April 1996

Volume 21
Number One

REAL ESTATE ISSUES

THE COUNSELORS OF REAL ESTATE™
(American Society of Real Estate Counselors)

The ***JAMES E. GIBBONS EDUCATIONAL DEVELOPMENT TRUST FUND,*** of The Counselors of Real Estate, announces that in 1995 scholarships were presented to 32 graduate students in 17 identified university real estate programs nationwide. Scholarship recipients were:

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The American University

Felicia Jacques and Jan McGinty
Columbia University

Charles Kilgore and Charles McCadden
Massachusetts Institute of Technology

Tina Vizzini and Michael Burden
New York University

Stephen Saba and Thomas Phillips, III
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Jody Chaffin and Dani Voigt
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Timothy Hill and Jon Walsh
University of British Columbia

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University of Southern California

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The University of Tennessee-Knoxville

Craig Raddatz and Shari Crivello
University of Wisconsin, Madison

Paul Mauer
Virginia Commonwealth

CONTRIBUTOR INFORMATION FOR REAL ESTATE ISSUES

The journal is published three times annually (April, August and December), and reaches a lucrative segment of the real estate industry as well as a representative cross section of professionals in related industries.

Subscribers to *Real Estate Issues* are primarily the owners, chairmen, presidents and vice presidents of real estate companies, financial corporations, property companies, banks, management companies, libraries and Realtor© boards throughout the country; professors and university personnel; and professionals in S&Ls, insurance companies and law firms.

Real Estate Issues is published for the benefit of the CRE (Counselor of Real Estate) and other real estate professionals, planners, architects, developers, economists, government personnel, lawyers and accountants. It focuses on providing up-to-date information on problems and topics in the field of real estate.

Review Process
All manuscripts are reviewed by three members of the editorial board with the author's name(s) kept anonymous. When accepted, the manuscript and any recommended changes is returned to the author for revision. If the manuscript is not accepted, the author is notified by letter.

The policy of *Real Estate Issues* is not to accept articles that directly and blatantly advertise, publicize or promote the author or the author's firm or products. This policy is not intended to exclude any mention of the author, his/her firm or their activities. Any such presentations however, should be as general as possible, modest in tone, and interesting to a wide variety of readers. Potential conflicts of interest between the publication of an article and its advertising value should also be avoided.

Every effort will be made to notify the author on the acceptance or rejection of the manuscript at the earliest possible date. Upon publication, copyright is held by The Counselors of Real Estate (American Society of Real Estate Counselors). The publisher will not refuse any reasonable request by the author for permission to reproduce any of his contributions to the journal.

Deadlines
All manuscripts to be considered for the April edition must be submitted by January 15; for the August edition by June 1; for the December edition by September 1.

Manuscript/Illustrations Preparation
1. Manuscripts **must be submitted on disk** (along with hard copy): ASCII file format or Word for Windows 6.0 preferred. All submitted materials, including abstract, text and notes, are to be **double-spaced** on one side only per sheet, with wide margins. Recommended number of manuscript pages is not to exceed 15. **Submit five copies of the manuscript accompanied by a 50- to 100-word abstract and a brief biographical statement**.

2. All notes, both citations and explanatory, are to be numbered consecutively in the text and placed at the end of the manuscript.

3. Illustrations are to be considered as figures, numbered consecutively and submitted in a form suitable for reproduction. (Camera-ready form, line screen not to exceed 80 dots per inch-DPI.) If higher DPI is warranted to show greater image blends or contrast, illustrations must be computer-generated on a Macintosh or PC compatible using the following formats: QuarkXPress, PageMaker, Illustrator, Photoshop, Corel Draw. Any other formats will not be accepted.

4. Number all tables consecutively. All tables are to have titles.

5. Whenever possible, include glossy photographs to clarify and enhance the content in your article.

6. Title of article should contain no more than six words including an active verb.

7. For uniformity and accuracy consistent with our editorial policy, refer to the style rules in *The Chicago Manual of Style*.

REAL ESTATE ISSUES 1996 Editorial Calendar

April (Deadline for manuscript submission—January 15)
Articles on general real estate-related topics

August (Deadline for manuscript submission—June 1)
Focus Edition "Cap Rates/Yields: Market Trends and Relationships"

December (Deadline for manuscript submission—September 1)
Special Edition "The Dynamics of Sports and Community Development"

Readers are encouraged to submit their manuscripts to:

Halbert C. Smith, CRE, editor in chief
Real Estate Issues
The Counselors of Real Estate
430 North Michigan
Chicago, IL 60611

THE BALLARD AWARD MANUSCRIPT SUBMISSION INFORMATION

The editorial board of *Real Estate Issues (REI)* is accepting manuscripts in competition for the 1996 William S. Ballard Award. The competition is open to members of The Counselors of Real Estate and other real estate professionals. The $500 cash award and plaque is presented in November during The Counselor's annual convention to the author(s) whose manuscript best exemplifies the high standards of content maintained in the journal. The recipient is selected by a three person subcommittee comprised of members of The Counselors of Real Estate. Any articles published in *REI* during the 1996 calendar year are eligible for consideration and must be submitted by September 15, 1996.

AVERY NAMED RECIPIENT OF THE 1996 LUM AWARD

Jonathan H. Avery, CRE

Jonathan H. Avery, CRE, has been recognized with the highly esteemed Louise L. and Y.T. Lum Award for his distinguished contribution toward advancing knowledge and education in real estate counseling. Established by the late Y.T. Lum, CRE, the award encourages the continuing professional education of those engaged in real estate counseling through an understanding and advancement of its principles, theories, techniques and practices.

As principal of Avery Associates in Acton, Massachusetts, Avery's business day can include a variety of real estate consulting and appraisal activities with public, private and corporate clients. He also serves as an arbitrator and counselor in proceedings and negotiations involving real estate. In 1993 he was sent to Poland by the Eastern European Real Property Foundation to share his professional acumen and skills with those professionals in the country's emerging real estate industry. Locally, Avery has served in public service positions including membership on the Minority Appraiser Training Advisory Committee of the Massachusetts Housing Finance Agency.

Since being invited in 1985 to membership in The Counselors of Real Estate, Avery has assumed a leadership role in the areas of education and publications. He chaired the task force responsible for publishing what is now the industry standard, *THE OFFICE BUILDING: From Concept to Investment Reality,* he served as chairman of the Education Committee and presently chairs the Business Issues Committee. In addition to his responsibilities on the Board of Governors and the Executive and Finance Committees, he recently served as a liaison vice president for the Society.

Avery perpetuates the professional excellence exemplified by previous Lum Award recipients along with CREs Joseph Straus, Jr. (1995), Richard D. Simmons, Sr. (1994), Eugene G. Bowes (1993), John McMahan (1992), Wayne D. Hagood (1991), Charles W. Bradshaw, Jr. (1990), Jared Shlaes (1989), John R. White (1988) and Thurston H. Ross (1987).

REAL ESTATE ISSUES

Published three times annually by The Counselors of Real Estate (American Society of Real Estate Counselors) of the NATIONAL ASSOCIATION OF REALTORS®, 430 North Michigan Avenue, Chicago, Illinois 60611.

Third class postage paid at Chicago. Subscription rates: $33 per year ($60 for two years, $79 for three years); $27 per year to students and faculty; $38 foreign rate, submit in U.S. currency; single copy $12. Remittances may be made by personal check or by charge payable to The Counselors of Real Estate. Remittances, change of address notices, undeliverable copies and orders for subscriptions and editorial material should be sent to Real Estate Issues, The Counselors of Real Estate, 430 North Michigan Avenue, Chicago, Illinois 60611. 312/329-8427 FAX: 312/329-8881.

Library of Congress card number LC 76-55075

Printed in U.S.A.

REFLECTIONS, ETC., FROM THE EDITOR IN CHIEF

Halbert C. Smith, CRE

On behalf of the Editorial Board of *Real Estate Issues*, I would like to thank The Counselor's president, Logan Babin, CRE, for his kind words about the journal. (see "The President Speaks" page iii) This volume celebrates the 20th year of publication for *Real Estate Issues*. Twenty years of publication excellence is an outstanding record and a reminder to those of us currently responsible for REI of the legacy we are fortunate to perpetuate. It is also a time to rededicate ourselves to improving the journal so it continues to serve as the "flagship vehicle of public outreach for all CREs."

Some reflections may be in order. What is the primary goal of *Issues*? Should it be primarily a profit-making vehicle for the CREs? Should it be primarily an outlet for members' writings, whether they be opinions, experiences or research? Or, should it be the best professional journal that we can possibly make it (within those always-present budget constraints), no matter who writes the articles and even if we don't turn a profit. The answer, of course depends on the goals of the organization. In fact, these goals were recently re-examined and now comprise The Counselors of Real Estate's Strategic Plan. I contend that by adhering to the highest standards of quality for the journal, *Real Estate Issues* can best contribute to these goals by providing a forum for recognition of the CRE Designation and the quality and diversity of services provided by CREs.

Thus, we attempt to encourage submission of articles by experts who may or may not be CREs in order to have the best possible submissions to select from. All articles are reviewed by three members of the editorial board and the editor in chief to assure quality, relevance and appropriate writing style. In this regard, we tend not to publish material with lengthy equations or other difficulties (such as technical tax code matters) that would detract from the article's ability to be understood. Our goal is to have an attractive journal with articles that the membership and other real estate professionals *want* to read because the information is readable, interesting and helpful to their practices.

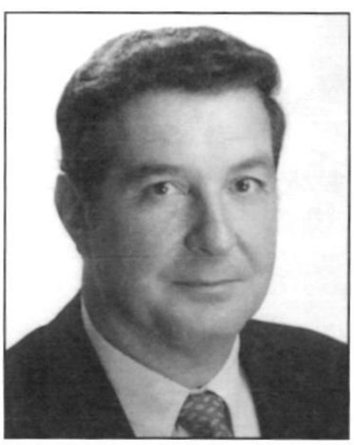
I believe the current edition of *REI* meets the above criteria. The variety of authors and topics represents important issues facing real estate professionals today. We hope particularly that as non-CREs come to value *Real Estate Issues* and the interpretation, analysis and insight it provides, they also become aware of the advantage of qualifying for membership. We know CREs will find this and other editions to be excellent vehicles for publicizing the organization and their own professional expertise. Now let's look to even higher goals for the 30th and 40th anniversaries of *Real Estate Issues*.

Hal Smith

Halbert C. Smith, CRE
Editor in chief

THE PRESIDENT SPEAKS

REAL ESTATE ISSUES CELEBRATES 20 YEARS OF PUBLICATION EXCELLENCE



Logan H. Babin, Jr., CRE

In *Real Estate Issues'* first edition, 1976 President Neil J. King, CRE wrote, "The scope of topics herein reflects the wide-ranging pursuits of the society's members whose interests include yet transcend brokerage, appraising, management, real estate securities, land development and mortgage banking." Looking ahead he predicted that "While *Real Estate Issues* addresses macro and micro matters related to real estate, articles will also appeal to those in allied fields: planners, architects, developers, economists, politicians, scientists and sociologists. Hopefully the perpetration of a common language based on experience and theory will benefit all who put real estate to use." Twenty years later, the journal is sought by industry experts as a forum to express and interpret major issues in commercial real estate.

During the two decades of publication by The Counselors of Real Estate, the journal has benefited from the editorial guidance and wisdom of its four editors in chief: James H. Macmillan, CRE, 1976; Jared Shlaes, CRE, 1977-1986; Rocky Tarantello, CRE, 1987-1993; and our current editor Halbert C. Smith, CRE. These dedicated individuals, in partnership with the editorial board and Linda Magad as managing editor, have contributed to ensuring that REI's editorial direction will reflect and often predict the good and sometimes not so good cycles and technological changes in real estate.

Today *Real Estate Issues* is truly a journal of the nineties. The April edition includes articles written by practitioners from leading accounting organizations, the legal community, universities, research centers and real estate counseling firms. They provide their insights and predictions on industry concerns relevant to environmental liability, pending capital gains legislation, institutional investment and opportunities in international real estate. The Experts' and Consultants' Guide to CRE Services includes an alphabetical list of Counselors and the expert services and problem-solving skills they provide to clients.

On behalf of The Counselors of Real Estate, I want to applaud the contribution *Real Estate Issues* has made to the industry. It continues to serve as a valuable benefactor to real estate literature and as the flagship vehicle of public outreach for all CREs.

Logan H. Babin, Jr.

Logan H. Babin, Jr., CRE
1996 President
The Counselors of Real Estate

REAL ESTATE ISSUES

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DEPARTMENTS

ABOUT THE COUNSELORS OF REAL ESTATE

The Counselors of Real Estate, now in its 43rd year, is an international group of high profile professionals including members of prominent real estate, financial, legal and accounting firms as well as leaders of government and academia who provide expert, objective advice on real property and land-related matters.

Membership is selective, extended by invitation only on either a self-initiated or sponsored basis. The organization's **CRE Designation** *(the Counselor of Real Estate)* is awarded to all members in recognition of superior problem solving ability in various areas of specialization such as litigation support, asset management, workouts, valuation, feasibility studies, acquisitions/dispositions and general analysis.

