,300	(5,700)	(5,400)
Total	3,600,000	60,000	0	1,920,000	1,340,000	719,600	4,039,600	439,600	417,700

(Continued)

(Complete 20-Year Projection, continued)

Year	Total Income	Operating Expenses	Reserves Deposits	CASH FLOW: Interest and MIP	CASH FLOW: Amortization	CASH FLOW: Surplus (Deficit)	Total Applications	Cash Distributions	95 Percent Allocation
0	0	0	0	0	0	0	0	0	0
1	180,000	96,000	0	71,900	3,700	0	171,600	8,400	8,000
2	180,000	96,000	0	71,600	4,000	0	171,600	8,400	8,000
3	180,000	96,000	0	71,300	4,300	0	171,600	8,400	8,000
4	180,000	96,000	0	70,800	4,700	100	171,500	8,400	8,000
5	180,000	96,000	0	70,500	5,000	100	171,500	8,400	8,000
6	180,000	96,000	0	70,100	5,400	100	171,500	8,400	8,000
7	180,000	96,000	0	69,700	5,800	100	171,500	8,400	8,000
8	180,000	96,000	0	69,100	6,300	200	171,400	8,400	8,000
9	180,000	96,000	0	68,600	6,800	200	171,400	8,400	8,000
10	180,000	96,000	0	68,100	7,300	200	171,400	8,400	8,000
11	180,000	96,000	0	67,400	7,900	300	171,300	8,400	8,000
12	180,000	96,000	0	66,800	8,500	300	171,300	8,400	8,000
13	180,000	96,000	0	66,100	9,100	400	171,200	8,400	8,000
14	180,000	96,000	0	65,400	9,800	400	171,200	8,400	8,000
15	180,000	96,000	0	64,500	10,600	500	171,100	8,400	8,000
16	180,000	96,000	0	63,700	11,400	500	171,100	8,400	8,000
17	180,000	96,000	0	62,700	12,300	600	171,000	8,400	8,000
18	180,000	96,000	0	61,700	13,300	600	171,000	8,400	8,000
19	180,000	96,000	0	60,600	14,300	700	170,900	8,400	8,000
20	180,000	96,000	0	59,400	15,400	800	170,800	8,400	8,000
Total	3,600,000	1,920,000	0	1,340,000	165,900	6,100	3,425,900	168,000	160,000

Impact of Various Tax Changes
On Taxpayers in 50, 60, and 70 Percent Brackets

A. BASE CASE

20-YEAR SUMMARY

Year	Income or Loss (-)	Tax Savings or Cost (-) at 50%	Cash Distribution	Total Benefits	Cumulative Benefits
0	-60,000	30,000	0	30,000	30,000
1	-48,300	24,200	8,400	32,600	62,600
2	-45,000	22,500	8,400	30,900	93,500
3	-41,900	21,000	8,400	29,400	122,900
4	-38,300	19,200	8,400	27,600	150,500
5	-35,100	17,600	8,400	26,000	176,500
6	-31,700	15,900	8,400	24,300	200,800
7	-28,300	14,200	8,400	22,600	223,400
8	-24,700	12,400	8,400	20,800	244,200
9	-21,400	10,700	8,400	19,100	263,300
10	-17,800	8,900	8,400	17,300	280,600
11	-14,200	7,100	8,400	15,500	296,100
12	-12,300	6,200	8,400	14,600	310,700
13	-10,200	5,100	8,400	13,500	324,200
14	- 8,200	4,100	8,400	12,500	336,700
15	- 6,100	3,100	8,400	11,500	348,200
16	- 4,000	2,000	8,400	10,400	358,600
17	- 1,600	800	8,400	9,200	367,800
18	700	- 300	8,400	8,100	375,900
19	3,100	-1,500	8,400	6,900	382,800
20	5,700	-2,800	8,400	5,600	388,400
Totals	-439,600	220,400	168,000	388,400	
	Total Gain on Sale			467,600	
	Tax on Sale at:				
	25%			116,900	
	30%			140,280	
	35%			163,660	

A. BASE CASE

RETURN TO INVESTOR - SYNDICATION OF $140,000

	Tax Bracket					
	50 percent		60 Percent		70 Percent	
Discounted Rate of Return	20.4%		26.0%		32.0%	
Cash Payback on Initial Investment a/	Yrs.	Mos.	Yrs.	Mos.	Yrs.	Mos.
Payment 1	1	7	1	4	1	2
Payment 2	2	1	1	8	1	4
Payment 3	2	10	2	1	1	7

PRESENT VALUE OF TAX SHELTER SAVINGS b/ TO INVESTOR (95 PERCENT SHARE) AND BUILDER/DEVELOPER (5 PERCENT SHARE) IN DOLLARS

