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Report To The Honorable Donald W. Riegle, Jr. United States Senate

Impact Of Federal Tax Provisions On Resyndication of Federally Assisted Rental Housing

The sale of used rental properties to new groups of investors (resyndication) has become an increasingly popular way of obtaining investment in low-income rental housing administered by the Department of Housing and Urban Development (HUD). This report provides information on the tax incentives for resyndicated HUD rental housing under (1) tax laws in effect from 1969 to 1980, (2) the Economic Recovery Tax Act of 1981, and (3) the Deficit Reduction Act of 1984, as amended.

GAO developed a financial model to analyze the financial incentives under these laws. GAO also interviewed officials of HUD, housing investment firms, and housing interest groups on the impact of the 1984 tax legislation on federally assisted resyndication investment.

GAO found that these resyndications became more attractive to investors in and sellers of federally assisted rental property following the Economic Recovery Tax Act of 1981, which provided greater opportunities for tax incentives related to the resyndications. GAO also found that tax provisions of the 1984 act limited some of the financial incentives available to resyndication investors and sellers.

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UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

RESOURCES, COMMUNITY, AND ECONOMIC DEVELOPMENT DIVISION

B-217926

The Honorable Donald W. Riegle, Jr.
Ranking Minority Member
Subcommittee on Housing and
Urban Affairs
Committee on Banking, Housing
and Urban Affairs
United States Senate

Dear Senator Riegle:

This report responds to your November 27, 1984, request and our subsequent discussions with your office that we analyze the impact of federal tax provisions on the resyndication of federally assisted, low-income rental housing property having a mortgage held or insured by the Department of Housing and Urban Development (HUD). Resyndication refers to the sale of interests in the property by the owners to new investors. As the insurer or holder of multifamily mortgages, HUD approves the resyndication of federally assisted properties to new groups of investors to protect its interest in the property. As a precondition of its approval, HUD generally requires the new investors in the property to make some new capital investments to restore the property's physical or financial viability. Federal tax laws also encourage resyndications by making preferential tax incentives available to investors in low-income existing rental property.

We identified financial incentives available to investors in federally assisted resyndicated rental housing under tax laws in effect from 1969 to 1980, the Economic Recovery Tax Act of 1981 (ERTA), and the Deficit Reduction Act of 1984 as amended by Public Law 98-612 (1984 act). These laws primarily relate to investors' ability to obtain tax deductions on the property through preferential depreciation allowances and their use of certain accounting methods relating to their financing arrangements. We analyzed the financial incentives by using a financial model that we developed. Our model can be used to compare the degree of variations in the estimated financial returns of investment in resyndication property under the tax laws from 1969 through 1984; its results, however, should not be considered to be representative of actual resyndications. We also obtained the views of representatives of HUD, investment firms, and low-income housing organizations on the 1984 Deficit Reduction Act's potential effects on resyndication investment. In addition, we obtained information on HUD's efforts to determine the most effective and efficient alternatives for preserving the existing federally assisted rental housing stock. Appendix I provides additional information on our scope and methodology.

In summary, ERTA, primarily by providing more advantageous depreciation incentives, increased the financial benefits available to investors in resyndicated, federally assisted low-income rental property. The incentives encouraged an increase in private investment in resyndication. For example, HUD estimates that ERTA's tax incentives led to about 3,000 to 4,000 resyndications--a tenfold increase over the number of resyndications before ERTA went into effect.

The Congress became concerned, however, that investors were using below-market interest rate financing arrangements with the sellers to artificially increase the depreciable basis of investment property. The 1984 act reduced opportunities for investors to use these arrangements. It also required resyndication investors and sellers to uniformly account for the interest on these borrowing arrangements, limiting certain tax advantages from the arrangements. Although it is too early to fully assess the impact of the 1984 act on resyndication investment, our analysis of financial incentives to the investors indicates that the 1984 act could reduce the financial returns available to these investors. Further, our discussions with representatives of HUD, private investment firms, and housing interest groups indicate that there might be significantly fewer investments in federally assisted resyndications in the future.

Nevertheless, we found that investment firms are exploring alternative ways to make investments in resyndicated property more attractive. In addition, HUD's Office of Policy Development and Research is conducting a study, which it plans to complete by October 1985, to determine the effectiveness and efficiency of various alternatives, including tax incentives, subsidies, and other means of preserving federally assisted rental property.

The following sections discuss the results of our review. Details on our financial model, including the assumptions we used to develop it and the resulting impact information, are shown in appendix II.

ANALYSIS OF FINANCIAL INCENTIVES

Our analysis shows that the primary tax incentives that have been available to investors in federally assisted rental resyndications are related to (1) depreciation of the property and (2) use of accounting methods which allowed investors to claim tax deductions for expenses concerning their financing arrangements, before they paid the expenses. The extent of these incentives has differed substantially since 1969.