Networking is the hallmark of The Counselor organization. Throughout the year, educational programs provide Counselors with opportunities, both nationally and locally, to meet with fellow members and professional colleagues to discuss the latest trends affecting commercial real estate. A publications program, highlighted by our award winning professional journal, *Real Estate Issues*, provides a venue for members to showcase their knowledge of such areas as office buildings, retail centers, hotels/motels, real estate counseling , etc.

What is a real estate counselor?

A counselor is a real estate practitioner whose primary business is providing expert, experienced advisory services to clients for agreed-upon fees. Counseling denotes an activity that is, by its nature, relational. The client relies upon the counselor for skilled and objective aid in the client's real estate needs, implying both trust on the part of the client and trustworthiness on the part of the counselor. The counselor typically has acquired a broad range of experience in the real estate field, possesses technical competency in more than one real estate discipline, and places those competencies at the service of the client. While objective in analysis, the counselor directs his efforts toward the client's best interests through the development of particular strategies, evaluating options available to the client, advocacy of the client's interests, and - where required - execution of strategy on the client's behalf.

Those designated as Counselors of Real Estate (CRE) have been recognized and esteemed by their peers as persons meeting the above definition in an exemplary fashion. They have demonstrated knowledge, experience, integrity and judgment in their real estate expertise. The CRE subscribes to and is bound by The Counselors' Code of Ethics and Standards of Professional Practice and endeavors to generously assist fellow CREs who are performing client services in a spirit of collegiality. Thus, the commitment to the individual client is complemented by a commitment to raise the standard of counseling practice for the industry as a whole.

Users of counseling services

The demand increases for expert counseling in real estate matters worldwide. Through the years, institutions, estates, individuals, corporations and federal, state and local governments have recognized the necessity and value of a Counselor's objectivity in providing advice. These real estate professionals honor the confidentiality and fiduciary responsibility of the client-counselor relationship.

CREs service both domestic and foreign clients. Assignments have been accepted in Africa, Asia, the United Kingdom, the Caribbean, Central and South America, Europe and the Middle East. The Counselor has the benefit of proven knowledge and experience which qualifies him for practical application and proper interpretation of trends affecting real estate. A major player in the technological revolution, the Counselor regularly accesses the most advanced methodologies, techniques and computer-generated evaluation procedures available.

Determinants of compensation

The CRE is compensated by pre-agreed fee or salary for services, rather than by commission or contingent fee. The counseling fee itself is assured and rendered for advice rather than achievement or outcome of the transaction. Overall compensation can be determined by the complexity of the service performed, its value to the client, the time and expense involved, the breadth of the Counselor's knowledge and experience, and the responsibilities assumed. **Anyone involved in real estate should consider consulting with a CRE.**

For more information on The Counselors of Real Estate, contact The Counselors' office, 430 North Michigan Avenue, Chicago, Illinois 60611; 312.329.8427; fax 312.329.8881. ■

ENVIRONMENTAL RACISM: THE NEW LIABILITY FOR INDUSTRIAL SITE SELECTION

by Andrew Holmes and Lary B. Cowart

Industrial site selection is a real estate decision impacted by many variables. Whereas location for retail site selection can effect the firm's revenues, this is rarely applicable to industrial locations, since most industrial goods are exported. Consequently, industrial site selection becomes a right side of the balance sheet decision for the firm. Decision makers attempt to counterbalance production and transfer costs with occupancy costs so their consumers (other industrial or retail firms) have a lower product cost, given the risk associated with each variable's future expense.

Since most production, transfer and occupancy cost are easily quantified after the negotiation processes, the location decision is usually straightforward. Today, however, the new issue of environmental racism is complicating industrial site selection decisions and creating new liabilities.

Environmental Racism

In 1982, protesters attempted to block the siting of a hazardous waste dump in minority-dominated Warren County, North Carolina. The protest failed and the landfill was completed. Although the attempt was unsuccessful, it did serve to focus national attention on the relationship between geographical racial patterns and environmental hazards.

This phenomenon, known as environmental racism, has become a topic much discussed in the popular press. It is analogous to the widely debated mortgage redlining, which refers to an alleged effort to prevent mortgage capital from flowing into an area based on non-economic factors like race. Environmental racism, sometimes referred to as reverse redlining, is the alleged effort on the part of industrial planners to force industrial capital into minority areas without regard for economic considerations.

Looking at simple correlations between racial composition of neighborhoods and environmental hazards, many community activists claim the existence of systematic bias against minority communities in the site selection process for environmentally undesirable facilities.[1,2] Indeed, much anecdotal evidence of environmental racism

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***Lary B. Cowart** is an assistant professor of real estate at the University of Alabama at Birmingham and serves as a consultant with Delta Realty Researchers also in Birmingham. Cowart has published in The Journal of Real Estate Finance and Real Estate Review.*

exists. For instance, the U.S. General Accounting Office (GAO) recently reported that three out of four commercial hazardous waste landfills in the Southeast United States were located in predominately black communities.[3]

Industry leaders, of course, deny allegations of racism. Instead, they point to the economic criteria used in choosing industrial locations, e.g., land prices, access to major transportation arteries, taxes, available labor force, proximity to major suppliers, zoning laws and natural geology. Racism, they claim, is not part of the equation.

However, industry advocates also have anecdotal evidence to support their position. For example, a recently protested landfill site was located near Emelle, Alabama, a town with a predominantly black population and a poor economy. In response to the protest, the company argued that the site was chosen not because of the community's racial composition, but rather because a study by the environmental protection agency reported the site had ideal geology.[4] Although interesting, the anecdotal evidence presented, to date, does not satisfactorily address the issue of whether race has any impact on industrial location choice after controlling for prudent economic variables.

The Allegations

The allegations of environmental racism are not as simple as they may initially appear. Economic research and economic policy analysis usually follows the lines of some clear economic mandate. That is, researchers attempt to identify the economic incentives available to the participants in the market and then assume that these incentives will influence behavior. Where there are clear incentives, it is often elementary to devise a methodology to expose the rational workings of market forces.

In cases where the objective is to test for potential discrimination, the standard practice has been to test for the consequences of the economic incentives. If the expected consequences are found to exist, then the industry/participants in question are exonerated of the discrimination allegations. If these consequences are not present, it is usually interpreted as evidence that discrimination exists.

This standard procedure is much more difficult to adhere to in the case of environmental racism since the economic incentives involved are not straightforward. Between the community activist's allegations, the industrial planner's response and the pontification of policymakers and ivory tower researchers, at least four states of environmental racism need to be considered before satisfactory conclusions are made.

Strong-Form Arguments

The first argument may be called strong-form allegations or the indictment of industrial planners as blatant and malicious racists. Under this argument, industry officials target minority neighborhoods in the siting of environmentally undesirable facilities in a conspiratorial effort to protect white neighborhoods. In this case, economics is completely dominated by bigotry.

In response to the strong-form allegations, there is a strong-form defense where industry responds that the siting decisions are based on economic criteria such as land values, proximity to markets and suppliers, zoning laws, tax rates and other legitimate economic factors. Racism, it is argued, is not part of the equation. If only the opposing strong-form arguments existed, it would be relatively easy to verify the validity of the allegations. Unfortunately, the question is more complex than this simple dichotomy implies.

Weak-Form Arguments

There is a line of reasoning which might be called the weak-form allegation. This more subtle allegation charges that, while industrial planners are not blatant and malicious racists, they do choose the path of least resistance. Further, this path systematically leads to the choice of minority neighborhoods as host communities.

The siting of an undesirable facility often becomes a NIMBY (Not In My Back Yard) political struggle. Thus, it may be that the degree of political empowerment of potential host community residents becomes an economic factor in the sense that politically weaker neighborhoods would offer less resistance. Given the purported positive correlation between wealth and political power and the well documented inverse correlation between income and minority status, it may very well be that minority neighborhoods are systematically perceived as less powerful and therefore less difficult targets. That is, political realities may see poorer, minority neighborhoods as better candidates in the siting process simply because they lack the resources to challenge the location decision. Thus, under this line of thought, environmental racism exists not from malicious racism, but because of economic externalities.

Finally, and perhaps most insidious, there is the weak-form defense. In this view, the industrial planners acknowledge that minority communities may be exposed to a disproportional share of the larger community's environmental hazards. However, they maintain that siting decisions are made without regard for neighborhood racial composition. This current distribution of hazards, it is argued, is caused by the existence of the undesirable facility which alters the patterns of population migration. So, the observed simple correlation between facility location and minority communities is not a function of the racist siting decision, but rather the residential filtering process which occurs after the siting.[5]

Consequently, a confounding factor in establishing the existence of environmental racism is the age of the facilities in question. Given that the location decisions are historical (in some cases dating back scores of years), scrutinizing the current racial composition may not suffice. Industry officials are quick to claim that a change in racial makeup after the siting decision is beyond their control.

Issues

A literature search indicates that an objective study of the allegations involving both community characteristics and economic factors has yet to be published. Ultimately, two empirical questions must be answered before the corresponding policy analysis is addressed. First, anecdotal evidence aside, are minority communities currently bearing a disproportionate share of the burden caused by environmentally undesirable commercial facilities? That is, holding constant economic factors relative to the choice of industrial location, are minority neighborhoods currently host to a larger number of polluting facilities and/or the recipient of more actual pollution than similar non-minority neighborhoods?

The second question is whether current inequities, if they exist, are the result of systematic bias on the part of industrial planners? In other words, are minority neighborhoods bearing a disproportionate share of the larger community's environmental liabilities due to discrimination in the choice of industrial location or due to other factors? Analysis of this problem will require examining the characteristics of the host community's characteristics when the siting decision was made.

In both the current state and event time questions, it is possible for the existence of environmental racism on two levels. First, it can be viewed strictly as a function of location for polluting facilities. Does a disproportional number of industrial environmental hazards exist in minority areas? This assumes that the sited facility is unambiguously bad for the host neighborhood and that all facilities are equally bad. Most studies, to date, examine the phenomenon on a facilities only level. However, all facilities are not equal. The analysis also must be taken beyond a simple examination of facility locations to the amount of pollution released by the plant.

Siting of an industrial plant has positive as well as negative implications for the host community. Increased local employment and additions to the local tax base are, in isolation, favorable components of the siting process. Therefore, potential host communities may be faced with a cost/benefit decision when courting or opposing a proposed facility's location. For some facilities, the positive attributes may far outweigh the negative impact of modest pollution levels. For particularly undesirable facilities, the negative environmental impact may dwarf any benefits received.

Conclusion

The potential impact is enormous for industry and host communities regarding the allegations and litigation surrounding the issue of environmental racism. Billions of dollars and the health of whole communities may literally hang in the balance. Unfortunately, an objective analysis of whether this phenomenon even exists has yet to appear in real estate/economics/finance literature.

To date, current research fails to satisfactorily address the correctness of the allegations for two primary reasons. First, to account for the economic criteria of the siting process, the costs and benefits to the local community must be included. Heretofore, the issue has only been viewed from industry's point of view. Second, an event time analysis is necessary to determine if current inequities were caused by discrimination on the part of industrial planners or population migration after the siting decision.

The issues are complex. Multiple allegations, the lack of a clear economic directives, the need to differentiate the hazards caused by facilities, political realities and neighborhood incentives all impact the question. A multi-step approach is necessary to determine whether the allegations of environmental racism are true or false. In the meanwhile, industrial planners are well advised to document the economic factors leading to the selection of a specific site. Allegations of environmental racism and environmental racism litigation certainly represent a new liability in the choice of site selection for industrial locations.

NOTES

1. Ervin, Mike. "The Toxic Doughnut," *Progressive*, Jan. 1992, 15.
2. Grund, Howard P. "Responsible Care Confronts Charge of Environmental Racism," *Chemical Week*, 8 Dec. 1993, 57-58.
3. Godsil, Rachel D. "Remedying Environmental Racism." Michigan Law Review. 90 (Nov. 1991): 394-427.
4. Suro, Roberto. "Pollution-Weary Minorities Try Civil Rights Tack," *New York Times*, 11 Jan. 1993, A1, B7.
5. Filtering is the process of neighborhood change where housing passes to a less wealth class when a former occupant moves up. This is a positive social phenomenon because all occupants are in a better situation.

ENVIRONMENTAL REGULATION: HOW IT EVOLVED AND WHERE IT IS HEADED

by Jane S. Shaw

The Republican sweep of the House and Senate in November 1994 was partly a backlash against growing federal regulation in the areas of health, safety and the environment. This backlash explains why during the first 100 days of the reconfigured Congress, the House of Representatives declared a moratorium on many new regulations, passed a bill requiring agencies to conduct a risk assessment and cost/benefit study before issuing major regulations and proposed a bill to ease the Clean Water Act. While that reform movement has slowed, we can expect to see a resurgence of regulatory reform in the months ahead.

The reasons for the backlash are not hard to find. Increasing regulation has hurt a wide swathe of businesses and individuals. Writing for the Center for the Study of American Business, Murray Weidenbaum and Melinda Warren point out that the Federal Register, which records regulatory actions by the federal government, reached 87,000 pages in 1980, fell to 53,000 in 1988 and was back up to 69,684 in 1993. They also report that in real terms, the budget for federal regulatory agencies is about 35 percent higher now than it was during the last year of the Carter Administration.[1] Just the cost of compliance with federal environmental regulations is now about $150 billion annually, reports Thomas D. Hopkins of the Rochester Institute of Technology.[2]

Environmental Laws—Logical Or Ludicrous?