	Tax Bracket		
	50 percent	60 percent	70 percent
20% Discount Rate			
Before Sale	72,500	87,100	101,600
On Sale	3,050	3,660	4,270
Total	75,550	90,760	105,870
7.5% Discount Rate			
Before Sale	93,900	112,700	131,500
On Sale	27,520	33,020	38,530
Total	121,420	145,720	170,030

a/ The investor is assumed to make his investment in three equal annual installment payments, beginning with the start of the construction period. The time shown is the length of time needed for each payment to be returned in full from cash distributions from the project and from tax savings.

b/ Includes tax savings from (1) using accelerated rather than straight-line depreciation, (2) deducting construction period interest and taxes immediately rather than writing them off over the life of the building, and (3) paying tax on the gain on sale in year 20 at capital gain rates (no recapture of depreciation) rather than ordinary income rates (full recapture). The builder/developer is assumed to be in the same tax bracket as the investors.

B-1. MINIMUM TAX: EXCESS DEPRECIATION

20-YEAR SUMMARY

Year	Income or Loss (-)	Tax Savings or Cost (-) at 50%	Cash Distribution	Total Benefits	Cumulative Benefits
0	-60,000	30,000	0	30,000	30,000
1	-48,300	24,200	4,100	28,300	58,300
2	-45,000	22,500	4,500	27,000	85,300
3	-41,900	21,000	5,000	26,000	111,300
4	-38,300	19,200	5,400	24,600	135,900
5	-35,100	17,600	5,900	23,500	159,400
6	-31,700	15,900	6,200	22,100	181,500
7	-28,300	14,200	6,400	20,600	202,100
8	-24,700	12,400	6,600	19,000	221,100
9	-21,400	10,700	6,800	17,500	238,600
10	-17,800	8,900	7,000	15,900	254,500
11	-14,200	7,100	7,100	14,200	268,700
12	-12,300	6,200	7,300	13,500	282,200
13	-10,200	5,100	7,400	12,500	294,700
14	- 8,200	4,100	7,500	11,600	306,300
15	- 6,100	3,100	7,700	10,800	317,100
16	- 4,000	2,000	7,800	9,800	326,900
17	- 1,600	800	7,900	8,700	335,600
18	700	- 300	8,100	7,800	343,400
19	3,100	-1,500	8,200	6,700	350,100
20	5,700	-2,800	8,300	5,500	355,600
Totals	-439,600	220,400	135,200	355,600	
	Total Gain on Sale			467,600	
	Tax on Sale at:				
	25%			116,900	
	30%			140,280	
	35%			163,660	

B-1. MINIMUM TAX: EXCESS DEPRECIATION

RETURN TO INVESTOR - SYNDICATION OF $140,000

	Tax Bracket					
	50 percent		60 Percent		70 Percent	
Discounted Rate of Return	17.0%		22.6%		28.5%	
Cash Payback on Initial Investment a/	Yrs.	Mos.	Yrs.	Mos.	Yrs.	Mos.
Payment 1	1	8	1	4	1	2
Payment 2	2	6	1	11	1	6
Payment 3	3	5	2	7	1	10

PRESENT VALUE OF TAX SHELTER SAVINGS b/ TO INVESTOR (95 PERCENT SHARE) AND BUILDER/DEVELOPER (5 PERCENT SHARE) IN DOLLARS

	Tax Bracket		
	50 percent	60 percent	70 percent
20% Discount Rate			
Before Sale	59,000	73,500	88,000
On Sale	3,050	3,660	4,270
Total	62,050	77,160	92,270
7.5% Discount Rate			
Before Sale	72,200	91,000	109,700
On Sale	27,520	33,020	38,530
Total	99,720	124,020	148,230

a/ The investor is assumed to make his investment in three equal annual installment payments, beginning with the start of the construction period. The time shown is the length of time needed for each payment to be returned in full from cash distributions from the project and from tax savings.

b/ Includes tax savings from (1) using accelerated rather than straight-line depreciation, (2) deducting construction period interest and taxes immediately rather than writing them off over the life of the building, and (3) paying tax on the gain on sale in year 20 at capital gain rates (no recapture of depreciation) rather than ordinary income rates (full recapture). The builder/developer is assumed to be in the same tax bracket as the investors.