Depreciation

Owners of rental housing are generally permitted to deduct from their income, depreciation allowances as an expense on their annual income tax returns, enabling them to recover a portion of their investment in real estate property. There are several different methods available for depreciating rental property. Under the straight-line method of depreciation, property is depreciated in equal increments over its useful life. However, through another method known as accelerated depreciation, investors are entitled to depreciate their properties more rapidly in the earlier years than under the straight-line method. This enables them to recover larger increments of their investment over a shorter period.

As rental property becomes older, the depreciable basis of the rental property decreases, commensurate with the depreciation deductions that have been claimed on the property. However, if an owner sells the property to new investors, these investors can start a new depreciation cycle on the property generally based on the purchase price.

ERTA increased tax incentives relating to accelerated depreciation on existing federally assisted rental property. These incentives, according to HUD and housing industry officials, were a key factor in spurring investment in the property. For example, compared to the amount that could be depreciated under the law prior to ERTA, the total amount that could be claimed for accelerated depreciation during the first 5 years of an investment in an existing federally assisted rental property could, under ERTA, be increased nearly 90 percent.[1]

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[1]This estimate assumes a low-income rental property that (1) is placed into service at the beginning of a tax year, (2) is depreciated over a 20-year period in accordance with pre-ERTA rules, and over a 15-year period under ERTA, and (3) has no salvage value.

Also, under ERTA, existing real estate investment property could be depreciated over a 15-year period, regardless of its actual useful life. Prior to ERTA, accelerated depreciation was available for used rental property only if its useful life was at least 20 years or more. This shorter depreciation period, in addition to the accelerated depreciation opportunity previously discussed, made existing federally assisted rental projects more attractive than they had been to investors because the investors could more quickly recoup the amount of their investment.

In a study of the changes brought about by ERTA, HUD concluded that ERTA would encourage a succession of property owners who would generate a new investment and depreciation cycle every 15 years.[2] The HUD Deputy Director of the Office of Multifamily Housing Management told us that HUD did not maintain nationwide statistics on the number of federally assisted rental housing properties that were resyndicated before or after ERTA. He estimated, however, that about 3,000 to 4,000 such properties changed ownership for tax purposes after ERTA. He said that HUD believes this is approximately a tenfold increase over pre-ERTA levels.

In addition, investors of resyndicated property were able to increase the depreciable basis of their investment by entering into financing arrangements with the previous owners, or sellers. Under these arrangements, the sellers agreed to finance the purchase at a below-market rate of interest.[3] Prior to the 1984 act, the Internal Revenue Code required that parties to a seller-financing arrangement provide for at least 9 percent simple interest. If the arrangement did not meet this minimum rate, the Internal Revenue Service (IRS) would require that the parties recognize, for tax purposes, interest at a higher rate. However, as noted by the Joint Committee on Taxation in June 1983, interest above the 9-percent rate, but below

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[2] Federal Tax Incentives and Rental Housing, U.S. Department of Housing and Urban Development, April 1983 (HUD-PDR-731).

[3] On federally assisted resyndicated properties, the purchase price generally consists of (1) the outstanding mortgage balance on the property assumed by the investor and (2) any additional funds, including secondary financing, which may be negotiated between the investor and seller.

the current market rate, could be disguised as part of the purchase price.[4] Similarly, in February 1984, the Joint Committee stated that when a seller-financed loan agreement states an interest rate above 9 percent but below the current market rate, the purchase price of the property is overstated for taxation purposes. This is because a portion of the loan proceeds, which normally would have been characterized as payment of interest on the property, through below-market interest rate financing is instead recharacterized as payment of sales price or loan principal.[5]

Investors benefited from the below-market interest rate financing because the larger purchase price resulted in an increased depreciable basis and correspondingly higher depreciation deductions. On the other hand, the cost of the loan to the investors (principal plus interest) was no more than it would have been if the sellers had charged a market interest rate on a lower principal amount. Thus, the total pre-tax cost of the loan would remain the same, but the respective amounts of principal and interest would change.

Likewise, the sellers of the property were able to obtain tax benefits from these financial arrangements. On the one hand, they received less interest income because of the below-market interest rate. On the other hand, their taxable gain, based on the principal amount specified in the below-market seller financing, would be taxed at a preferential capital gains tax rate.[6]

The 1984 act addressed the problem of seller-financed, below-market interest rate loans being used as a basis to artificially increase the seller's capital gain and the investor's depreciation deductions. Under the act, seller-financed real estate sales must more accurately reflect the current market cost of borrowing, thus preventing the buyers and sellers from

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[4]"Background on Tax Shelters," Joint Committee on Taxation, June 23, 1983, Publication no. JCS-29-83.

[5]"Staff Pamphlet on Tax Shelters and Other Tax-Motivated Transactions," Joint Committee on Taxation, February 17, 1984.

[6]The capital gains tax rate discussed above applies to gain from investments that investors hold for more than a 6-month period, the so-called "long-term capital gain." Sixty percent of an investor's net long-term capital gain is excluded from ordinary income taxation.

using below-market interest rates to reduce payment of taxes. If a seller-financed loan does not reflect a current market interest rate as determined periodically by the IRS, interest is imputed into the transaction by applying a statutorily prescribed interest rate. The effect of imputing interest income is not to increase the amount paid by the investor, but to recharacterize a portion of the payments (designated as principal by the parties) as interest for federal income tax purposes. Hence, the investor's basis in the property, for determining depreciation deductions, would be reduced.