For the real estate business, several laws have been particularly onerous in recent years.

- The Superfund's expensive and unpredictable liability provisions have discouraged the redevelopment of urban sites that may have had hazardous waste. These brownfields, which otherwise might be attractive, are being ignored in favor of the greenfields where there is no Superfund liability.
- Regulation of wetlands under the Clean Water Act has forced developers to pay mitigation fees if they drain or fill land that the Environmental Protection Agency (or the Army Corps of Engineers) deems a wetland. If developers drain or fill without a permit, they can be prosecuted as criminals. A number of people have gone to prison for filling land under these rules. William Ellen was creating a hunting area for waterfowl in eastern Maryland just as the federal government changed its definition of wetlands. Frustrated with bureaucratic red tape, Ellen placed two truckloads of dirt on land that, under the

Jane S. Shaw is a senior associate of PERC (Political Economy Research Center) in Bozeman, Montana.

new definition, might be a wetland. He went to jail even though he was adding wetlands to the property![13]

- Zealous administration of the Endangered Species Act has also put development of private property on hold. The Fish and Wildlife Service interprets the Endangered Species Act to mean that habitat cannot be modified if it will cause the death of an endangered species. Although most of the public discussion on endangered species has focused on logging (because protection of such birds as the northern spotted owl and the red-cockaded woodpecker affect forests), a number of developments have been thwarted or slowed by the ability of the Fish and Wildlife Service to control how people use the land.

For example, Beth Morian has been unable to develop homesites on her property west of Austin, Texas, because the area is habitat for the black-capped vireo, a bird on the endangered species list.[4] The act does allow development if a landowner creates a habitat conservation plan, but such plans are costly and must be worked out, step by step, with the Fish and Wildlife Service. According to one estimate, a habitat conservation plan proposed by The Nature Conservancy for a 34,000-acre area around Austin will cost $173 million over 30 years.[5]

While these obtrusive regulations have hampered real estate development, what probably changed the mood in Washington was that they were beginning to border on the absurd. For example: an EPA rule requires municipal sewage treatment plants to remove 30 percent of organic materials in sewage that is discharged into the ocean. In Anchorage, Alaska, sewage is so diluted with snow or rain that it practically has no organic material by the time it reaches the ocean. Yet Anchorage still must meet the EPA's requirement. To do so, fish processors are *adding* 5,000 pounds per day of fish waste into the system, so that it can be cleaned up to EPA standards![6]

And then there are Superfund rules. To decide what kind of cleanup should be undertaken, the EPA considers site contamination based on the following assumptions: a site will be turned into a residential mobile home park; children living there will eat between 100 and 200 milligrams of contaminated dirt per day; and residents will drink water solely from wells on the site.[7] In sum, Congressman Robert S. Walker (R-Pa.), an author of one reform bill, says that with today's environmental laws, "people are seeing too much of the absurdity and not enough of the benefits."

These rules, which sometimes seem ludicrous, might be forgiven if the programs they belonged to were viewed as effective. But EPA administrator Carol Browner has criticized the Superfund program (which she supervises) as one that "frequently moves too slowly, cleans up too little, has an unfair liability scheme and costs too much."[8] The Endangered Species Act isn't just burdensome; it's having perverse effects. By penalizing people who find endangered species on their property, the act creates an incentive to manage one's property so species are kept out or removed if found. Michael Bean, often informally credited with writing the Endangered Species Act, recently told a group that some private landowners are "actively managing their land to avoid potential endangered species problems" simply because they want to avoid "potentially significant economic constraints."[9] Indeed, few species have been taken off the endangered species list and some of the highly touted recoveries, such as the gray whale and the peregrine falcon, are due to factors other than the act itself.

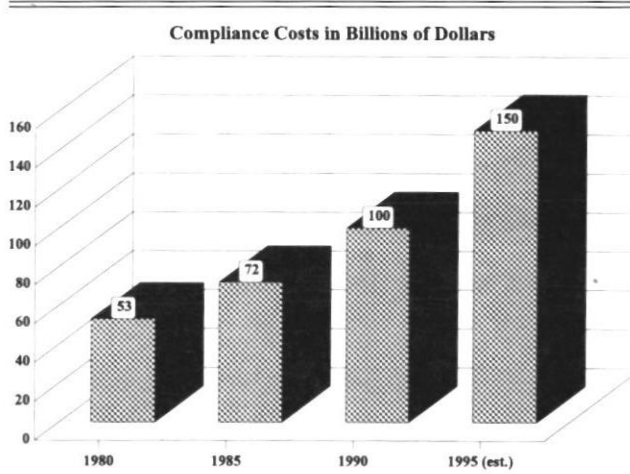
In defense of current regulations, environmentalists have argued that the anecdotes are unrepresentative of federal rules. The National Wildlife Federation issued a series of refutations of the horror stories.[10] These refutations (each is only a few paragraphs long) dispute some aspects of each story but offer no proof that their interpretations are more accurate than the proponents' versions.

Environmental activists in Washington are on the defensive, and there is a clear move toward regulatory reform. However, to put the nation on a more reasonable track, it is necessary to understand how the nation got on this one.

How Environmental Regulation Grew

Three factors lie behind the regulatory juggernaut of the past two-and-a-half decades: a growing concern about the environment (reflecting both greater affluence and fear generated by apocalyptic forecasts); overconfidence in the federal government; and the tunnel vision that comes with regulatory territory.

Environmental Regulations Keep Climbing



Source: *Cost of Federal Regulation* by Thomas D. Hopkins, Rochester Institute of Technology, 1992.

Growing Concern About The Environment

Most people date the start of the modern environmental movement with the 1962 publication of *Silent Spring*.[11] This eloquent book by Rachel Carson aroused fears that the natural world was being damaged, perhaps destroyed, by human technology. Carson focused on pesticides, especially DDT, and what followed was the Environmental Protection Agency's 1972 ban on the use of DDT.

In 1972, another book, *The Limits to Growth*[12] raised fears of famine, overpopulation and resource depletion. Basing their views on computer models developed at MIT, the authors predicted that "the limits to growth on this planet will be reached sometime within the next 100 years. The probable result will be a rather sudden and uncontrollable decline in both population and industrial capacity."[13] When the OPEC oil embargo occurred in 1973 and prices of energy began to climb, the book's fearful predictions looked credible, although they have since been shown to be completely unrealistic.

At the same time, Americans looked around and saw environmental problems. In many cities the air was dirty and rivers were polluted and full of debris. The Cuyahoga River actually caught fire in 1969, and the event became a symbol of the severity of pollution, galvanizing many people to do something.

What they did was pass federal laws. From the National Environmental Policy Act, which became law in 1969, to the creation of Superfund[14] in 1980, Congress enacted a steady progression of laws designed to correct what seemed to be wrong. These included the Clean Air Act, the Clean Water Act and the Endangered Species Act, among others.[15]

But was the environment really getting worse in the years preceding the enactment of these laws? Probably not. Robert Crandall, an economist with the Brookings Institution, has studied evidence of air pollution during the 1960s and 1970s. He concludes that the nation's air was improving steadily for decades before 1970 and, in fact, was improving *faster* in the 1960s, before the passage of the Clean Air Act, than in the 1970s after it was passed.[16]

How can this be? Air pollution is usually unburnt fuel. Losing fuel through the smokestack is costly and burning it more efficiently saves the company money. Other kinds of pollution, too, such as heavy metal pollution in water, represent wasted resources, so reducing waste through technology improves the bottom line. Thus, even though in the short run it is convenient to emit pollutants into the air or water, over the long run, profit-making companies have an incentive to clean up their waste.

But something else also was happening. People's attitudes were changing as their incomes rose. The factory smokestack that once symbolized progress now was viewed as an unpleasant nuisance for those living nearby. "Postwar affluence had produced a generation reared in relative comfort, one now in search of post material values long deferred by their elders," writes Christopher Bosso to explain the rise of environmentalism in the 1960s. "Once-dominant economic concerns gave way to 'superior' goods, those not necessary to human survival but increasingly regarded as essential to the overall quality of life."[17]

Subsequent studies have confirmed the link between rising income and environmental protection. A study by Gene Grossman and Alan Krueger of Princeton University[18] suggests that at low levels of income, economic growth puts initial stress on the environment, but after a certain level of wealth is reached, the environment begins to improve. Using World Health Organization data, the authors compared levels of particulate and sulfur dioxide pollution with levels of income. They found that pollution began to decline when per capita income reached between $4,000 and $5,000 (in 1985 dollars).

Rising incomes affect both the demand for environmental quality and the ability to supply it. People have to know they have food on the table before they care about streams and lakes. And as income rises, they have the discretionary funds to pay for environmental quality through higher taxes or their own economic choices.

There are numerous indications of the correlation between income and concern for the environment. For example, members of environmental organizations tend to be among the more affluent Americans. Readers of *Sierra*, the magazine of the Sierra Club, have incomes twice as high as those of the average American.[19] And a study for the Park Service indicates that in 1980 the average visitor to Bryce Canyon National Park had an annual household income of $30,000, compared with the national average of about $18,000.[20]

The latest round of environmental activism, starting visibly in 1988, is probably linked to the nation's strong economic growth after 1983, kicked off by a hot summer and fear about global warming. From 1983 to 1990, the United States experienced what the *Economic Report of the President* called "the longest peacetime expansion on record and the second longest expansion in U.S. history."[21] This expansion spurred people to increase their interest in environmental amenities and gave them the income to do something about it.

Elevation Of Local Problems To The National Level
As awareness of the environment emerged in the late 1960s, Americans looked to the federal government for solutions. Confidence in government, especially the federal government, was strong; the nation had just embarked on the War on Poverty, and the Apollo program to land a man on the moon was nearing its objective.

Furthermore, state and local governments were sending mixed signals about protecting the environment. Thomas Tietenberg, writing in his textbook on economics and the environment, describes how the federal government tried to "cajole the states into action" on controlling air pollution. State governments resisted.

But the mood of the late 1960s was activist, and environmental activists were impatient. They considered the attitudes of state and local governments as parochial, unenlightened and political. To force the states to act, they sought more control at the federal level, and they got it. Pollution control went off in a "bold new direction," says Tietenberg, with a "massive attempt to control the injection of substances into our air."[22] That federal attempt still is ongoing.

Resistance by state officials stemmed from the fact that strict controls would place their state at a competitive disadvantage as they tried to attract jobs and industry. Politically, they would face problems with company officials whose profits would go down and to employees who could lose their jobs. Even though concern about pollution was rising, residents did not necessarily want cleaner air and streams to override other goals.

The nationalization of pollution control did not eliminate environmental politics but changed its chief location to Washington, D.C., rather than states or municipalities. Today, local and state governments find themselves in battles with the Environmental Protection Agency as it insists they meet national ambient air standards and threatens to cut off funds if they don't. Furthermore, congressmen from one state pit themselves against those of other states. Robert Crandall of Brookings studied the voting patterns that led to the passage of the 1977 amendments to the Clean Air Act. He found that representatives of the industrialized rustbelt states in the Northeast and Midwest had banded together, voting to impose heavier controls on new plants built in pristine areas such as the growing sunbelt. By insisting on tougher controls for the sunbelt states, these congressmen reduced the competitive advantages of the southern states,[23] which had lower production costs.

The Effects Of Tunnel Vision
By elevating pollution control and environmental protection to the level of the national government, faster cleanup seemed possible. But in many cases these hopes have not been realized. One reason federal regulation has not lived up to expectations is that government officials have tunnel vision, a term adopted by Supreme Court Justice Stephen Breyer. This "classic administrative disease," explains Breyer, "arises when an agency so organizes or subdivides its tasks that each employee's individual conscientious performance effectively carries single-minded pursuit of a single goal too far, to the point where it brings about more harm than good."[24]

The Superfund program illustrates this tunnel vision. People in towns like Aspen, Colorado and Triumph, Idaho have been battling with the EPA over whether they should have Superfund sites. These are mining towns that have areas with significant mine tailings. In Aspen, for example, a mobile home park located right on top of the tailings has been in existence for years. Because of the way that the EPA calculates contamination by small quantities of heavy metals, the EPA contends these sites are extremely dangerous to residents and must be completely cleaned up for people to live there safely.[25] But residents counter by pointing out there are no epidemiological signs of harm and, in fact, there is no elevation of lead in the residents' blood among people who have lived for years on or near the affected areas. However, the EPA persists in pressing for "zero risk" even though the trucks that would haul away the waste may well pose a greater risk to the health and safety of the residents.

This tunnel vision explains why the nation is spending millions of dollars to clean up Superfund sites that may pose a one-in-a-million risk of cancer while far greater risks are ignored. Experts have calculated the costs of lives saved by regulation. By one estimate, it costs $31,000 to avert a death by upgrading traffic signs; in contrast, the EPA's ban on the production and use of asbestos costs $110.7 million per life saved.[26]

Reforms Currently Underway
With regulation so out of kilter, the effort to reduce regulatory burdens is not surprising. Congress has taken the initiative in some ways, but ideas for reform are also circulating in state and local governments, in think tanks, among interest groups and within businesses. Even the executive branch recognizes that some change is needed. It is too soon to know how everything will sort out. No one knows just how strong the momentum is to repeal, reform and reinvent.