B-2. MINIMUM TAX: EXCESS DEPRECIATION PLUS CAPITAL GAIN ON SALE

20-YEAR SUMMARY

Year	Income or Loss (-)	Tax Savings or Cost (-) at 50%	Cash Distribution	Total Benefits	Cumulative Benefits
0	-60,000	30,000	0	30,000	30,000
1	-48,300	24,200	4,100	28,300	58,300
2	-45,000	22,500	4,500	27,000	85,300
3	-41,900	21,000	5,000	26,000	111,300
4	-38,300	19,200	5,400	24,600	135,900
5	-35,100	17,600	5,900	23,500	159,400
6	-31,700	15,900	6,200	22,100	181,500
7	-28,300	14,200	6,400	20,600	202,100
8	-24,700	12,400	6,600	19,000	221,100
9	-21,400	10,700	6,800	17,500	238,600
10	-17,800	8,900	7,000	15,900	254,500
11	-14,200	7,100	7,100	14,200	268,700
12	-12,300	6,200	7,300	13,500	282,200
13	-10,200	5,100	7,400	12,500	294,700
14	- 8,200	4,100	7,500	11,600	306,300
15	- 6,100	3,100	7,700	10,800	317,100
16	- 4,000	2,000	7,800	9,800	326,900
17	- 1,600	800	7,900	8,700	335,600
18	700	- 300	8,100	7,800	343,400
19	3,100	-1,500	8,200	6,700	350,100
20	5,700	-2,800	8,300	5,500	355,600
Totals	-439,600	220,400	135,200	355,600	

Total Gain on Sale 467,600

Tax on Sale at:

25% = 116,900 + 35,100 Min. Tax = 152,000
30% = 140,280 + 35,100 Min. Tax = 175,380
35% = 163,660 + 35,100 Min. Tax = 198,760

B-2. MINIMUM TAX: EXCESS DEPRECIATION PLUS CAPITAL GAIN ON SALE

RETURN TO INVESTOR - SYNDICATION OF $140,000

	Tax Bracket					
	50 percent		60 Percent		70 Percent	
Discounted Rate of Return	16.6%		22.4%		28.5%	
Cash Payback on Initial Investment a/	Yrs.	Mos.	Yrs.	Mos.	Yrs.	Mos.
Payment 1	1	8	1	4	1	2
Payment 2	2	6	1	11	1	6
Payment 3	3	5	2	7	1	10

PRESENT VALUE OF TAX SHELTER SAVINGS b/ TO INVESTOR (95 PERCENT SHARE) AND BUILDER/DEVELOPER (5 PERCENT SHARE) IN DOLLARS

	Tax Bracket		
	50 percent	60 percent	70 percent
20% Discount Rate			
Before Sale	59,000	73,500	88,000
On Sale	2,130	2,740	3,350
Total	61,130	72,240	91,350
7.5% Discount Rate			
Before Sale	72,200	91,000	109,700
On Sale	19,260	24,760	30,270
Total	91,460	115,760	139,970

a/ The investor is assumed to make his investment in three equal annual installment payments, beginning with the start of the construction period. The time shown is the length of time needed for each payment to be returned in full from cash distributions from the project and from tax savings.

b/ Includes tax savings from (1) using accelerated rather than straight-line depreciation, (2) deducting construction period interest and taxes immediately rather than writing them off over the life of the building, and (3) paying tax on the gain on sale in year 20 at capital gain rates (no recapture of depreciation) rather than ordinary income rates (full recapture). The builder/developer is assumed to be in the same tax bracket as the investors.

C-1. CONSTRUCTION PERIOD INTEREST AND TAXES AMORTIZED OVER 10 YEARS

20-YEAR SUMMARY

Year	Income or Loss (-)	Tax Savings or Cost (-) at 50%	Cash Distribution	Total Benefits	Cumulative Benefits
0	- 6,000	3,000	0	3,000	3,000
1	-54,300	27,200	8,400	35,600	38,600
2	-51,000	25,500	8,400	33,900	72,500
3	-47,900	24,000	8,400	32,400	104,900
4	-44,300	22,200	8,400	30,600	135,500
5	-41,100	20,600	8,400	29,000	164,500
6	-37,700	18,900	8,400	27,300	191,800
7	-34,300	17,200	8,400	25,600	217,400
8	-30,700	15,400	8,400	23,800	241,200
9	-27,400	13,700	8,400	22,100	263,300
10	-17,800	8,900	8,400	17,300	280,600
11	-14,200	7,100	8,400	15,500	296,100
12	-12,300	6,200	8,400	14,600	310,000
13	-10,200	5,100	8,400	13,500	324,200
14	- 8,200	4,100	8,400	12,500	336,700
15	- 6,100	3,100	8,400	11,500	348,200
16	- 4,000	2,000	8,400	10,400	358,600
17	- 1,600	800	8,400	9,200	367,800
18	700	- 300	8,400	8,100	375,900
19	3,100	-1,500	8,400	6,900	382,800
20	5,700	-2,800	8,400	5,600	388,400
Totals	-439,600	220,400	168,000	388,400	
	Total Gain on Sale			467,600	
	Tax on Sale at:				
	25%			116,900	
	30%			140,280	
	35%			163,660	

C-1. CONSTRUCTION PERIOD INTEREST AND TAXES AMORTIZED OVER 10 YEARS

RETURN TO INVESTOR - SYNDICATION OF $140,000

	Tax Bracket					
	50 percent		60 Percent		70 Percent	
Discounted Rate of Return	16.8%		20.9%		24.9%	
Cash Payback on Initial Investment a/	Yrs.	Mos.	Yrs.	Mos.	Yrs.	Mos.
Payment 1	2	3	2	1	1	11
Payment 2	2	9	2	4	2	1
Payment 3	3	4	2	9	2	3