Accounting methods

Taxpayers, in computing their annual taxable income, may generally choose either the cash method of accounting or the accrual method. A taxpayer's choice of accounting method affects the timing of both income and tax deductions.

Under the cash method of accounting, income items such as cash receipts are normally taxed in the year in which they are actually received. Likewise, expenses are generally deducted for the year in which they are actually paid. However, under the accrual method of accounting, income is generally taxed when earned, rather than when received, and expenses are generally deducted when incurred, rather than when paid. Therefore, under the accrual method, a taxpayer may be able to take a tax deduction for an expense incurred during a given year, even though the expense actually will not be paid until a later year.

Prior to the 1984 act, many investors in resyndications found it advantageous to structure their below-market interest rate financing arrangements so that all or a portion of the principal and interest payment was deferred until a future year. The investors were able to use an accrual method of accounting to take tax deductions for the interest expenses that they would not actually pay until a future year. At the same time, the seller of the property could use a cash method of accounting to defer recognition of interest income until payment was actually received from the investor.

The 1984 act was enacted, in part, to stem federal tax revenue losses on below-market seller financing resulting from a mismatch of interest income and expenses by accrual-basis purchasers and cash-basis sellers. In transactions that do not reflect current market borrowing costs, the 1984 act requires that investors and lenders use an economic accrual method of accounting for interest on deferred payment borrowing arrangements. Generally, under this method, the seller realizes interest income each year in an amount equal to the investor's annual interest expense deduction even though the interest may not actually be paid until a future year.

The economic accrual method also affects the timing of investors' interest deductions on their tax returns. Under this method, annual interest deductions are limited to the amount that "economically" accrues each year. The method takes into account the compounding of interest, that is, the fact that more interest economically arises in the later periods because the amount of the debt is increased by the accrued but unpaid interest from earlier periods. Prior to the 1984 act, investors arranged their accrued interest deductions so that much of them were taken over the early years of the investment cycle. However, when the economic accrual method must be used, this would no longer be possible.

Applying the economic accrual method generally results in smaller interest deductions for the investor in the early years of a loan and larger ones through the later years. This is a significant change because investors in resyndications generally consider early timing of tax deductions in the investment cycle to be an important factor in increasing their potential investment returns.

RESULTS OF FINANCIAL MODEL ILLUSTRATING POTENTIAL INVESTMENT INCENTIVES FROM RESYNDICATION

We developed a financial model to analyze the potential financial incentives available to the original owner and a new investor in a resyndicated, federally assisted rental housing project.[7] Our model is based on assumptions about a hypothetical federally assisted housing project built in the early 1970's under HUD's Section 236 federal mortgage insurance and interest rate reduction program.[8] Under this program, HUD subsidizes mortgage interest rates to enable the owner of the project to charge lower monthly rents, thus making the housing affordable to lower income families.

The model assumes that the original investor operates the project for 10 years before selling it to a new investor. The new investor is assumed to hold the project for 15 more years before selling it for cash. The model is broken down into

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[7]Although our model assumes a resyndication between an original owner and a new investor, resyndications also may be negotiated between subsequent owners of the projects and new investors.

[8]Section 236 of the National Housing Act (12 U.S.C. 1715 z-1).

several cases which show variations in (1) the new investor's financing of the project and (2) different tax treatments of the transaction under the tax laws in effect from 1969 through 1984. For each case we computed the overall cash which both the original owner and the new investor would realize from operating the project and from selling it after the designated holding period. We also computed an annual rate of return on investment for each case. This computation was based on the internal rate of return method, a commonly used real estate investment analysis tool.

The internal rate of return method was selected for our analysis because it takes into account the data relating to the financing, depreciation, and income tax plans of the particular investor who acquires the property. The internal rate of return is referred to as a time-adjusted rate because it accounts for the timing of all individual future cash amounts paid and/or realized by the investor. The sooner the investor makes a payment or realizes income in the investment cycle, the greater the weight the payment/income is given in the calculation of the internal rate of return.

In summary, our analysis shows the following:

--ERTA increased the financial returns available to new investors in resyndicated properties by increasing the depreciation allowances available to them.

--Even greater financial returns were available to new investors when they used seller-financed, below-market interest rate borrowing arrangements and claimed interest expense deductions, prior to paying the expense, by using the accrual method of accounting.

--Tax provisions of the 1984 act reduced the financial incentives available to resyndication sellers and new investors who use below-market interest rate borrowing arrangements with the seller to finance the resyndication cost.

Appendix II presents a summary of the results of our analysis (see pp. 4 and 5) and contains an explanation of the assumptions used in developing our financial model.