Congressional Action
As noted at the beginning of this article, the House passed rules requiring federal agencies to conduct risk assessment and cost/benefit analysis before issuing upcoming regulations. However, these have not become law. A number of congressmen are trying to change specific environmental laws, e.g., the Endangered Species Act, the Clean Water Act and Superfund, to make them less burdensome and, in some cases, more effective. However, the battles over these laws are likely to be contentious, and at this point no one can predict the outcome.

Another step taken by the House was an effort to force the federal government to compensate owners whose property values are reduced unfairly through regulation controlling land use. This takings legislation has been championed by the property rights movement, a loose grassroots network of people, primarily property owners, who are upset by the encroachment of the federal government. These owners contend that when regulation to produce a public good (rather than to stop damaging pollution) reduces the value of property, the property owner must be compensated, just as if the property had been taken under eminent domain.

The House of Representatives passed a bill requiring that when 20 percent of the value of property is taken by a regulation, the property owner must be compensated. Since this legislation is hotly debated and since it could be costly to the federal government, its enactment by the full Congress (and its endorsement by the White House) is highly uncertain. On the other hand, the property rights movement shows no signs of slackening its pressure.

State And Local Action
The push for takings legislation is not limited to Congress. According to Defenders of Property Rights (a Washington, D.C. group that monitors property rights issues), by May 1995, 18 state legislatures had passed property rights legislation and bills had been introduced into at least 45 state legislatures.[27]

Most of the successful state laws are less ambitious than the federal counterpart passed by the House. They simply require that the state consider the financial implications of regulations under consideration in light of their potential as takings. When contemplating a regulation, the state government must formally consider whether a court will rule that the regulation is a taking and require compensation to the property owner. Complicating this task is the fact that the takings law in the courts is "unsettled constitutional law." [28] Some courts, including the Supreme Court, have found that regulations in some instances are uncompensated takings, but so far these occasions have been rare. (The *Dolan vs. Tigard* case, decided by the Supreme Court in 1994, is an example where the Court ruled a regulation was an uncompensated taking.)

Another area of potential regulatory reform is through devolution. The term, which surfaced initially in the debate over welfare reform, refers to returning responsibilities to the states. So far, not a great deal has happened in the environmental area, but devolution is a concept that is likely to spread. Most pollution is local and can be handled locally. Jerry Taylor, director of natural resource studies at the increasingly influential Cato Institute, urges such an approach. If Superfund, for example, were a local responsibility, he told *National Journal*, "it might well be that a community would fence off the site and spend its money on something else."[29]

Local handling of environmental issues would not be a panacea. In Michigan, for example, a tough law patterned after the federal Superfund law has made commercial development in cities such as Detroit extremely costly, because it applies liability for any contamination from hazardous waste to purchasers of property. The good news, however, is that local pressure from those who felt the impact led to its repeal. This happened long before anything was done about the federal law on which it is based. While local regulation can be harsh, it offers greater opportunity for correcting mistakes.

Conclusion
For property owners concerned about excessive regulation, the future looks better than the recent past. The buildup of regulation over the past two-and-a-half decades has resulted in so many problems that some change is inevitable. What shape that change will take is not yet clear, but two directions are likely: Federal laws will be revised to be less costly and burdensome and some regulatory activity may devolve to state and local communities.

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INSTITUTIONAL INVESTMENT IN WASHINGTON, D.C.

by Anthony Reynolds, CRE

As a Counselor of Real Estate (CRE) in Washington, D.C., my assignments are varied, rewarding and enjoyable. Many of my clients are from the local area, but not so for institutional investors, who can be dispersed nationwide. Apparently, the subject of Washington real estate can crop up at anytime in a client's conversation with a CRE.

While the substance of this article is opinion and not necessarily conventional wisdom, the material presented here represents my insights regarding Washington, D.C. and its investment real estate together with pertinent counseling tips.

Political Washington

Of the 3.6 million people who live within the commuting area of the nation's capital and whose livelihood is linked here on a day-to-day basis, 84 percent live in Maryland or Virginia and only 16 percent live in the District of Columbia. These three jurisdictions compete for economic success. The local Council of Governments (representing counties and cities in the three jurisdictions) is analogous to the United Nations in that its representatives are relatively low-level officials who notionally support cooperation. They tend to adopt joint recommendations without any authority for their implementation.

For example, Montgomery County, Maryland, for 30 years immediately following World War II, was the dominant suburban jurisdiction principally because it was an hour closer drive to New York City, and its residents enjoyed the benefits of astute county and state governments. The completion of the Capital Beltway and the balance of the interstate highway system removed the driving time advantage. Other factors working together have resulted in suburban Virginia surpassing suburban Maryland as the economic leader. Why? The Pentagon presence in Virginia enables that state to benefit from defense contracting. Also, both airports for the Washington metropolitan area are in Virginia. National is very close to the center city and the much larger Dulles is popular, growing and provides development synergy. Suburban Virginia's population is noticeably more physiocratic and more cohesive than suburban Maryland's. In 1994, however, both Maryland counties (Prince George's and Montgomery) adjacent to Washington elected responsible governments but both must work within limited financial resources.

Washington's long-term population decline has depleted its middle class. A revealing statistic is that 67 percent of the municipal employees live out

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of the municipality, mostly in Maryland. City officials operate an unsuccessful public school system and tolerate a high level of street crime in the poorer neighborhoods.

The city has no port access, no factory, no large bank and a weak retail core, but it does have a large collection of thriving private office buildings, a disproportionately high employment relative to population, lots of entertainment (including entertainment shopping), an adequate number of successful hotels, an excellent subway system, six universities, tourism-conducive attractions and weather, and superior print and radio/tv outlets.

Because of the high proportion of Washington real estate owned by international agencies, foreign governments and the United States itself, the city cannot be self-supporting. The U.S. Congress subsidizes Washington's budget and supervises its administration. For the next decade, Congressional supervision will be more direct in reaction to profligate and deceptive municipal practices of the past ten years.

Institutional real estate investments in downtown office buildings and hotels are as resilient to economic cyclical fluctuation and as protected from potential casualty loss as this real estate would be in other communities. To put this into perspective, in 1995 the most expensive office building transaction sold for $119 million or $348 per full-floor rentable square foot of finished space.

Architectural Washington

There are no canyons of steel here. Generally, Washington's streets are relatively wide and its building heights limited. The original District of Columbia included Alexandria, Virginia and Georgetown, Maryland, but the portion of the federal district that was the subject of the original but enduring city planning for the city was farmland. There have been successive comprehensive plans but each respected L'Enfant's original city plan. Federal agencies and congressional committees monitor land use in Washington. However, that the federal government itself is immune to the city's zoning and planning requirements is evidenced by the recent closing of the 1500 and 1600 blocks of Pennsylvania Avenue, N.W. to automobile traffic.

The owner of the local hockey and basketball teams is developing a new arena for music concerts, sports and other events at the Chinatown edge of downtown. The new arena is also expected to benefit hoteliers. It is generally thought that a new and much larger convention center could be successful, but funds for its development have yet to be identified. The Washington Opera intends to leave the Kennedy Center and presently is seeking a downtown site with the assistance of a major private donor.

Zoning Codes

Within various areas of the Central Employment District, building heights are limited to 90 feet, 110 feet, 130 feet and 160 feet. Those height limits correspond to 8 stories, 10 stories, 12 stories and 15 stories, respectively, and to floor area to land area ratios (FAR) of 6.5, 8.5, 10.0 and 12.0, respectively. The ease in which development can proceed within these various constraints indicates (for example, a 12-story building within a 130-foot-height limit to a density of 10.0 times the land area): 1. that almost all construction downtown is of reinforced concrete rather than steel frame and 2. first floors are built with relatively high ceiling heights for retail use and are on grade with adjacent sidewalks. Office suites occupying the top floors command premium rents as do buildings that are closest to the White House, front on mid-town park squares (for the less valuable easterly locations), or provide prominent views of the Capitol's dome. Automobile parking is the primary use of multiple cellars located under all buildings developed since 1970 and a few built earlier. Buildings that are developed to the maximum permitted zoning density (most post-1950 structures) with adequate parking, are not completely demolished as they age; rather their slabs and columns are retained during any major rebuilding.

Before the popularization of central air conditioning, office building floor plates in Washington were designed to maximize fenestration. As a result, both the density and the efficiency of older buildings, within any given height limit, are obsolete, and over the years many have been replaced with buildings of modern design. Washington now has a rather strict and rather strictly enforced preservation law which has resulted in the forced retention of buildings that are economic only if priced below the value of their underlying sites.

In general, Washington has an extremely complicated zoning code: the Central Employment District includes seven distinct Euclidean zones together with provision for the densities of each to be enhanced by predevelopment zoning-proffer negotiations. Furthermore, part of downtown is subject to various zoning map overlays that require mandatory but uneconomic partial-building uses: office development may require inclusion of apartments, theatres, art galleries, retail stores, etc. in locations that are not economically conducive to such uses. The result is either above-market rent subsidizing the uneconomic uses or (since often that is not possible) sites left vacant. Historic preservation further complicates the zoning code by limiting development of on-site density and permitting restricted transfer of development rights to other sites.

Changes to land use requirements are made by the Zoning Commission. Exceptions to existing requirements are granted by the Board of Zoning Adjustment. Neither group has veto power over the other; appeals are heard in the municipal court system. Exceptions to the preservation ordinance are heard and occasionally granted by yet a different board from which administrative appeal is possible.

Real estate counselors should advise their clients not to enter into purchase contracts for real estate in downtown Washington until the clients fully understand which uses are permitted and what the probable costs associated with seeking relief will be, as well as the risks involved when relief is denied. And all of that must be weighed against the risks and costs associated with trying to amend purchase contracts by inserting contingency clauses.

Office Buildings

Starting in the 1980s, office buildings developed in Washington were significantly more expensive than those developed in the preceding 25 years. This increase in capital was commensurate with a runup in land value. It was noticeable not only in facades but also in entrance lobbies, elevator lobbies, corridors and toilet rooms and in HVAC equipment, elevators and fire/smoke safety systems. For the most part, tenants negotiated more opulent building material finishes and installed more expensive furnishings in the newer, better-designed and better-built buildings.

Economic Washington

Office Space

The United States, of course, is the largest owner of office space in Washington and is, by far, the largest tenant. Although government leases specify a net usable measurement, all negotiations are conducted on a commercial gross rentable basis. Several federal agencies have independent negotiating authority, although most rely on the General Service Administration (GSA). In either case, rents are paid monthly, in arrears, for which the usual adjustment is an increase of 1 percent in the rental rate. Full-service government leases are typical, although utilities will be paid directly by the tenant if the agency occupies all or nearly all the office space in the building or needs unusual computer rooms or large meeting rooms. Landlord-provided services following the base lease year will be indexed to the national urban Consumer Price Index (CPI); for private tenants, leases require passing through the actual increases. The two systems would probably be equivalent on a long-term basis, but government leases only tend to be three to five years in duration or ten years for entire buildings.

Appropriations and oversight committees of Congress and the Executive Branch's Office of Management and Budget (OMB) are united in suggesting shorter and shorter terms. If the agency likes the building and has a continuing need for the same amount of space, it might renew for decades, but the renewal risk attendant on a short-term lease, especially for a large block of space, has slight appeal to institutional investors. This is particularly true if the building occupies a secondary location, as do many large government-leased buildings, because there is minimal private multitenant demand in such locations. Government leases often include tenant options to renew, but a decision to stay usually results in renegotiation rather than an exercise of the option. Leases for large blocks of space to private tenants often provide for options to lease adjacent suites or floors. If negotiations to renew an entire building should fail, the United States, as tenant, may well condemn the use-and-occupancy rights for a one-year period. That, of course, could be inconvenient and expensive for the landlord.

A more prevalent problem has been the government's inability to quit the premises on schedule. In this instance an eminent domain action is substituted that amounts to an indeterminate number of daily takings for use and occupancy, i.e., a taking for an undetermined time. The usual cause for such an action is that the building in which the agency intends to relocate is behind in its construction or renovation schedule. In such cases, when the tenant eventually moves out of the condemned building, it is on a gradual, perhaps one-floor-at-a-time basis. Sometimes the just compensation awards have recognized compensable damages related to the landlord's reliance on the original lease expiration date when contracting with another tenant, with a purchaser or with a remodeling-construction contractor. Othertimes, a jury may award compensation equal to the difference between available rents at the end of the government's holdover occupancy as compared with available rents on the original lease termination date. If the government does not formally file an eminent domain proceeding, the landlord may pursue an inverse-take action in the United States Court of Federal Claims.

Government rental occupancy of entire buildings generally results in the landlord's being compelled to lead the market regarding such safety considerations as asbestos-free space and modifications to accommodate disabled Americans. Some agencies require elaborate anti-terrorist protection of pedestrian and vehicle access.

Office Tenants

Law Firms
In Washington, many government offices, and even more private offices, are staffed with lawyers. Most large law firms, nationwide, maintain a Washington office in order to represent their clients who wish to influence legislation and the wording of regulations or to represent clients in adversarial hearings before administrative law judges. These judges have the authority to grant exceptions to the regulations and extract penalties for violations of foreign and domestic commerce regulations. Other law firms specialize in constitutional law, admiralty law, the law of intellectual property and the law regarding civil and criminal fraud. Almost always, large law firms rent rather than build or buy. The last recession strengthened some Washington law firms and closed others.