PRESENT VALUE OF TAX SHELTER SAVINGS b/ TO INVESTOR (95 PERCENT SHARE) AND BUILDER/DEVELOPER (5 PERCENT SHARE) IN DOLLARS

	Tax Bracket		
	50 percent	60 percent	70 percent
20% Discount Rate			
Before Sale	57,600	69,200	80,700
On Sale	3,050	3,660	4,270
Total	60,650	72,860	84,970
7.5% Discount Rate			
Before Sale	86,100	103,300	120,500
On Sale	27,520	33,020	38,530
Total	113,620	136,320	159,030

a/ The investor is assumed to make his investment in three equal annual installment payments, beginning with the start of the construction period. The time shown is the length of time needed for each payment to be returned in full from cash distributions from the project and from tax savings.

b/ Includes tax savings from (1) using accelerated rather than straight-line depreciation, (2) deducting construction period interest and taxes immediately rather than writing them off over the life of the building, and (3) paying tax on the gain on sale in year 20 at capital gain rates (no recapture of depreciation) rather than ordinary income rates (full recapture). The builder/developer is assumed to be in the same tax bracket as the investors.

C-2. CONSTRUCTION PERIOD INTEREST AND TAXES CAPITALIZED AND DEPRECIATED

20-YEAR SUMMARY

Year	Income or Loss (-)	Tax Savings or Cost (-) at 50%	Cash Distribution	Total Benefits	Cumulative Benefits
0	0	0	0	0	0
1	-52,300	26,200	8,400	34,600	34,600
2	-48.800	24,400	8,400	32,800	67,400
3	-45,400	22,700	8,400	31,100	98,500
4	-41,700	20,900	8,400	29,300	127,800
5	-38,300	19,200	8,400	27,600	155,400
6	-34,800	17,400	8,400	25,800	181,200
7	-31,100	15,600	8,400	24,000	205,200
8	-27,500	13,800	8,400	22,200	227,400
9	-23,700	11,900	8,400	20,300	247,700
10	-20,200	10,100	8,400	18,500	266,200
11	-16,200	8,100	8,400	16,500	282,700
12	-14,200	7,100	8,400	15,500	298,200
13	-12,200	6,100	8,400	14,500	312,700
14	-10,000	3,000	8,400	13,400	326,100
15	- 7,800	3,900	8,400	12,300	338,400
16	- 5,500	2,800	8,400	11,200	349,600
17	- 3,100	1 600	8,400	10,000	359,600
18	- 800	400	8,400	8,800	368,400
19	1,800	- 900	8,400	7,500	375,900
20	4,300	-2,100	8,400	6,300	382,200
Totals	-427,500	214,200	168,000	382,200	
	Total Gain on Sale			455,600	
	Tax on Sale at:				
	25%			113,900	
	30%			136,680	
	35%			159,460	

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C-2. CONSTRUCTION PERIOD INTEREST AND TAXES CAPITALIZED AND DEPRECIATED

RETURN TO INVESTOR - SYNDICATION OF $140,000

	Tax Bracket					
	50 percent		60 Percent		70 Percent	
Discounted Rate of Return	15.3%		19.0%		22.6%	
Cash Payback on Initial Investment a/	Yrs.	Mos.	Yrs.	Mos.	Yrs.	Mos.
Payment 1	2	5	2	2	2	1
Payment 2	2	11	2	6	2	3
Payment 3	3	8	3	0	2	6

PRESENT VALUE OF TAX SHELTER SAVINGS b/ TO INVESTOR (95 PERCENT SHARE) AND BUILDER/DEVELOPER (5 PERCENT SHARE) IN DOLLARS

	Tax Bracket		
	50 percent	60 percent	70 percent
20% Discount Rate			
Before Sale	45,400	54,400	63,500
On Sale	2,970	3,570	4,160
Total	48,370	57,970	67,660
7.5% Discount Rate			
Before Sale	68,200	81,800	95,400
On Sale	26,810	32,180	37,540
Total	95,010	113,980	132,940

a/ The investor is assumed to make his investment in three equal annual installment payments, beginning with the start of the construction period. The time shown is the length of time needed for each payment to be returned in full from cash distributions from the project and from tax savings.

b/ Includes tax savings from (1) using accelerated rather than straight-line depreciation, (2) deducting construction period interest and taxes immediately rather than writing them off over the life of the building, and (3) paying tax on the gain on sale in year 20 at capital gain rates (no recapture of depreciation) rather than ordinary income rates (full recapture). The builder/developer is assumed to be in the same tax bracket as the investors.