POTENTIAL IMPACT OF THE DEFICIT REDUCTION ACT OF 1984 ON RESYNDICATION INVESTMENT

Although it is too early to fully assess the 1984 act's impact on resyndication investment, it might reduce the profitability of such investment by altering the nature of below-market interest rate borrowing arrangements used to finance the resyndications. As previously discussed, the tax advantages of such financing arrangements are considered to be a key element in making federally assisted resyndications more attractive investments.

We were told by the Deputy Director of HUD's Office of Multifamily Housing Management that HUD has not performed any studies of the 1984 act's impact on resyndication investment. Moreover, he said that his office has not yet examined any resyndication proposals submitted under the 1984 act and, consequently, could not comment on the potential impact of the new tax rules on resyndication investment.

However, the Deputy Director told us that HUD anticipates a considerable slowdown in the number of federally assisted resyndication applications during 1985. He said that the slowdown would result partly because of (1) the changes made in the 1984 act that affect seller financing and (2) uncertainty about the outcome of anticipated congressional deliberations on tax reform.

In May 1984, the Secretary of HUD stated that investors' ability to claim interest expenses on their income tax returns, while deferring the actual payment of the expenses, is a crucial factor in the viability of federally assisted resyndication investments. According to the Secretary, these deferred payments, which were used as the basis of tax deductions under the accrual method of accounting, accounted for 20 percent to 35 percent of the dollar value of tax incentives available to investors through resyndication investments. Accordingly, he said that the then-proposed 1984 act may make resyndication in federally assisted rental housing unattractive to investors.

Our discussions with representatives of investment firms that resyndicate federally assisted housing and with low-income housing interest groups indicated that these organizations are concerned about the impact that the 1984 act might have on future resyndication investments in federally assisted rental housing. The views of these officials were consistent with the literature on resyndication that we reviewed and symposia on resyndication that we attended. For example, the chairman of a large investment firm that resyndicated federally assisted housing told us that the reductions in deferred interest deductions stemming from the 1984 act will probably result in significantly fewer investments in resyndicated, federally assisted rental properties.

The chairman also said that the reductions in tax benefits might result in a greater number of defaults and foreclosures because, with more limited tax advantages for resyndication, many of the rental properties will not continue to be financially viable. Moreover, he pointed out that the economic accrual method of accounting may discourage many resyndication sellers from making deferred-payment loans to new investors because the sellers would be taxed as though they had received interest payments on the loans, even though they actually would not receive payment until a future year. Similar comments were made to us by a member of a low-income housing interest group who was concerned about the effect of the economic accrual provisions on resyndication investment.

Even though tax incentives have been limited by the 1984 act, our review shows that resyndication firms are examining possibilities for offering federally assisted resyndication projects that will still be attractive to investors. At the present time, however, it is not clear what type of resyndication possibilities will be implemented and what their impact will be on investment. Some of the possibilities that have been publicly discussed by resyndication investment firms include the following:

--Resyndicating rental housing that is to be rehabilitated and, under the Internal Revenue Code, is eligible for special tax deductions.[9] This would allow investors a more rapid recovery mechanism for the costs of rehabilitating the property than would be otherwise available.

--Extending the customary 3- to 7-year period over which investors pay their cash investment on resyndications to as many as 12 years. This would enable investors to obtain the benefit of tax deductions for depreciation and interest expense in the investment's early years while spreading their cash outlay over a longer period.

--Resyndicating federally assisted projects that are owned and financed by nonprofit entities. Under this arrangement, the investor may be able to claim a tax deduction for accrued interest on a loan secured to buy the property, but the nonprofit seller would not be taxed on the interest income.

INFORMATION IS BEING DEVELOPED ON ALTERNATIVES FOR PRESERVING THE EXISTING FEDERALLY ASSISTED RENTAL HOUSING STOCK

HUD's Office of Policy Development and Research is conducting a study of the condition and needs of existing federally assisted rental property and the effectiveness and efficiency of

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[9]Section 167(k) of the Internal Revenue Code permits investors to take tax writeoffs over a 5-year period for certain costs associated with rehabilitating low-income housing.

various alternatives, including tax incentives, subsidies, and other means of preserving the property. The study, which is scheduled to be completed in October 1985, will address resyndication as one of the preservation alternatives at HUD's disposal.

Although HUD has generally been supportive of using resyndication as a tool for infusing new capital into needy projects, it has been concerned about the use of tax incentives resulting from seller-financing arrangements to achieve the resyndication of federally assisted projects. In May 1984, the Secretary of HUD stated that these tax incentives have been crucial to encouraging resyndications and that the then-proposed provisions of the 1984 act would reduce funds that could be raised from investors to meet the needs of federally assisted rental projects--particularly projects which are most in need of cash infusions. The Secretary, however, stated that he could not say whether the benefits of resyndication outweigh the tax revenue losses that result from resyndication. Further, HUD has estimated that only about 20 percent of cash raised through resyndications is used to correct property deficiencies.

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The views of directly responsible officials were sought during the course of our work and are incorporated where appropriate. We did not request HUD to review and comment officially on a draft of this report.

As arranged with your office, unless you publicly announce its contents earlier, we plan no further distribution of this report until 7 days from the date of the report. At that time we will send copies to interested parties and make copies available to others upon request.