Trade Associations And Labor Unions
Washington includes hundreds of trade associations, many of which have enormous staffs, although recently almost every organization has reduced duplicative layers of management. The largest trade associations tend to own their buildings. The city also has quite a few large think-tank associations employing intellectuals both on a career basis and as a respite between government appointments. Such organizations favor the best locations. National labor unions often own monumental buildings, and those who rent tend to seek the best. The huge press corps representing news organizations from all over the world is a major component of office occupancy in Washington.

Leasing Considerations
It is customary for both tenant and landlord to be represented separately by real estate professionals for lease negotiations. Leasing agents tend not to be in property management or in real estate sales, although their colleagues in the same firm might perform such functions. Some leasing agents represent tenants exclusively.

Major private tenants typically negotiate 10-year leases with expansion and renewal options. Also typically, they negotiate concessions to provide for 1. outfitting their own suites and 2. occupancy for a substantial early part of the lease while incurring no obligation to pay rent. The cash- and free-rent concessions result in an above-market rental rate until the rent commences and is subsequently paid. A sixth-year base rent increase (a "bump") is customary in a private 10-year lease. The recent recession has reduced both effective market rents and the higher paid rents ("face" rents) and has reduced the disparity between them.

Meanwhile, most of Washington's best multiple-tenant buildings are occupied by tenants paying concession-reflective and pre-recession-negotiated rents that are well above the current market rent level, i.e., well above the rent that would be available today for the same space. The tenant's predicament in such cases is exacerbated by the pass-through lease provisions for services and real estate taxes that tend to increase over time. Most tenants are aware that they are paying above-market rents. Some have commenced negotiating lease extensions at reduced rents; others are merely waiting to do so when their lease terms expire. By and large, in the future such buildings will have lower incomes as leases turn.

For clients interested in acquiring Washington real estate, a CRE (designation awarded to members of The Counselors of Real Estate) should conduct some analysis of the total dollars paid under each extant lease relative to the likely rent for each at its respective rollover. If analyzing the price vis-à-vis capitalization rates, consider the use of a K factor or some other device if the income being capitalized is, in fact, a declining annuity as measured in constant dollars.

Organized Labor
Washington is not a strong labor town. The construction trades have unions, but hourly rates on union jobs and non-union jobs are identical. Until last year, the largest union construction company and the largest non-union construction company were owned and managed by the same holding company. Some clients require that construction proceed with organized labor.

Office building char forces are supplied by cleaning contractors rather than by management staff employees. Most of the cleaning companies maintain open shops, but a labor union exists and is engaged in a multi-year process of what appears to be a well-funded membership drive.

Generally, the top hotels in Washington employ union labor. Marriott chooses, and is apparently able, to avoid union labor while operating the city's largest downtown hotel along with two other downtown hotels.

D.C.'s Real Estate Overview

Most wholesale and distribution centers, most research and development facilities, most office parks and most modern motels are located outside of Washington in suburban Maryland and Virginia, typically at Beltway interchanges with other major roads. Some suburban neighborhoods have significant collections of office towers. This is particularly true in Northern Virginia because of 1. the proximity of Arlington (which was formerly part of the District of Columbia), 2. the location of the two Virginia airports, and 3. the success of Tysons Corner, near McLean.

Retail

With the metropolitan area's population overwhelmingly suburban, major shopping is almost entirely a suburban enterprise. However, the municipality has forced the retention of department store use for part of the now defunct downtown retail sites. Meanwhile, adjacent to the Pentagon in nearby Arlington, a new Galleria-like, multi-level, and multi-department store mall, with an attached Ritz Carlton Hotel and an integral subway station, is highly successful.

The Friendship Heights neighborhood, which spans the Washington-Maryland boundary, has a concentration of successful department stores, hotels, offices and apartments. There is no enclosed shopping mall at that location, although one is contemplated.

The best retail properties in the metropolitan area tend not to be institutionally owned but held by local or retail developers. Generally, the retail centers are burdened with great institutional debt. Much of downtown Washington's office inventory, too, was put in place by successful local developers. Some of the largest of these did not weather the last recession and their properties were acquired by institutional investors or securitized as real estate investment trusts. Some mixed-use facilities remain in local hands, but L'Enfant Plaza, which includes a large shopping component, a major hotel and four office buildings, is mostly owned by a United Kingdom pension scheme.

Washington's choice hotel properties are owned primarily by foreigners or by hotel interests and business partnerships which cheerfully outbid the institutions. Washington hotels are constructed, furnished and staffed to compete in a category somewhere between the expensive and luxury levels. Out-of-town Counselors should recognize that Washington hotels sell at high prices with capitalization rates that recognize room rates can be adjusted almost instantly for either competitive reasons or in reaction to inflation. Also, while the prices represent relatively high price earning ratios, they are still below the level of cost required to develop which precludes new construction.

Conclusion

Institutional investors are attracted to Washington real estate. While wealthy individuals may choose investments on an ad hoc basis, institutions do so only within a certain context and after careful study. Institutions seek real estate investments that are characterized by significant magnitude, acceptable income, potential gain, observable prestige and manageable risk. For all these reasons, investment in Washington is desirable. Also, institutions tend to be reassured when faced with competition, and the amount of quality real estate in the Washington area is sufficient to attract broad competition. The demand for real estate here, both domestic and foreign, also is balanced by a steady growth in a population which tends to be well educated and increasingly cosmopolitan.

The nation's government has withstood many and varied tests and remains strong, stable and democratic. It provides extensive liberties to its citizenry and a reliable currency for the globe. The federal government closely monitors its immeasurable investment in the Capital City. Washington continues to attract tourists because of its monumental and natural beauty and its usually agreeable climate. The CRE Designation is respected by the local legal and real estate communities. Thus, real estate counselors should consider the investment opportunities prevalent in Washington D.C.

INSTITUTIONAL REAL ESTATE ANALYSIS

by Terry V. Grissom, CRE, and James R. DeLisle

The increase of institutional involvement in commercial real estate has heightened the interest of many Counselors of Real Estate (CRE) and other professional service providers in this segment of the real estate market. The equity interest held by six key institutional types as of mid-1995, is approximately $232 billion, the debt funds are approximately $982 billion. Pension funds are the leading holders of equity real estate, followed by life insurance companies and REITs. On the debt side, the key players are the traditional real estate institutions of commercial banks, life insurance companies and thrifts. Pension funds and REITs are only minor debt holders. Foreign investors and foreign banks also are relatively active in both capital sectors (12.3 and 10.5 percent respectively).

Figures 1 and 2 address the relative positions of equity and debt institutions over time. Changing levels of participation are presented in these dynamic illustrations. In general, the more traditional institutions are declining or stabilizing, while the previously designated alternative capital sources of REITs, foreign investors and pension funds are increasing. The magnitude of the institutional market and the changing structure of participants can impact the decision process and approaches to real estate problem solving which, in turn, affects real estate clients and the professional services they require.

An Institutional Framework

This brief overview of the institutional market reflects the thought process, concerns and perspective of many institutional decision makers. They want to position themselves relative to the capital markets and so frame their analysis on the deductive reasoning and techniques taught and used in finance and economics. Practiced, influenced and educated in these areas, influential institutional managers have extended these tools to real estate. Institutional clients, by the nature of their concerns and responsibilities, must compare their real estate interest to capital markets and investment alternatives. Their overview is from investment alternatives and decision criteria, to appropriate investment markets, to possible property types and then specific properties.[1] However, responsibilities and many concerns require a broader

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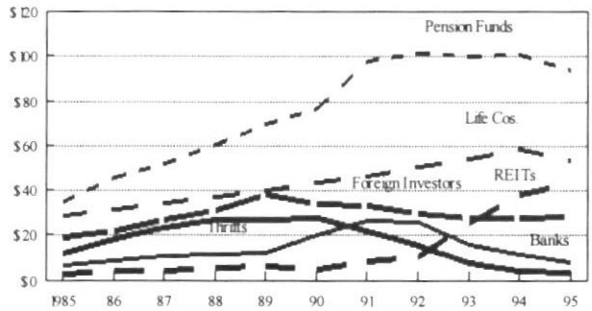
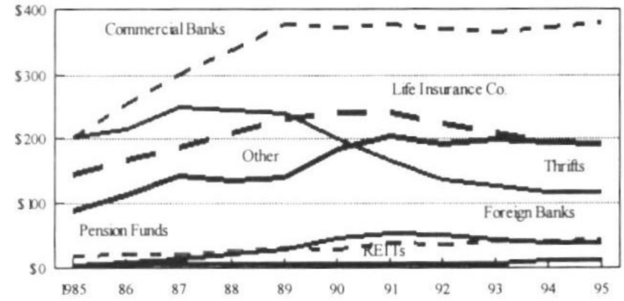
FIGURE 1
Trends in Equity Real Estate Investment Amongst Institutions



Source: GSU & Equitable Investment Research

FIGURE 2
Trends in Mortgage Debt to Real Estate Amongst Institutions



Source: GSU & Equitable Investment Research

perspective than a parcel-by-parcel view of real estate.[2]

Also, because institutional ownership is relatively long-term (liquidity is not a key concern given other investments and ongoing capital sources), trends and cycles are as important as current market performance (the traditional emphasis of real estate analysis). This often requires institutional work to link with prior research or to recognize the changes that have occurred over time.

An institutional group must be concerned with problems that often require an analysis of more than an individual property. The analytical unit may be a portfolio of properties, an urban market or comparative markets, a mixed asset portfolio or real estate related assets which vary in terms of private or public interests and debt or equity markets. The latter unit of mixed public/private, debt/equity real estate related assets, often is referred to as the Four Quadrant Model or Paradigm and further promulgates the deductive approach used or required by institutions. It is a framework of analysis based on a collective asset format which mixes and groups by sources of capital and types of ownership.

Although individual parcel analysis will not become extinct and is necessary to achieve the deductive perspective, it often is used for institutional analysis in the form of secondary real estate databases and indices, rather than real estate's traditional singular transaction orientation. This runs counter to the traditional real estate scenario of inductive logic, beginning with a specific property and its specific market and expanding to more aggregated market and investment concerns. In traditional real estate analysis, information on the real estate is the primary data with the economic, financial and other aggregated data employed from secondary sources. Therefore, the fundamental analysis traditionally employed in real estate consulting differs in how it is emphasized versus a totally different process of treatment when compared to the overall institutional analytic framework.[3]

The following example demonstrates that traditional real estate tools are used to address institutional problems but often with a different twist on the analytical framework.

Reserve Capitalization Rate Study

A reserve capitalization rate study is a study of capitalization rates in times series analysis developed to assist in calculating the reserve requirements of a special account (a portfolio of properties). This study is a follow-up to a prior study. The result is a modification, extension and rejection of a previous study executed for a specific portfolio. Because of the need to link real estate performance to other familiar capital market benchmarks (to assist the client's orientation), prior work investigated the pattern and statistical relationships of cap rates and treasury returns over time. The prior research also dealt with statistical relationships of cap rates and various yield series and identified what is termed a normalized period from 1986-1990. This period is characterized as a term in which real estate cap rates and 10-year Treasuries were highly correlated. In the prior study, the period of uncorrelated rates and interest returns from 1991-1993 is considered atypical. The previous report then used the normalized period as the basis of comparison, assuming a high correlation between treasury yields and cap rates. The treasuries performance was used to establish the appropriate cap rates for the reserves.

Real estate cycle analysis suggests that these two periods were inappropriately designated as normative and atypical and required further investigation. Thus, the study extends the prior investigation and places an emphasis on the relationships in long term patterns rather than a normalized period. Also, additional cap rate indices are included in the analysis to better proxy market activity over time.

Methodology: Replication And Modification

The modeling technique of this and previous studies is regression analysis, the traditional tool of economic time series analysis. The previous study is replicated by investigating the time series structure of the American College of Life Insurance (ACLI) cap rate data and the cap rate series available from Real Estate Research Corporation (RERC).

> The ACLI data is from a quarterly mortgage commitment report representing new mortgage activity. The cap rates in ACLI reports using property data, represent stabilized current income divided by market value (cost/appraisal based). The ACLI data is gathered from corresponding insurance companies and is considered an institutional database series. The ACLI data consist entirely of leveraged properties. (The other indices used in this research reflect equity investments or varying debt combinations of debt and equity financing segments.)

> RERC periodically surveys market participants regarding their acquisition pricing parameters for real estate. Since 1992, approximately 30 participants are interviewed each year. The cap rates in this series are for expected or desired ratio/yield relationships.

These two series were analyzed as individual times series variables. They are then analyzed in relation to one another. The average ACLI cap rate is 10.22 percent. The average RERC rate is 7.43 percent. No significant association is identified between the two cap series based on regression and correlation analysis. The correlation between RERC rates and ACLI rates is 27.50 percent, compared to an R2 of 7.56 percent, derived from the regression. Changes in the expected rate of either ACLI or RERC cannot be used to significantly predict rates in the other series. However, a range is set by the calculations of the ACLI and RERC series and their trends. ACLI reflects historic stabilized rates and RERC offers expected cap rates. The range, if not the association of these two series, can assist policy decisions. The low correlation and regression association of the rates over time are rational when the volatility of the variables are compared. Correlation tests the relationship between means and deviation of each rate series, and the ACLI rates have been more volatile than the RERC rates (until the 1990s). This can partially be attributed to amplified volatility of leveraged properties in the ACLI index. It also suggests that actual performance varies to a greater extent than expectations, suggesting real estate is not appropriately measured or priced by investors (valuation error in pricing risk, regardless of equal access to information).