D. STRAIGHT-LINE DEPRECIATION

20-YEAR SUMMARY

Year	Income or Loss (-)	Tax Savings or Cost (-) at 50%	Cash Distribution	Total Benefits	Cumulative Benefits
0	-60,000	30,000	0	30,000	30,000
1	-19,600	9,800	8,400	18,200	48,200
2	-19.300	9,700	8,400	18,100	66,300
3	-19,000	9,500	8,400	17,900	84,200
4	-18,500	9,300	8,400	17,700	101,900
5	-18,200	9,100	8,400	17,500	119,400
6	-17,800	8,900	8,400	17,300	136,700
7	-17,400	8,700	8,400	17,100	153,800
8	-16,800	8,400	8,400	16,800	170,600
9	-16,300	8,200	8,400	16,600	187,200
10	-15,800	7,900	8,400	16,300	203,500
11	- 6,000	3,000	8,400	11,400	214,900
12	- 5,400	2,700	8,400	11,100	226,000
13	- 4,700	2,400	8,400	10,800	236,800
14	- 4,000	2,000	8,400	10,400	247,200
15	- 3,100	1,600	8,400	10,000	257,200
16	- 2,300	1,200	8,400	9,600	266,800
17	- 1,300	700	8,400	9,100	275,900
18	- 300	200	8,400	8,600	284,500
19	800	- 400	8,400	8,000	292,500
20	2,000	-1,000	8,400	7,400	299,900
Totals	-263,000	131,900	168,000	299,900	
	Total Gain on Sale			291,000	
	Tax on Sale at:				
	25%			72,750	
	30%			87,300	
	35%			101,850	

D. STRAIGHT-LINE DEPRECIATION

RETURN TO INVESTOR - SYNDICATION OF $140,000

	Tax Bracket					
	50 percent		60 Percent		70 Percent	
Discounted Rate of Return	10.5%		13.5%		16.8%	
Cash Payback on Initial Investment a/	Yrs.	Mos.	Yrs.	Mos.	Yrs.	Mos.
Payment 1	2	0	1	7	1	3
Payment 2	3	9	3	1	2	6
Payment 3	5	7	4	7	3	10

PRESENT VALUE OF TAX SHELTER SAVINGS b/ TO INVESTOR (95 PERCENT SHARE) AND BUILDER/DEVELOPER (5 PERCENT SHARE) IN DOLLARS

	Tax Bracket		
	50 percent	60 percent	70 percent
20% Discount Rate			
Before Sale	30,000	36,000	42,000
On Sale	1,900	2,280	2,660
Total	31,900	38,280	44,660
7.5% Discount Rate			
Before Sale	30,000	36,000	42,000
On Sale	17,130	20,550	23,980
Total	47,130	56,550	65,980

a/ The investor is assumed to make his investment in three equal annual installment payments, beginning with the start of the construction period. The time shown is the length of time needed for each payment to be returned in full from cash distributions from the project and from tax savings.

b/ Includes tax savings from (1) using accelerated rather than straight-line depreciation, (2) deducting construction period interest and taxes immediately rather than writing them off over the life of the building, and (3) paying tax on the gain on sale in year 20 at capital gain rates (no recapture of depreciation) rather than ordinary income rates (full recapture). The builder/developer is assumed to be in the same tax bracket as the investors.

E-1. EXCESS DEPRECIATION RECAPTURE

20-YEAR SUMMARY

Year	Income or Loss (-)	Tax Savings or Cost (-) at 50%	Cash Distribution	Total Benefits	Cumulative Benefits
0	-60,000	30,000	0	30,000	30,000
1	-48,300	24,200	8,400	32,600	62,600
2	-45,000	22,500	8,400	30,900	93,500
3	-41,900	21,000	8,400	29,400	122,900
4	-38,300	19,200	8,400	27,600	150,500
5	-35,100	17,600	8,400	26,000	176,500
6	-31,700	15,900	8,400	24,300	100,800
7	-28,300	14,200	8,400	22,600	223,400
8	-24,700	12,400	8,400	20,800	244,200
9	-21,400	10,700	8,400	19,100	263,300
10	-17,800	8,900	8,400	17,300	280,600
11	-14,200	7,100	8,400	15,500	296,100
12	-12,300	6,200	8,400	14,600	310,000
13	-10,200	5,100	8,400	13,500	324,200
14	- 8,200	4,100	8,400	12,500	336,700
15	- 6,100	3,100	8,400	11,500	348,200
16	- 4,000	2,000	8,400	10,400	358,600
17	- 1,600	800	8,400	9,200	367,800
18	700	- 300	8,400	8,100	375,900
19	3,100	-1,500	8,400	6,900	382,800
20	5,700	-2,800	8,400	5,600	388,400
Totals	-439,600	220,400	168,000	388,400	
	Total Gain on Sale			467,600	
	Tax on Sale at:				
	(291,000 at 25%; 176,600 at 50%)			161,050	
	(291,000 at 30%; 176,600 at 60%)			193,260	
	(291,000 at 35%; 176,600 at 70%)			225,470	