Sincerely yours,

Ralph Carlone for

J. Dexter Peach
Director

Contents

ABBREVIATIONS

ERTA Economic Recovery Tax Act of 1981

HUD Department of Housing and Urban Development

IRS Internal Revenue Service

ILLUSTRATION

OBJECTIVES, SCOPE, AND METHODOLOGY OF OUR REVIEW

In response to your November 27, 1984, request and our subsequent discussions with your office, our review analyzed the impact of federal tax provisions on the resyndication of federally assisted, low-income rental property having a mortgage held or insured by the Department of Housing and Urban Development (HUD). We identified the financial incentives available to investors under tax laws in effect from 1969 to 1980, the Economic Recovery Tax Act of 1981 (ERTA), and the Deficit Reduction Act of 1984 as amended by Public Law 98-612 (the 1984 act). We reviewed the federal tax laws in effect since 1969 to identify differences in their treatment of financial incentives for investment in resyndicated, federally assisted rental housing. We examined HUD resyndication policies and procedures and Internal Revenue Service (IRS) publications on the tax treatment of resyndication. We also reviewed HUD studies on tax subsidies for rental housing and housing industry analyses of tax law changes.

We also obtained information on the 1984 Deficit Reduction Act's potential financial effect on resyndication investment by interviewing officials of HUD's Offices of (1) Housing, (2) Policy Development and Research, and (3) General Counsel. These officials provided us with documents on HUD's policies, procedures, and related research efforts pertaining to resyndication and tax law changes. In addition, we interviewed representatives of private firms that invest in resyndications and low-income housing interest groups to obtain their perspectives on federal resyndication, regulatory, and tax policies.

Further, we developed a financial model that can be used in analyzing the potential financial benefits realized by investors in resyndicated rental properties. The model takes into account variations in depreciation and financing for the properties. It incorporates investors' borrowing arrangements that are used to finance resyndicated, federally assisted rental housing according to (1) our discussions with HUD multifamily housing officials, (2) representatives of resyndication firms, (3) HUD project files, (4) case studies presented in housing industry symposia on resyndication, and (5) trade publications.

Based on our discussions with your office, we generally structured our model to show the tax benefits available to resyndication investors and the effect of ERTA and the 1984 act on resyndication investments. In this regard, our calculations to determine the estimated profitability of resyndications were based on the 1984 tax law as amended by Public Law 98-612. The 1984 act was enacted in July 1984. Its provisions relating to seller financing transactions were generally scheduled to become effective on January 1, 1985. However, an amendment to the act (Public Law

98-612, October 31, 1984) provided for a 6-month moratorium on the act's effective date to July 1, 1985, and for certain interim rules. Thus, we made our financial analysis to show a range of returns to the investors based on the interest rates that would be applicable under the 1984 law scheduled to become effective in July 1985, and under the temporary amendments effective from January to June 1985.

Subsequent to the completion of our resyndication financial analysis, the Congress considered a legislative proposal (H.R. 2475) that may alter the tax treatment of investors' real estate financing arrangements, such as those used to finance federally assisted resyndications. We did not take the time to perform an analysis of the proposal using our financial model. However, on the basis of interest rates contained in the proposal, our investor profitability calculations would be slightly higher than they would be under the rates in effect for the 1984 act amendments effective from January to June 1985. As of June 24, 1985, H.R. 2475 had been passed by the House and was being considered by the Senate. A Senate vote on the bill had not yet been scheduled.

Because resyndication structures vary widely and economic conditions differ by location and change over time, the results of our model should not be considered to be representative of actual resyndications. Therefore, we do not estimate the increase in rental housing investments brought about by resyndications. Nevertheless, our analysis uses a consistent analytical approach for comparing the results of the different investment alternatives, taking into account the value over time of the money invested. Accordingly, the model can be used to compare the degree of variations in the estimated financial returns of investment in resyndication property under the tax laws since 1969.

The views of directly responsible officials were sought during the course of our work and are incorporated where appropriate. We did not request HUD to review and comment officially on a draft of this report.

RESULTS OF OUR RESYNDICATION INVESTMENT MODEL

ANALYSIS OF INVESTORS' FINANCIAL RETURNS

Analysis of the Financial Returns Realized by the First and Second Investors from Resyndicating a Hypothetical Section 236 Project Unit[a]

	Case A[b]	Case B		Case C		Case D	
	No resyndication	Resyndication with cash investment paid over 3 years		Resyndication with secondary financing note having fully deferred payments[c]		Resyndication with secondary financing note having partially deferred payments[c]	
	Original owner	Original owner	New investor	Original owner	New investor	Original owner	New investor
Return on investment-tax law prior to 1981							
Cash invested in project unit[d]	$ 2,714	$ 2,714	$11,813	$ 2,714	$19,508	$ 2,714	$19,508
Cash realized on investment, after taxes[e]	$24,473	$ 9,456	$28,600	$13,668	$32,360	$13,667	$32,360
After tax annual rate of return (percent)[f]	12.0	15.6	7.7	12.7	12.3	13.0	11.5
Return on investment-Economic Recovery Tax Act of 1981[g]							
Cash invested in project unit[d]	$ 2,714	$ 2,714	$11,813	$ 2,714	$19,508	$ 2,714	$19,508
Cash realized on investment, after taxes[e]	$24,473	$ 9,456	$30,069	$13,668	$33,827	$13,667	$33,827
After tax annual rate of return (percent)[f]	12.0	15.6	9.4	12.7	18.4	13.0	16.8