This study further replicated the previous report's relationship of ACLI and RERC rates with 10-year Treasuries. The relationship of the treasury bonds to ACLI cap rates as a time series is still high, with an R2 of 74.58 percent. RERC and the treasuries have a negligible R2 of .06 percent, which is effectively zero. The regression analysis is supported by the correlation coefficients between the interest rate and the ACLI and RERC series. They are low, at −25.01 and −7.75 percent, respectively. These negative correlations illustrate an inverse relationship between cap rates and interest yields which weakens their use as direct indicators for one another. Treasuries have shown a greater volatility over the period from 1980-1994, than the ACLI and RERC rates.This suggests a greater market driven volatility for the bonds, despite the perception of the contractually reduced financial risk which is typical of treasuries. The high coefficients of determination indicate a linear association between the changes in treasuries and ACLI rates. RERC rates show no association with interest rates, although all three series trend in the same general direction. The negative correlation of the treasuries and the ACLI and RERC rates, though consistent with accounting for financial risk in the decision equation, requires further investigation to accept linking the cap rate policy to the treasury rates. Without further detail, such a link may introduce an unnecessary loading of leverage risk in equity deals.

Methodology: Extension

Three other capitalization rate series are considered, given the inconsistency in the previous research based on the findings of trend and correlation analysis. The series are the National Real Estate Index (NREI), the National Council of Real Estate Investment Fiduciaries (NCREIF) and the Korpacz Yield Index Survey (KYI). Because the real estate markets, like the general economy, are in transition, alternative market perspectives are needed. Thus, these rate series, which can be considered market indices, are employed to reflect the more competitive and broadening institutional investment market. As indices, they vary in data source and method of calculation. These differences, allow further insights to cap rate structure and policy.

Data Sources And Analysis

Following is a brief description of each cap rate series used to extend the investigation. These series, like the ACLI and RERC rates, are available to and used by many institutional and general market investors. Although the preferred approach is to back-up the market indices with specific property level cap rates in the different markets, these series offer insight to the overall trends and patterns in capitalization rates and allow for tests of relationships between the cap rate series traditionally used by institutional investors. Also, the institutional market can be compared to more general market activities as they are represented (in part) by these indices. With an inclusion of local data, these series enable a link of individual property analyses to economic activities in various geographical markets and allow for a tie of that market to general economic activity.

The NREI cap rate series is published by the Liquidity Fund. The reported rates are derived from transactions sent in by correspondents to the index analysts. Though the broad series of data behind the NREI rates is fraught with the potential of inconsistent measures and techniques (i.e., stabilized versus actual or current cap rates), it can be perceived as the broadest market index. This series considers both institutional and non-institutional grade properties.

The NCREIF series is developed from quarterly reports of institutional real estate performance. The composite index is based on the relationship of current leases to appraised values, modified by actual transactions that have occurred during the period.

Although NCREIF has developed leveraged and combined (both leveraged and equity properties) indices, the equity index is used in this report. The KYI or Korpacz Index is based on a survey of mixed respondents that includes institutional investors. The survey is limited to specific major cities and considers mostly institutional grade investments. This survey offers detailed discussion of how specific rates are determined and considered. As a survey, it reflects desired or expected returns, but it can be considered as a level of fundamental analysis.

These series are considered with the same statistical methods as the ACLI and RERC data. Given concern for markets in transition, each series is considered as a separate market index. Distinct patterns can be developed as historic cap rates partially influence future rates (current time periods are not independent of the past, despite the model's assumption). Therefore, allowing some market segmentation, each index is analyzed as a distinct individual time series. The distinct market patterns are then considered in relation to one another.

The average NREI cap rate in the series is 9.03 percent. The average NCREIF rate is 7.59 percent and the average KYI cap rate is 8.40. Despite this tight range, low to moderate associations are identified between KYI, NCREIF and NREI cap rates and ACLI rates based on regression analysis. The regression coefficients are 45.58, 21.76 and 25.52 percent, respectively. The correlation between each of these market indices and ACLI rates are higher at 67.51, 42.84 and 59.55 percent.

The RERC index has a relatively high regressed association with the NREI and KYI series and a very high association with the NCREIF series (68.21, 59.23 and 88.43 percent, respectively). The correlations of the three additional series are 82.5, 76.69 and 94.04 percent.

The significant coefficients of determination and the higher correlations suggest that linear associations between the various cap rates series are strong, which could result in an appropriate model for forecasting rates. The high correlation measure suggests that similar patterns, rate levels and volatility levels are present. This would indicate that an entire real estate cycle be considered for predictive purposes rather than the trend of a normal period. A practical approach is to use the various rate series as a range or flow of ratios depicting a market range, based on different orientations (ex post, ex ante and different methods of measurement).

The latter three rate series are also regressed and correlated with the 10-year Treasuries' returns. The implications are:

The NREI and KYI have relative high R2s of 51.51 percent and 57.88 percent. The association is negative showing that capital market measures relate to cap rates inversely. The NCREIF coefficient relative to treasuries is insignificant at 2.34 percent, suggesting that institutional equity decisions may not be related to traditional debt market activities (at least in a linear relationship).

The correlation measures are −76.08 percent for KYI, −81.57 for NREI and −58.14 for NCREIF. Key is the highly correlated negative relationship between the cap rate series and the treasuries' rates. This has intuitive appeal for the implication is that as interest rates increase, the income to value ratio declines marking a decrease in the emphasis on income and a transfer of return expectations to the capital component. The math of the relationship directs attention to the relationship of ratio rates and yields. The traditional relationship of interest and inflation is another possible factor that may alter the cycle of a series.[4]

The associations and relationships between KYI, NREI and NCREIF cap rates are also considered. They are:

KYI and NREI show a high regression coefficient of determination of 95.20 percent. This high association is interesting given that NREI is transaction based and KYI is a survey of expected (or desired) cap rates. The two series overlap in time frame, NREI beginning in the fourth quarter of 1985 and KYI beginning in 1988.

KYI and NCREIF have a coefficient of determination measured at 53.05 percent. This is significant because of the different basis of each series (survey versus historic returns based on either appraisals or transactions). The positive relation may result from the implication of expectations in the appraisals used by NCREIF as the foundation of its database.

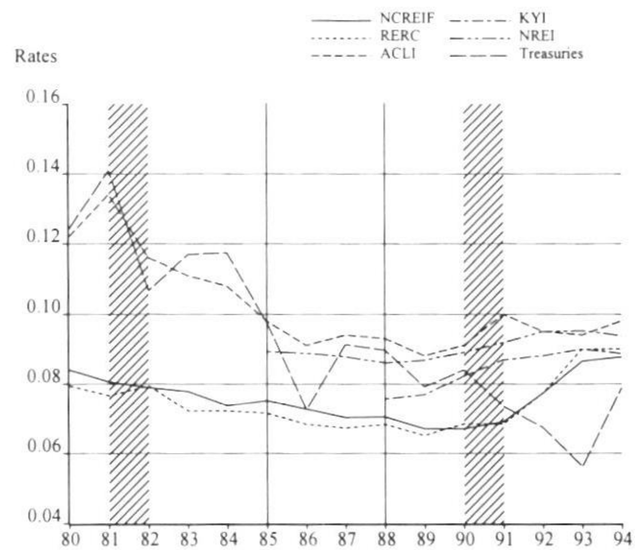
The NREI and NCREIF association reflects an R2 of 59.85. This supports a moderately high linear association between the two indices. This is interesting because NREI has more independent participants involved in the transactions used as its database than it does institutional grade property which populates the NCREIF database. This significant association may be partially attributed to the integration of general market comparables into the appraisals used to establish the NCREIF values, a component of its cap rates calculations.

Implications And Findings

The significance of the relationships between the rate series, as indicated in the analysis of cap rates and the 10-year Treasuries, is that although the bonds have less contractual risk, their returns have a history of greater volatility. This can be linked to the deregulated, market driven interest rate which has been in effect since going off the gold standard in the mid-1970s. Because of their computation, yields or total returns can be expected to fluctuate more than cap rates (income ratios) over time. The nature of the relationship between cap rates and the interest surrogate offered by the treasuries is inverse or negative. Over, the long-run, there is not a consistent and positive relationship as indicated in the normalized period from 1986-1990. The more general situation or norm is that real estate returns are cyclical and rate determinations for policy decisions should reflect this aspect. This cyclical nature is illustrated by the changes in all the rate series since 1990. However, this historic change is greater than the variation between the series as projected into 1996. Although real estate cycles coincide with general economic cycles, they can vary in relations with specific economic measures and indicators. Other than the norm in aggregated institutional analysis, a more direct comparison of debt to debt and equity to equity assets and other more specific investment attributes of distinct asset classes must be identified before a higher degree of inferential analysis can be conducted.

FIGURE 3

Trends in Five Cap Rate Series Relative to Ten Year Treasuries Rates



Source: GSU & Equitable Investment Research
Shaded areas on Figure 3 denote recessions.

Based on these implications resulting from intuitive and empirical analysis, it is concluded that an appropriate indication of current and expected cap rates can be derived from cap rate series and trends along with explanatory consideration given to changes in the economy and the impact of key events. A synthesis of the above analysis is illustrated in Figure 3.

The implications of Figure 3 are:

That the treasuries yields have declined since 1981 with relatively amplified volatility over the period that bottomed out in 1993. Treasuries rates have shown increasing yields for 1993 through 1994. The 1994-1995 changes coincide with the Fed's interest rate policies.

During the initial phase of the period studied, as depicted in Figure 3 (1980-1985 with treasuries bottoming in 1986), the RERC and NCREIF cap rates made a modest decline, reflecting expectations of capital appreciation and lowered emphasis on income. Note NREI data begins in 1985 and is fairly consistent over time. The ACLI data, more closely associated with the interest rates partly because of a leveraged portfolio, shows a steeper decline. The stabilized phase, identified in the 1994 study, extends from 1986-1990 and shows a stable period for cap rates with moderate declines consistent with the 10-year Treasuries rate. However, even during this period of high correlation, the government bonds are still more volatile.

The final phase of the time series, 1990-1994, shows all cap rate series as counter-cyclical to the treasuries' yield.

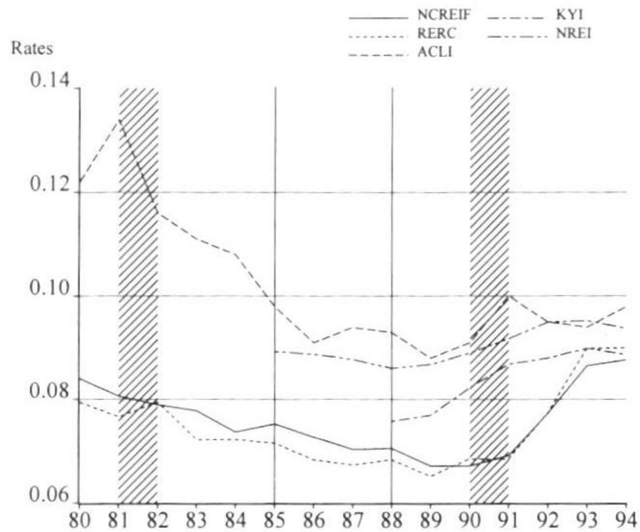
The implications of the trends suggest that a unique or divergent market has evolved beginning in 1990. Investigating the economy of this period (1980-1995), events were sought that would reflect the shifts observed in traditional economic relationships. Two key events appear to be the timing of taxing policy and inflation impacts. The changing tax policy shifted emphasis to value and after-tax benefits for the period 1981-1986.

After the tax law change in 1986, emphasis shifted to the productivity of the investment, specifically the income stream before taxes (and financing). The flip-flop in 1981 and 1986 tax policies changed the thrust of investment standards and the rates used to measure performance. The impact placed an upward pressure on cap rates.

The implications of the impact of the decline in inflation since 1981 are that the interest rate has declined to some degree with the rate of inflation and the development of alternative sources of capital. The need for the alternative sources arose in part from the troubles experienced in the thrift and banking systems. With these forces in effect for capital markets, the oversupply generated in real estate markets with limited but less costly capital uncoupled the real estate market from the traditional capital markets. The emphasis was placed on the economics of real estate, competitive supply and demand. The interaction in the market is directly reflected in absorption rates and income productivity measures. These factors support a rise in cap rates. This is observed in the transition, beginning in 1992, to alternative capital sources with further changes expected in the relationships of capital and real estate markets.

The implication of economic trends, as linked to various rate series, is assisted by observing Figure 3. The implication is that the capital and real estate markets are not consistently associated, but currently are observed as merging. This merging trend depicted by the five rate indices is illustrated in Figure 4. As shown, the top index, the ACLI series, currently is increasing. However, a forecast (conducted as part of this investigation) based on the interest rate indicates the ACLI series will level off through 1996 at about 9.5 percent. The NREI rate is expected to decline to 9 percent, with the KYI, RERC and NCREIF rates merging toward a range of 8.5 to 9.5 percent. The ranges are rounded from their actual forecast. The former rate series is currently declining and the latter two series are increasing.

FIGURE 4
Trends in Five Cap Rate Series



Source: GSU & Equitable Investment Research
Shaded areas on Figure 4 denote recessions.