E-1. EXCESS DEPRECIATION RECAPTURE

RETURN TO INVESTOR - SYNDICATION OF $140,000

	Tax Bracket					
	50 percent		60 Percent		70 Percent	
Discounted Rate of Return	20.1%		25.8%		31.9%	
Cash Payback on Initial Investment a/	Yrs.	Mos.	Yrs.	Mos.	Yrs.	Mos.
Payment 1	1	7	1	4	1	2
Payment 2	2	1	1	8	1	4
Payment 3	2	10	2	1	1	7

PRESENT VALUE OF TAX SHELTER SAVINGS b/ TO INVESTOR (95 PERCENT SHARE) AND BUILDER/DEVELOPER (5 PERCENT SHARE) IN DOLLARS

	Tax Bracket		
	50 percent	60 percent	70 percent
20% Discount Rate			
Before Sale	72,500	87,100	101,600
On Sale	1,900	2,280	2,660
Total	74,400	89,380	104,260
7.5% Discount Rate			
Before Sale	93,900	112,700	131,500
On Sale	17,130	20,550	23,980
Total	110,030	133,250	155,480

a/ The investor is assumed to make his investment in three equal annual installment payments, beginning with the start of the construction period. The time shown is the length of time needed for each payment to be returned in full from cash distributions from the project and from tax savings.

b/ Includes tax savings from (1) using accelerated rather than straight-line depreciation, (2) deducting construction period interest and taxes immediately rather than writing them off over the life of the building, and (3) paying tax on the gain on sale in year 20 at capital gain rates (no recapture of depreciation) rather than ordinary income rates (full recapture). The builder/developer is assumed to be in the same tax bracket as the investors.

E-2. FULL RECAPTURE

20-YEAR SUMMARY

Year	Income or Loss (-)	Tax Savings or Cost (-) at 50%	Cash Distribution	Total Benefits	Cumulative Benefits
0	-60,000	30,000	0	30,000	30,000
1	-48,300	24,200	8,400	32,600	62,600
2	-45,000	22,500	8,400	30,900	93,500
3	-41,900	21,000	8,400	29,400	122,900
4	-38,300	19,200	8,400	27,600	150,500
5	-35,100	17,600	8,400	26,000	176,500
6	-31,700	15,900	8,400	24,300	200,800
7	-28,300	14,200	8,400	22,600	223,400
8	-24,700	12,400	8,400	20,800	244,200
9	-21,400	10,700	8,400	19,100	263,300
10	-17,800	8,900	8,400	17,300	280,600
11	-14,200	7,100	8,400	15,500	296,100
12	-12,300	6,200	8,400	14,600	310,700
13	-10,200	5,100	8,400	13,500	324,200
14	- 8,200	4,100	8,400	12,500	336,700
15	- 6,100	3,100	8,400	11,500	348,200
16	- 4,000	2,000	8,400	10,400	358,600
17	- 1,600	800	8,400	9,200	367,800
18	700	- 300	8,400	8,100	375,900
19	3,100	-1,500	8,400	6,900	382,800
20	5,700	-2,800	8,400	5,600	388,400
Totals	-439,600	220,400	168,000	388,400	
Tax on Sale with Full Recapture				-233,800	
Net Benefits				154,600	
	Total Gain on Sale			467,600	
	Tax on Sale at:				
	50%			233,800	
	60%			280,560	
	70%			327,320	

E-2. FULL RECAPTURE

RETURN TO INVESTOR - SYNDICATION OF $140,000

	Tax Bracket					
	50 percent		60 Percent		70 Percent	
Discounted Rate of Return	19.6%		25.6%		31.8%	
Cash Payback on Initial Investment a/	Yrs.	Mos.	Yrs.	Mos.	Yrs.	Mos.
Payment 1	1	7	1	4	1	2
Payment 2	2	1	1	8	1	4
Payment 3	2	10	2	1	1	7

PRESENT VALUE OF TAX SHELTER SAVINGS b/ TO INVESTOR (95 PERCENT SHARE) AND BUILDER/DEVELOPER (5 PERCENT SHARE) IN DOLLARS

	Tax Bracket		
	50 percent	60 percent	70 percent
20% Discount Rate			
Before Sale	72,500	87,100	101,600
On Sale	0	0	0
Total	72,500	87,100	101,600
7.5% Discount Rate			
Before Sale	93,900	112,700	131,500
On Sale	0	0	0
Total	93,900	112,700	131,500

a/ The investor is assumed to make his investment in three equal annual installment payments, beginning with the start of the construction period. The time shown is the length of time needed for each payment to be returned in full from cash distributions from the project and from tax savings.

b/ Includes tax savings from (1) using accelerated rather than straight-line depreciation, (2) deducting construction period interest and taxes immediately rather than writing them off over the life of the building, and (3) paying tax on the gain on sale in year 20 at capital gain rates (no recapture of depreciation) rather than ordinary income rates (full recapture). The builder/developer is assumed to be in the same tax bracket as the investors.