(Continued)

	Case A[b]	Case B		Case C		Case D	
	No resyndication	Resyndication with cash investment paid over 3 years		Resyndication with secondary financing note having fully deferred payments[c]		Resyndication with secondary financing note having partially deferred payments[c]	
	Original owner	Original owner	New investor	Original owner	New investor	Original owner	New investor
Return on investment-Deficit Reduction Act of 1984[h]							
Interim amendments, effective until June 30, 1985[i]:							
Cash invested in project unit[d]	$ 2,714	$ 2,714	$11,813	$ 2,714	$19,508	$ 2,714	$19,508
Cash realized on investment, after taxes[e]	$24,473	$ 9,456	$30,069	$12,888	$33,870	$12,989	$33,865
After tax annual rate of return (percent)[f]	12.0	15.6	9.4	11.1	16.0	11.6	15.1
Law scheduled to become effective on July 1, 1985:							
Cash invested in project unit[d]	$ 2,714	$ 2,714	$11,813	$ 2,714	$19,508	$ 2,714	$19,508
Cash realized on investment, after taxes[e]	$24,473	$ 9,456	$30,069	$12,480	$33,894	$12,581	$33,887
After tax annual rate of return (percent)[f]	12.0	15.6	9.4	11.1	15.0	11.5	14.3

[a]The resyndication cases assume that, the original owner sells the property to a buyer, or new investor, at the end of 10 years.
[b]No resyndication is assumed under this case; the original owner holds the property for 25 years and then sells it for a cash payment.
[c]Refers to the new investor's borrowing arrangment, in addition to the sum of the cash downpayment and installments required for the new investor's initial cash investment in the project unit. (See pp. 8 and 10 of this enclosure.)
[d]This includes all cash payments made by the investors over the time which the investment is held.
[e]This includes investors' financial returns from project operations, including project income from rents and all tax savings the investors realize from depreciation and interest expense deductions. It also includes income realized for the property's sale, both from cash payments and/or interest income.
[f]Annual rate of return is computed using the internal rate of return method.
[g]The original owner's tax liability would be the same for each pre-1981 case because the property was placed in service during the early 1970's and it is subject to tax provisions under the Tax Reform Acts of 1969 and 1976.
[h]Assumes that the original owner and new investor are subject to the 1984 Act's deferred-payment accounting and minimum federal interest rates on their secondary borrowing arrangments.
[i]Public Law 98-612, October 31, 1984.

ASSUMPTIONS USED TO DEVELOP OUR RESYNDICATION INVESTMENT MODEL

General information

Type of project: Section 236 garden apartments
Age and condition: 10 years old, well maintained, and current on all financial obligations
Type of unit: 2-bedroom, approximately 900 square feet

Cost and financing assumptions on a per-unit cost basis

Development costs (original owner):	
Land cost	$ 560
Construction period costs	1,440
Depreciable assets	12,000
Total development costs	$ 14,000
Financing:	
Mortgage (90 percent of development costs)[1]	$ 12,600
Equity investment (10 percent of costs)	1,400
Total development costs	$ 14,000
Original project cash investment: 20 percent of mortgage amount	$ 2,500[2]

[1]Assumes a mortgage insured by HUD with a 7-percent interest rate over a 40-year period, with federal subsidy payments that reduce the interest rate to 1 percent.

[2]Includes cost of raising capital through the sale of ownership interests in the project unit (called syndication costs). Investment amount is rounded to nearest $100 increment.

Resyndication costs (new investor):

We developed several case examples for analyzing the resyndication of the project unit to a new investor after the seller has operated the unit for 10 years. The new investor holds the project for an additional 15 years and then sells it. These cases include examples of different financing methods used by the new investor, and the use of different accounting methods (the cash method, the accrual method, or the economic accrual method as provided for in the Deficit Reduction Act of 1984). The following general assumptions apply to each case.

Sales price, end of year 10[3]	$ 22,000
Sales price, end of year 25[3]	$ 43,000
Land value, end of year 10	$ 1,200

Case A

No resyndication takes place under this case; the seller (original owner) holds the property for 25 years and sells it for a cash payment at the end of 25 years. The seller recognizes expense and income from operations and sale of the unit under the cash method of accounting.