Conclusions And Suggestions

Real estate is cyclical and as such institutional cap rate policies for reserves and other capital considerations can expect changing economic relationships over time. However, the capital component of the total return, with its high volatility, absorbs the bulk of shifts in the economy. Thus, despite cyclical turns overall, the cap rate tends to hold relatively constant. Consistency exists whether the real estate returns are coupled or uncoupled with financial markets. Therefore, recognizing that the period from 1990-1994 is as typical of real estate market performance as was 1987-1989, and that the markets of the 1970s and 1980s may be unique in the long run, an overall strategy for cap rate policy decisions might suggest operating in a manner that keeps rates constant. Management concerns would then emphasize risk exposure and seek to identify those variables that may cause variance in the ratio of income to value/price. Recognition of these variables may allow hedging options that trade-off inverse relationships between income and value positions.

NOTES

1. Grissom, Terry and Julian Diaz III, *Basic Valuation: Guide to Investment Strategies*, (Wiley: New York, 1991), Chapter 8, pp. 323-338.
2. Graaskamp, James A., *The Appraisal of 25 North Pinckney: A Demonstration Case for Contemporary Appraisal Methods*, (Landmark Research Publishers: Madison, WI, 1977) p. 7.
3. Grissom and Diaz, pp. 336-337.
4. Some economic literature addresses inflation cycles in the context of cycles within cycles.

SICK BUILDING SYNDROME AND THE MODERN OFFICE BUILDING

by James H. Boykin, CRE, and Ronald L. Sauer

People who work within an office environment make up an increasingly higher proportion of the work force. While these workers are entitled to a healthy workplace, this is not always the case. The consequences of an unhealthy work environment can be both physically harmful to employees and expensive for employers and office building owners to remedy. The purpose of this article is to identify the major causes of building-related health problems and to suggest strategies for dealing with them.

Growing Concern

Unquestionably there is growing public concern over indoor air quality. For example, a 1989 article noted that in a report by the Environmental Protection Agency (EPA), there were complaints of building-related illness in 20-30 percent of all existing buildings in the United States.[1] Later, in March 1992, the AFL-CIO petitioned the Occupational Safety and Health Administration (OSHA) to promulgate an overall standard for indoor air quality. Of the comments OSHA received on whether it should regulate indoor air quality, a majority (75%) supported regulation.[2] The concern increases as structures get older, more energy efficient buildings are built, capacities of building ventilation systems are reduced and rising[3] operating costs pressure building owners to reduce HVAC maintenance and operating expenses. In April 1994, OSHA proposed in the Federal Register to adopt standards which address air quality in indoor work environments. This notice states, "The basis for this proposed action is a preliminary determination that employees working in indoor work environments face a significant risk of material impairment to their health due to poor indoor air quality and that compliance with the provisions proposed in this notice will substantially reduce that risk."[4] The proposed standards would require affected employers to develop a written indoor air quality compliance plan. It would include details of each system that influence indoor air quality, how often and in what manner a system is maintained, what corrective changes are made, the number and type of complaints and

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what remedial actions are taken to resolve the complaints. The new standards could be quite costly to implement since many owners currently do not adhere fully to such requirements.[5]

There clearly is not universal support for new standards. In testimony given at a public hearing on proposed standards for indoor air quality before the United States Department of Labor Occupational Safety and Health Administration in Washington, D.C., on January 9, 1995, Edwin N. Sidman, of the National Realty Committee, expressed concern over three issues:

1. OSHA has not demonstrated that a uniform national rule applicable to all office buildings will produce benefits proportionate to its multibillion dollar cost.
2. The proposed rule will not be effective in solving Inside Air Quality (IAQ) problems despite its disproportionately high costs.
3. Government can best protect workers currently exposed to IAQ problems by encouraging the development of science and technology that will lead to the identification and control of source contaminants.[6] The National Realty Committee goes on to state that: ". . .the costs of the proposed rules are not only very high in the aggregate, but they are totally unnecessary and arbitrary in many instances, because they will apply whether or not the building in question has had any indoor air quality problems. In our opinion, the costs do not change significantly if there are no IAQ complaints at the building, nor, for that matter, do they change because the building owner or occupants have chosen to ban smoking. The compliance costs are the same even if the building owner already has a sophisticated and progressive program aimed at separately ventilating all known contaminant sources or preventing them from being used in the workplace. In short, the rule is arbitrary and over broad in that it applies equally to buildings with excellent indoor air and those with large numbers of tenant complaints."[7]

Whatever the outcome of the proposed OSHA rules, property managers, building owners and employees must become more fully aware of indoor work environments and continually monitor their buildings for signs of deteriorating air quality. Building systems must be maintained in sound operating condition. Unfortunately, building contents are often installed by someone other than the current owner even though they may be the source of contamination. Many types of particles are released from modern office buildings and their expanding range of materials and furnishings. Most of these particles are too small to be seen with the naked eye while others are readily visible as gross dirt.

Most Common Building-Related Health Problems

Typically indoor air quality problems are placed into two categories: sick building syndrome (SBS) and building-related illness (BRI). While both cause significant health problems for building occupants, they differ in cause and severity. Sometimes the cause is obvious, and affected persons have symptoms that point to a specific problem. Other times it may elude even careful examination, and those affected will have symptoms which also could be attributed to such common afflictions as allergy or the common cold.

Sick building complaints commonly are attributed to very general and numerous (often unspecified) building design, operation and maintenance factors, but rarely is a specific source identified. Typical SBS complaints include lethargy (56%), headache (45%), stuffy nose (43%), dry throat (40%), dry eyes (30%), itchy/watery eyes (22%), runny nose (22%), flu-like symptoms (15%), breathing difficulties (8%) and chest tightness (8%).[8] Nausea and dizziness are common in this environment, but those affected usually recover completely after leaving the building. They are probably not diseased, but feel temporarily ill while inside the sick building.

Building-related illness is potentially very dangerous and is caused usually by an identifiable source which needs to be found and eliminated. Such buildings are commonly referred to as diseased buildings. Related illnesses may be an infection such as Legionnaire's Disease, a severe allergy or chemical poisoning due to something dangerous in the building. The signs and symptoms are not as vague as in SBS. The stricken people may become seriously ill and should not enter the building again until the source has been eliminated.[9]

Causes Of Harmful Building Environments

Office building discomfort from poor indoor air quality is traceable back to the Arab oil embargo in the mid-197Os, which resulted in skyrocketing energy costs. Two major by-products to conserve energy during this and subsequent periods were the "reduction in ventilation rates and the improving of the air tightness of buildings."[10] Modern office windows usually are rendered inoperable to ensure building tightness, and workers must rely on HVAC systems for comfort and recirculation of air. Thus the name tight building syndrome is used to describe the symptoms found in these buildings.[11]

Today's newly constructed office buildings become occupied almost immediately upon completion. The consequence of this tight sequence of events is that chemicals contained in the building furnishings, carpets, draperies, insulation and many other building components are not given adequate time to fully cure prior to the building's occupancy. These products naturally offgas or cure throughout their lifetime, but when new furnishings are placed in a new tightly constructed building, higher levels of volatile chemicals accumulate. These chemicals can be diluted by increased quantities of fresh air or by providing for a longer time lapse between building completion and occupancy.

In a sick building, the balance has been altered between clean, safe air and the number of airborne particles.[12] The likelihood of building-related health problems increases as the interior air quality deteriorates. The National Institute for Occupational Safety and Health (NIOSH) conducted over 500 indoor air investigations throughout the late 1970s and 1980s and came up with the following finding: The most important problem with these ill buildings is inadequate ventilation which allows an increase of potentially harmful particles in the air.[13] These airborne particles are called aerosols. Some particles are gaseous and naturally airborne, others become airborne when disturbed and others exist in solid, liquid or gaseous phases. However, nearly all particles can be dispersed through a building by aerosolization. Three conditions can lead to a potentially harmful environment: 1. source or reservoir for the particles which later become airborne; 2. a way to increase or amplify the number of airborne particles; 3. a way for the particles to disseminate or spread throughout a building.[14]

Reservoir

A reservoir is where microbes, dust mites, chemicals and other potential hazards reside without significant danger of destruction. Such reservoirs can be animals, birds, insects, damp ventilation systems, stagnant water (in unlikely areas such as plant containers), leftover food, soil, storage tanks, new furniture, sanitary landfill, smokestack, poor hygiene by building inhabitants or any other breakdown in proper building management. Moisture accumulation in ducts or under refrigeration units, around walls, under floor tiles or carpets, poorly ventilated rooms and high humidity all provide reservoirs for microbes and other live pests to increase.

Amplification

Amplification is a process which increases the number of harmful substances in a reservoir. Moisture laden environments allow microbes to multiply and produce foul odors which may be aerosolized and spread throughout the building. Some of these microbes (such as common molds) are relatively harmless to a healthy person but can multiply on the surface of damp environments, such as contaminated air conditioning ducts, and produce offensive odors or cause infectious harm to extra sensitive people. Certain other microbes (Legionella) grow favorably in stagnant water found in cooling towers and drain pans. These organisms can be very dangerous to anyone who breathes the contaminated air. Thus, if a location stays moist, it will eventually become populated by some form of microbial life.

Toxic chemicals will amplify in a room if allowed to leak from a container. The number of chemical particles in the room is not increased by this leak, but they are redistributed disproportionately from their former state in the canister to the air as a gas. This causes the fresh air to quickly become contaminated with fumes. If the fumes are not too unpleasant, people may ignore them until serious and sometimes even fatal complications become evident. If new furnishings are placed in a poorly ventilated room, they also will release numerous gaseous products into the air, and if the air is not replaced or diluted with fresh air, the gaseous products will become the predominant airborne particles.[15]

Dissemination

Dissemination is the process of transmitting particles throughout the building or from person to person. Once they have multiplied, particles spread more easily by normal air flow or anything else that travels within a building. For example, volatilized substances can be carried long distances through the air, pests (such as insects or mice) can be carriers of whatever adheres to them and humans pass particles when sneezing, preparing foods or conveying papers and other materials to their coworkers.

Types Of Airborne Problems

Many substances that cause harm to humans are carried as particles in the air; these are known as aerosols. An aerosol can be any airborne substance, but some are more easily aerosolized than others. If an aerosol contains whole or partial living cells, such as bacteria, it is a **bioaerosol**. Yet, aerosols may consist of anything from water droplets to complex chemicals. There are numerous particles in every building, and while nothing can be done to completely eliminate them, steps can be taken not to increase (amplify) their number and to keep them from being dispersed.

An average building may contain hundreds of different volatile organic compounds (VOCs). These chemicals tend to volatilize or offgas away from their source and permeate the air as a gas. Some are more easily volatilized than others. These compounds are derived from a variety of household products and furnishings. They may be solids or liquids, but they tend to release gaseous products into the air. The primary sources of chemical aerosols are **consumer products**, such as deodorizers, solvents and cleaning compounds; **building materials**, such as paints, glues, caulks, fabrics, furnishings, carpets, curtains, pest control chemicals and **personal activities** of building occupants, such as smoking, nail polish and remover, hair spray, dry cleaned clothes, perfumes and anything that evaporates.[16]

Tobacco smoke is known to contain many different volatile organic compounds.[17] Most VOCs are relatively safe but cause problems if the building gets an insufficient replacement of fresh air or if an office houses very sensitive individuals. Most people have a large tolerance to the VOCs found in common building furnishings, but prolonged exposure to low levels or any exposure by hypersensitive individuals can result in skin, respiratory or other symptoms/problems.

Formaldehyde is a chemical found in many building products. It can be a liquid or gas at room temperature, and it has a strong unique odor. A component of urea formaldehyde-based foam insulation, it is used to help bond plywood and particleboard and also as a treatment for facial tissues, toilet paper, paper towels and bags, water repellents, wrinkle resisters, stiffeners and many other consumer products. It may be emitted from permanent press clothing, carpet backings, adhesive binders, cosmetics and many other products used daily by nearly everyone. Formaldehyde can enter the body by inhalation, skin absorption and ingestion, but it has a high affinity for water, and thus attaches quickly to the moist mucus membranes of the upper respiratory tract.[18]

Pesticides are another potentially dangerous product. When properly used, most do not present a hazard unless in concentrated form[19] or in prolonged direct exposure. Nevertheless, human exposure should be minimized, especially during the initial pesticide treatment. Good ventilation should be ensured after pesticide treatment and during the ensuing routine human exposure.

The indoor environment may contain many potentially harmful gasses. **Nitrogen dioxide** and **nitric oxide** are produced from gas furnaces, stoves and tobacco smoke. **Carbon dioxide** is an odorless gas produced by the combustion of oil, gas, coal, wood, paper and other combustible organic products, and it is a natural byproduct of breathing. **Carbon monoxide** is an odorless gas produced by combustion. No significant quantities of carbon monoxide gas should be found indoors unless the building's fresh air intakes are located near a parking structure or loading dock where truck motors are left running while being unloaded or there are poorly vented fuel-burning motors or indoor combustion devices such as kerosene heaters. **Sulfur dioxide** is a colorless gas, produced by combustion, with a strong suffocating odor. It can irritate the skin, eyes and mucous membranes and cause restriction of the upper airways at higher concentrations. Sulfur dioxide does usually develop into an indoor problem unless there are science laboratories or unvented kerosene heaters present. Generally it is produced in the outside environment by power plants, oil refineries and other large industrial complexes. **Natural gas and propane gas** are commonly used for heating and may be detected if there is unburned gas escaping from leaky pipes or from improper combustion. **Methane gas** is a component of natural gas and may exist where there is a nearby swamp or rotting vegetation. Thus, if a building is constructed on or near swampy land, accommodations must be made for gas diffusion. The methane gas levels produced by swamps should not harm building occupants, but the gas odor easily could become offensive. Most of these gasses can be reduced significantly from the indoor air if all HVAC systems are properly vented to the outside and checked regularly.