F. "AT RISK" LIMITATION

20-YEAR SUMMARY

Year	Income or Loss (-)	Tax Savings or Cost (-) at 50%	Cash Distribution	Total Benefits	Cumulative Benefits
0	-60,000	30,000	0	30,000	30,000
1	-48,300	24,200	8,400	32,600	62,600
2	-31,700	15,900	8,400	24,300	86,900
3	0	0	8,400	8,400	95,300
4	0	0	8,400	8,400	103,700
5	0	0	8,400	8,400	112,100
6	0	0	8,400	8,400	120,500
7	0	0	8,400	8,400	128,900
8	0	0	8,400	8,400	137,300
9	0	0	8,400	8,400	145,700
10	0	0	8,400	8,400	154,100
11	0	0	8,400	8,400	162,500
12	0	0	8,400	8,400	170,900
13	0	0	8,400	8,400	179,300
14	0	0	8,400	8,400	187,700
15	0	0	8,400	8,400	196,100
16	0	0	8,400	8,400	204,500
17	0	0	8,400	8,400	212,900
18	0	0	8,400	8,400	221,300
19	0	0	8,400	8,400	229,700
20	0	0	8,400	8,400	238,100
Totals	-140,000	70,100	168,000	238,100	
	Total Gain on Sale			168,000	
	Tax on Sale at:				
	25%			42,000	
	30%			50,400	
	35%			58,800	

F. "AT RISK" LIMITATION

RETURN TO INVESTOR - SYNDICATION OF $140,000

	Tax Bracket					
	50 percent		60 Percent		70 Percent	
Discounted Rate of Return	6.6%		8.8%		11.7%	
Cash Payback on Initial Investment a/	Yrs.	Mos.	Yrs.	Mos.	Yrs.	Mos.
Payment 1	1	7	1	4	1	2
Payment 2	3	4	1	10	1	5
Payment 3	8	2	6	6	4	10

PRESENT VALUE OF TAX SHELTER SAVINGS b/ TO INVESTOR (95 PERCENT SHARE) AND BUILDER/DEVELOPER (5 PERCENT SHARE) IN DOLLARS

	Tax Bracket		
	50 percent	60 percent	70 percent
20% Discount Rate			
Before Sale	62,700	75,300	87,800
On Sale	1,100	1,310	1,530
Total	63,800	76,610	89,330
7.5% Discount Rate			
Before Sale	79,200	95,100	110,900
On Sale	9,890	11,860	13,840
Total	89,090	106,960	124,740

a/ The investor is assumed to make his investment in three equal annual installment payments, beginning with the start of the construction period. The time shown is the length of time needed for each payment to be returned in full from cash distributions from the project and from tax savings.

b/ Includes tax savings from (1) using accelerated rather than straight-line depreciation, (2) deducting construction period interest and taxes immediately rather than writing them off over the life of the building, and (3) paying tax on the gain on sale in year 20 at capital gain rates (no recapture of depreciation) rather than ordinary income rates (full recapture). The builder/developer is assumed to be in the same tax bracket as the investors.

G. COMBINATION OF C-2 AND D

20-YEAR SUMMARY

Year	Income or Loss (-)	Tax Savings or Cost (-) at 50%	Cash Distribution	Total Benefits	Cumulative Benefits
0	0	0		0	0
1	-21,700	10,900	8,400	19,300	19,300
2	-21,400	10,700	8,400	19,100	38,400
3	-21,100	10,600	8,400	19,000	57,400
4	-20,600	10,300	8,400	18,700	76,100
5	-20,300	10,200	8,400	18,600	94,700
6	-19,900	10,000	8,400	18,400	113,100
7	-19,500	9,800	8,400	18.200	131,800
8	-18,900	9,500	8,400	17,900	149,200
9	-18,400	9,200	8,400	17,600	166,800
10	-17,900	9.000	8,400	17,400	184,200
11	- 7,500	3,800	8,400	12,200	196,400
12	- 6,900	3,500	8,400	11,900	208,300
13	- 6,200	3,100	8,400	11,500	219,800
14	- 5,500	2,800	8,400	11,200	231,000
15	- 4,600	2,300	8,400	10,700	241,700
16	- 3,800	1,900	8,400	10,300	252,000
17	- 2,800	1,400	8,400	9,800	261,800
18	- 1,800	900	8,400	9,300	271,100
19	- 700	400	8,400	8,800	279,900
20	500	- 200	8,400	8,200	288,100
Totals	-239,000	120,100	168,000	288,100	
	Total Gain on Sale			266,800	
	Tax on Sale at:				
	25%			66,700	
	30%			80,040	
	35%			93,380	