Case B

The new investor buys the property from the seller and assumes the existing HUD-insured mortgage balance of $11,728. The investor pays the seller the remaining balance of $10,272 ($22,000 - $11,728), with a downpayment due at closing of $1,359 and three equal installments, each due at the anniversary date of the closing of $2,339 principal and $632 interest. The new investor's payments also include a syndication fee of $1,541 payable at the time of closing. This is a fee commonly payable by the new investor to a third party, called a syndicator, who packages the transfer of ownership arrangements for sale between the seller and new investor. The investor's depreciable basis in the property is $18,904; it is computed by (1) adding the existing mortgage balance assumed ($11,728), the downpayment ($1,359), and the principal payments on the installments ($7,017) and (2) subtracting the land cost ($1,200). The seller and new investor use the cash

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[3]Sales prices are based on a 6-percent inflation rate and reflect adjustments for economic depreciation on the properties, based on an estimated 70-year useful economic life.

method of accounting. Tax treatment regarding depreciation and deferred payment financing is compared under (1) the tax laws in effect from 1969 through 1980, (2) the Economic Recovery Tax Act of 1981, and (3) the 1984 act as amended.

Under the 1984 act, the new investor's financing arrangement for the pay-in obligation of $10,272 meets the requirements for minimum interest rates on seller-financed transactions. Accordingly, the 1984 act would not change the structure of the borrowing arrangement between the seller and the investor, or the financial returns to either party. An interest rate of 11.17 percent compounded semiannually was used to test the transaction under the law that is scheduled to become effective on July 1, 1985[4] and a rate of 9 percent compounded semiannually under the law in effect until June 30, 1985 (for seller financing, generally up to $2 million of principal). Our analysis also assumes that a provision of the 1984 act exempting small transactions of under $250,000 does not apply.

Case C

In purchasing the property, the new investor assumes the existing HUD mortgage and borrows additional funds from the original owner. Part of the borrowing arrangement is structured as a deferred-payment secondary note of $5,700, with principal and interest due in 15 years. The investor pays the remaining balance of $4,572 ($22,000 - ($11,728 + $5,700)) with a downpayment due at closing of $1,359, and three equal installments of $843 principal and $228 interest that are due on the anniversary date of the closing. The syndication fee is treated the same as in Case B. The investor's depreciable basis is $20,116, computed by (1) adding the existing mortgage balance assumed ($11,728), the downpayment ($1,359), the principal payments on the installments ($2,529) and the deferred note principal ($5,700) and (2) subtracting the land cost ($1,200).

The secondary note of $5,700 accrues interest at a rate of 9 percent simple interest during its entire 15-year term. This rate satisfies the imputed interest rules on deferred payment transactions in effect prior to the 1984 act.

The original owner (seller) uses the cash method of accounting, while the new investor uses the accrual method of accounting. This combination enables both property owners to maximize financial returns from the financing arrangement. This occurs

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[4]This rate reflects the most current determination of the applicable semiannual federal interest rate (Internal Revenue Ruling 85-51).

because the new investor can deduct interest expenses on the secondary financing long before the debt is actually paid, while the seller can defer recognition of the corresponding interest income until actually receiving repayment of the debt. Tax treatment regarding depreciation and deferred payment financing is compared under (1) the tax laws in effect from 1969 through 1980, (2) ERTA, and (3) the 1984 act as amended.

We tested the new investor's pay-in borrowing arrangement of $4,572 and the $5,700 note to determine whether it would meet the law's requirements for minimum interest rates under the 1984 act as amended. Using the same methodology as in Case B, the investor's obligation of $4,572 was found to satisfy the requirements for minimum interest under current law and the rules that are scheduled to become effective on July 1, 1985. However, the $5,700 note did not satisfy the minimum interest rates. Until July 1, 1985, those rules require a minimum rate of 9 percent interest compounded semiannually. Since that rate was not satisfied, the current law requires that interest be imputed at the rate of 10 percent compounded semiannually. Similarly, the $5,700 note would fail the minimum interest rules that are scheduled to become effective after June 30, 1985. We assumed a test interest rate of 12.90 percent compounded semiannually and an imputed rate of 14.08 percent compounded semiannually.[5]

The result of imputing interest on the transaction is a decrease in the total principal payments made by the new investor and a corresponding increase in the investor's interest expense deductions. These changes do not, however, change the total dollar amount of the financing arrangement. The decreases in principal payments also result in reductions to the property's basis for determining depreciation deductions. We computed a reduction in the property's depreciable basis from $20,116 to $16,379 (after allocating the reduction in principal payments between the structure and land cost), under the rules scheduled to become effective on July 1, 1985. Under the rules effective through June 30, 1985, we computed a reduction to $17,661.

Because the investor's secondary note of $5,700 did not meet the minimum interest rate test, the new investor must calculate interest deductions on an economic accrual basis. Generally, under this method, the investor can deduct interest that accrues economically on the outstanding loan balance. However, interest which is accrued but not paid by the borrower is added to the unpaid principal. This results in smaller interest deductions in the early years and larger ones in the later years. Also, under the economic accrual method, the lender (seller) is required to

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[5]Rates applicable under Internal Revenue Ruling 85-51.

recognize interest income each year equal to the amount of the borrower's (investor's) interest deductions. The net effect is to alter (1) the amount of interest, (2) the timing when both the seller and investor must account for the interest, and (3) the amount of the investor's depreciation deductions.