G. COMBINATION OF C-2 AND D

RETURN TO INVESTOR - SYNDICATION OF $140,000

	Tax Bracket					
	50 percent		60 Percent		70 Percent	
Discounted Rate of Return	7.5%		9.1%		10.8%	
Cash Payback on Initial Investment a/	Yrs.	Mos.	Yrs.	Mos.	Yrs.	Mos.
Payment 1	3	6	3	3	3	1
Payment 2	5	2	4	8	4	2
Payment 3	6	10	6	1	5	5

PRESENT VALUE OF TAX SHELTER SAVINGS b/ TO INVESTOR (95 PERCENT SHARE) AND BUILDER/DEVELOPER (5 PERCENT SHARE) IN DOLLARS

	Tax Bracket		
	50 percent	60 percent	70 percent
20% Discount Rate			
Before Sale	0	0	0
On Sale	1,740	2,090	2,440
Total	1,740	2,090	2,440
7.5% Discount Rate			
Before Sale	0	0	0
On Sale	15,700	18,840	21,980
Total	15,700	18,840	21,980

a/ The investor is assumed to make his investment in three equal annual installment payments, beginning with the start of the construction period. The time shown is the length of time needed for each payment to be returned in full from cash distributions from the project and from tax savings.

b/ Includes tax savings from (1) using accelerated rather than straight-line depreciation, (2) deducting construction period interest and taxes immediately rather than writing them off over the life of the building, and (3) paying tax on the gain on sale in year 20 at capital gain rates (no recapture of depreciation) rather than ordinary income rates (full recapture). The builder/developer is assumed to be in the same tax bracket as the investors.

H. COMBINATION OF C-2, D, and E-2

20-YEAR SUMMARY

Year	Income or Loss (-)	Tax Savings or Cost (-) at 50%	Cash Distribution	Total Benefits	Cumulative Benefits
0	0	0	0	0	0
1	-21,700	10,900	8,400	19,300	19,300
2	-21,400	10,700	8,400	19,100	38,400
3	-21,100	10,600	8,400	19,000	57,400
4	-20,600	10,300	8,400	18,700	76,100
5	-20,300	10,200	8,400	18,600	94,700
6	-19,900	10,000	8,400	18,400	113,100
7	-19,500	9,800	8,400	18,200	131,300
8	-18,900	9,500	8,400	17,900	149,200
9	-18,400	9,200	8,400	17,600	166,800
10	-17,900	9.000	8,400	17,400	184,200
11	- 7,500	3,800	8,400	12,200	196,400
12	- 6,900	3,500	8,400	11,900	208,300
13	- 6,200	3,100	8,400	11,500	219,800
14	- 5,500	2,800	8,400	11,200	231,000
15	- 4,600	2,300	8,400	10,700	241,700
16	- 3,800	1,900	8,400	10,300	252,000
17	- 2,800	1,400	8,400	9,800	261,800
18	- 1,800	900	8,400	9,300	271,100
19	- 700	400	8,400	8,800	279,900
20	500	- 200	8,400	8,200	288,100
Totals	-239,000	120,100	168,000	288,100	
	Total Gain on Sale			267,000	
	Tax on Sale at:				
	25%			133,500	
	30%			160,200	
	35%			186,900	

H. COMBINATION OF C-2, D, AND E-2

RETURN TO INVESTOR - SYNDICATION OF $140,000

	Tax Bracket					
	50 percent		60 Percent		70 Percent	
Discounted Rate of Return	4.2%		6.1%		8.2%	
Cash Payback on Initial Investment a/	Yrs.	Mos.	Yrs.	Mos.	Yrs.	Mos.
Payment 1	3	6	3	3	3	1
Payment 2	5	2	4	8	4	2
Payment 3	6	10	6	1	5	5

PRESENT VALUE OF TAX SHELTER SAVINGS b/ TO INVESTOR (95 PERCENT SHARE) AND BUILDER/DEVELOPER (5 PERCENT SHARE) IN DOLLARS

	Tax Bracket		
	50 percent	60 percent	70 percent
20% Discount Rate			
Before Sale	0	0	0
On Sale	0	0	0
Total	0	0	0
7.5% Discount Rate			
Before Sale	0	0	0
On Sale	0	0	0
Total	0	0	0

a/ The investor is assumed to make his investment in three equal annual installment payments, beginning with the start of the construction period. The time shown is the length of time needed for each payment to be returned in full from cash distributions from the project and from tax savings.

b/ Includes tax savings from (1) using accelerated rather than straight-line depreciation, (2) deducting construction period interest and taxes immediately rather than writing them off over the life of the building, and (3) paying tax on the gain on sale in year 20 at capital gain rates (no recapture of depreciation) rather than ordinary income rates (full recapture). The builder/developer is assumed to be in the same tax bracket as the investors.

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