Case D

This case involves the same facts as Case C, except that the terms of repayment on the new investor's secondary note of $5,700 change. Although the repayment of principal and interest is still deferred for 15 years, the new owner pays $84 interest expense each year--an amount equal to the owner's anticipated cash distributions from operating the project (see p. 11). The principal and remaining interest is accrued and paid at the end of 15 years.

Similar to Case C, the transaction is subject to the deferred payment borrowing provisions of the 1984 act, as amended. Applying the same minimum federal borrowing rates as Case C, interest is imputed on the transaction, even though periodic interest payments are actually made. Accordingly, the depreciable basis of the property is reduced from $20,116 to $16,698 under the law scheduled to become effective on July 1, 1985, and to $17,981 under the rules applicable through June 30, 1985. The increased interest expense is accounted for using the economic accrual method.

Operating assumptions
(seller and new investor)

Annual project income

The initial monthly rent is estimated to be $125. The rent estimate is based on principal and interest being subsidized to a 1-percent interest rate. Annual income is computed by multiplying $125 X 12 months = $1,500. The rents are further reduced by a 5-percent vacancy allowance. Subsequent years' rents are assumed to increase at a 6-percent rate per year.

Operating expenses

The first-year operating expenses are estimated to be 80 percent of annual rents to reflect higher costs associated with achieving full occupancy. Subsequent years' operating expenses are assumed to be 65 percent of annual rents. These figures do not take into account the rental subsidy payments for interest reduction.

Debt service (first mortgage)

The debt service is $384 annually for principal and interest, based on a 1-percent interest rate.

Secondary financing

In Case C, we assumed that the secondary promissory note of $5,700 is not repaid out of the project's funds from operations, but from the cash proceeds upon sale of the unit in year 25. In Case D, we assumed that part of the interest ($84) on the secondary promissory note of $5,700 is paid annually by the new investor. The principal and remaining accrued interest are paid out of proceeds from the sale of the unit in year 25.

Depreciation allowance

Original owner: The 200-percent declining balance method is used. This method allows depreciation charges to be deducted at a rate twice as much as the straight-line rate. This method accelerates depreciation deductions in the early years of the asset's useful life. The writeoff period for the investment is assumed to be 30 years for total depreciable assets. The property is subject to low-income housing tax treatment under the Tax Reform Act of 1969, the last major tax act before ERTA that changed depreciation allowances for low-income rental housing. Total depreciable assets equal $12,000.

New investor: Under tax law prior to ERTA (the Tax Reform Act of 1969), the new investor uses a 125-percent declining balance method with an assumed writeoff period of 20 years. No salvage value is assumed on the property in our analysis. Post-ERTA depreciation is based on a statutory depreciation schedule for low-income housing that provides for a 200-percent declining balance depreciation rate over a 15-year recovery period. The new and old schedules switch to the straight-line depreciation method in the later years to maximize the investor's recovery allowance.

Replacement reserve

The replacement reserve amount is computed based on 0.6 percent times the cost of the total structure, approximately 80 percent of depreciable assets. The initial reserve (original owner) is estimated to be $58 per year and the updated reserve (new investor) is estimated at $100 per year. No revisions are made to the reserve for the new investor for Cases B through D.

Allowable cash distributions

The Section 236 Program limits cash distributions from project income to 6 percent of the initial equity investment ($1,400 X .06 = $84 per year). Any surplus cash remaining after deducting distributions is held in a special housing fund controlled by HUD.

Other assumptions

Syndication fee

The syndication fee, in accordance with IRS regulations, is not depreciated or expensed. Rather, it is added to the property's basis (i.e. capitalized) for purposes of determining the loss and gain on the eventual sale of the property.

Recapture of excess depreciation

Excess depreciation is accelerated depreciation claimed in excess of that allowable under the straight-line method at the time of sale. Depending upon the type of property sold and the length of time it was held, a portion of the excess depreciation could be "recaptured" and taxed as ordinary income rather than as capital gains. Rules affecting the recapture of excess depreciation on federally assisted rental property were most recently promulgated under two laws, the Tax Reform Acts of 1969 and 1976.

The seller's gain on sale in year 10 is subject to partial (38 percent) recapture of excess depreciation as ordinary income. The new investor's gain on sale in year 25 under post-ERTA tax treatment would not be subject to depreciation recapture because the property would be fully depreciated and, accordingly, there would be no excess depreciation. The new investor, however, would be subject to a minimal excess depreciation recapture under the pre-ERTA tax treatment, with 20 percent of the excess depreciation subject to the ordinary income tax rate. The remaining gain is subject to tax as capital gains in accordance with the installment method of accounting, which recognizes the seller's gains upon receipt of the principal installments.

Marginal ordinary income tax rate

The seller and investor are assumed to be in the 50-percent marginal tax bracket.

Capital gains tax rate

Sellers and investors are subject to a 20-percent effective capital gains tax rate on the sale of their investments. (Fifty percent (marginal tax rate for ordinary income) X 40 percent (long-term capital gain that is not excluded for taxation purposes).)

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