Radon gas is released from rocks, soil and building materials and enters a building through the soil, groundfill materials or from well water.[20] In small buildings, the quantity of radon in the soil, rocks and backfill beneath and around the building is a far greater contributor to interior radon gas levels than poor ventilation. Radon gas also escapes from products inside a building because building materials (especially those built from earth or rock products), water and natural gas all release radon. Radon gas is found in most buildings, but the concentration is usually low. Few buildings have concentrations as high as those found in uranium and other underground mines. There probably is a greater chance that smokers would have increased risk in commercial buildings as well, but solid epidemiologic data are scant.

Building-related bioaerosol problems usually occur where there is excess moisture accumulation. To resolve the moisture problem, the source of the moisture must either be eliminated or accommodated by installing a permanent drain. Unseen moisture problems may result from a leaking roof, a blocked refrigeration unit drain, a leaky water line, excess condensation collecting on a water pipe or excess humidity caused by poor air exchange. Moisture and the resulting microbial growth will cause stagnant air or musty odors which are both unpleasant and harmful to building occupants.

Strategies For Dealing With Sick Or Diseased Buildings

In attempting to identify the source and eventually develop a plan to solve building complaints, there may be: 1. infected people problems, 2. sick building problems or 3. building-related disease problems. The first problem generally ends when those infected go home. The sick building problem, while seldom fatal, nevertheless can cause worker loss of morale and productivity, absenteeism and even employee turnover. A diseased building, however, needs to be thoroughly examined and cured because it houses at least one potentially dangerous health problem. People with a building-related illness may not recover after leaving the building, and they may even be permanently damaged by a dangerous micro-organism, such as Legionella, or by highly toxic or allergenic substances.

Two well documented building-related diseases are Legionnaires disease and Pontiac fever. Both these diseases are caused by the same bacterium, Legionella pneumophila, which grows in untreated water of air conditioning cooling towers, whirlpool spas, industrial coolants, steam turbine condensers, evaporative condensers, shower heads and any other water source. It is a potentially dangerous bacteria that infects both healthy and medically compromised hosts. If these diseases are discovered in a person occupying a building, an examination and immediate cleaning and disinfecting of water and water handling equipment must be initiated.

Inadequate ventilation is a major problem associated with building-related complaints. When ventilation is reduced or the circulated air contaminated, indoor air accumulates numerous particles. Likewise, inadequate building maintenance can lead to health problems as the number of particles increase significantly and the probability grows that they will be disseminated throughout a building or will be acquired by humans through inhalation, trauma, skin contact or ingestion.

There is evidence that poor maintenance procedures contribute to indoor air problems in 75 percent of all buildings inspected. These maintenance deficiencies also drive up energy costs by reducing HVAC system efficiency. Some causes of impaired air quality are clogged air filters, untreated cooling water that has fouled surfaces with moss and fungi, moisture and dirt that combine in ductwork and promote growth of microorganisms, unrepaired damper linkages, causing too much or too little air to circulate and control settings that have been accidentally upset by marginally trained maintenance workers.[21]

Improved product labeling and usage, component substitutions and personal actions such as curtailing smoking; reducing use of perfumes, hair sprays, indoor application of fingernail polish and remover and the use of other volatile substances can enhance the quality of indoor air. If smoking is allowed within the building, designated areas should be incorporated and each smoking area should have its own independent ventilation which excludes any smoke from recirculating over the remainder of the building.

Some reservoirs are more difficult to eliminate than others. For example, new furnishings can be selected for minimal offgassing (release of volatile particles) properties and can be allowed to offgas in a properly ventilated area prior to human exposure. The danger of caustic chemicals can be reduced by using tight lids and properly storing chemicals. Routine cleaning and maintenance reduces the probability that dust, bird nests, dust mites and other similar nuisances will become a problem, but moisture can be very hard to control. If the building is kept too dry, there will be complaints of dry throats while excess humidity (greater than 60%) can cause serious moisture problems that encourage pests of all types and create both foul odors and a potentially large aerosolization hazard.

A small mouse or bird in a building is often overlooked, but it is an indication that there is an unwanted opening or that an environment exists which draws pests of all types. Moisture accumulation commonly goes unchallenged, but it will slowly damage a building and allow harmful creatures to reside and amplify. An open lid on a cleaning solution may appear harmless but, depending on the solution, may cause either immediate or long term damage. A room that smells stuffy may be avoided but nevertheless signals a lack of air circulation which can slowly lead to serious problems. Collectively these seemingly insignificant issues may present formidable air quality problems.

A well selected building site is the first step toward preventing building-related problems.[22] Careful site selection and a sound building design will help prevent both moisture accumulation and stuffy air. Proper building design will incorporate sufficient fresh air by using exterior air intakes that are located away from foul air sources, but these intakes still must be routinely maintained.

Basement construction must be tight and free of cracks and holes to reduce radon penetration from the soil outside the building. The most prevalent sources of entry are the crawl space, cracks in concrete slabs, sump holes and cracks in basement floors. Airborne radon gas levels are sharply increased when the interior air already contains particles such as tobacco smoke to which it can easily attach. Particulate bound radon can be removed by filtration while free radon gas levels are reduced by ventilation.

Thorough and regular cleaning practice should be used to remove contaminants. Merely disguising the symptoms, so prevalent in hotel rooms previously occupied by smokers, by application of perfumed sprays and cleaning agents, can aggravate sick building problems. Chimneys and other exhaust systems should be kept free of leaks, bird nests and other blockages. Portable kerosene heaters and other internal combustion devices should be properly vented to the outside exhaust so gas buildup is avoided. The location of fresh air intakes should allow only fresh unpolluted air to be drawn into the building. These intakes should not be adjacent to loading docks and accompanying truck exhaust fumes, trash dumpsters and air exhaust outlets—especially those from rest rooms, kitchens and manufacturing processes.

Both corporate and building managers should give their highest priority to office workers' complaints regarding discomfort from a building's interior environment. Failing to do so may cause the workers to initiate legal proceedings. Several cases are noted by OSHA in the Federal Register regarding litigation involving many millions of dollars due to building-related health issues. Such issues are likely to become more prevalent as office buildings are constructed even more air-tight.[23] Lees-Haley suggests to first listen to the complaints. Next, the problem must be investigated and its source sought and eliminated if possible. Management must always demonstrate that the problem is being addressed in an open and timely manner. A common sense starting point is to inspect and search the interior and exterior of the building with the building engineer for air duct obstructions, ceiling stains and sources of foul odors. It is wise to provide employees with status reports on a building's environment through its environmental committee. In addition to building and environmental factors, personal mediating factors are associated with sick building syndrome. These include job duties, job dissatisfaction, job stress, physical and personal vulnerability and social support.[24]

According to two California-based attorneys, "most complaints about the indoor environment are the result of undesirable temperatures, humidity, air movement, odors and other sensory input such as lighting, noise and vibration. Many indoor air pollution problems can be solved by simply turning down the thermostat."[25] They also note that setting aside designated smoking areas may be of little help to reduce the level of pollutants in a building unless the area is separately ventilated.[26] A building owner may be liable for personal injury from indoor air pollution as the result of: 1. design and construction problems and 2. improper maintenance. The first source relates both to a building and its systems. Therefore, if a building is poorly designed, it may supply insufficient fresh clean air or, for example, if during installation of the HVAC a worker spills or leaves his/her lunch in the vents and encloses it, that material becomes a reservoir for microbes and odors. Two-thirds of all buildings are estimated to have some ventilation deficiency. Post-construction problems also may be a source of liability for property owners. This may result from improper servicing of HVAC systems. Even tenant-generated air quality problems may ultimately be a liability source for an owner who allows tenant improvements such as carpet installation and interior painting. The upshot is that financially weak tenants may avoid lease payments by claiming they have been deprived of their right to quiet enjoyment of the leased premises.[27]

As stated earlier, OSHA is currently considering a new set of standards for the essential steps building owners and managers can take to prevent indoor air problems.[28] These standards will require that all aspects of indoor air quality be monitored and documented. Someone must be designated, trained and given the task of ensuring that HVAC systems are maintained and verified to be operating properly. The standards, if adopted, definitely will increase the cost of constructing and operating a building. Since the health problems and legal costs associated with poor indoor air quality will likely worsen in the absence of legally binding standards, it is in a building owner's best interests to initiate a prevention program as soon as possible. The detailed OSHA standards may provide a useful way to maintain a healthy workplace environment and ward off tenant complaints and possible lawsuits. Moreover, the required documentation will protect the owners if an air quality problem occurs. These standards may not be adopted as currently written and should be modified to distinguish between buildings with and without indoor air quality problems.

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OPPORTUNITIES FOR U.S. INVESTORS TO ACQUIRE U.S. REAL ESTATE ASSETS FROM JAPANESE OWNERS AND LENDERS

by Todd Moody, Kenneth G. Smith and Dale Strickland

In recent years, U.S. pension funds, real estate investment trusts, corporations, credit companies, foreign buyers and opportunity funds have allocated billions of dollars to acquire distressed U.S. real estate assets. The principal sellers have been the Resolution Trust Corporation, individual owners, life insurance companies and banks which have restructured and sold portfolios of performing and nonperforming real estate assets. With the RTC completing its asset sales and most banks and insurers concluding their restructuring programs, we have entered a period characterized by fewer opportunities for asset acquisition. With many well-capitalized investors still in the market, the competition for available assets has intensified. Given this environment, investors are looking for new sources of assets, including Japanese-owned U.S. properties.

Many Japanese owners, e.g., trading, real estate, construction, insurance and investment companies, are actively marketing their U.S. properties, along with many Japanese banks and other lenders. At the end of 1994, the Japanese had sold $2.2 billion of assets, had contracted to sell $1.4 billion and were actively marketing another $2.8 billion. This brings the total disinvestment activity to $6.4 billion, according to an analysis by the E&Y Kenneth Leventhal Real Estate Group (E&Y KL Group). (See Exhibit I)

Survey

According to a survey (Japanese Executive Survey: Strategies for U.S. Real Estate) conducted in Tokyo by the E&Y KL Group in mid-1995, most Japanese owners and lenders expect to complete asset sales during the next two to three years. Participating in the survey were senior executives of leading Japanese banks and insurance, leasing or finance companies, as well as real estate or construction companies which have financed or invested in U.S. real estate.

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EXHIBIT I

1994 Japanese Disinvestment Activity

By Disinvestment Category
($ in Billions)

Source: E&Y Kenneth Leventhal Real Estate Group

Nearly 45 percent of the Japanese owners and lenders survey respondents were currently in the process of marketing some of their U.S. real estate assets. Another 28 percent expected to sell assets in 1996 or 1997, assuming the real estate markets continue to recover and property values increase. The remaining 27 percent anticipated holding their assets as long-term investments. (See Exhibit II)

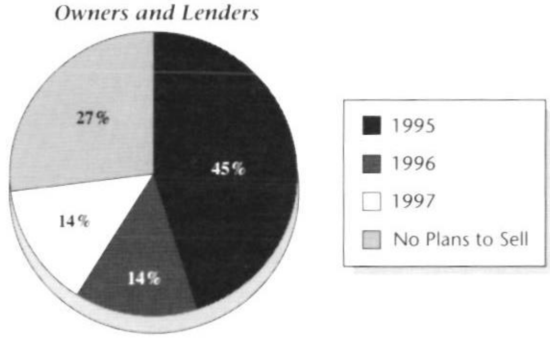
All the lenders and approximately 40 percent of the owners participating in the survey expected Japanese sales to slightly increase in 1995. About 27 percent of the owners looked for a significant increase in sales, while the remaining owners expected sales to remain flat. Owners and lenders generally said they were most likely to sell luxury hotel, resort properties and office buildings. Strongest sales activity was expected in California, New York and Hawaii where the majority of Japanese investments in the U.S. are located. Preliminary survey results for 1995 Japanese sales activity in the U.S. indicate a 15-20 percent increase over 1994.

EXHIBIT II

Survey of Japanese Investors in U.S. Real Estate

"Does your company intend to sell U.S. assets and, if so, when?"

Owners and Lenders

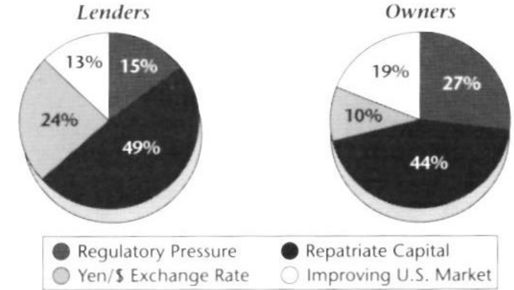


Percent of Respondents
Source: E&Y Kenneth Leventhal Real Estate Group

EXHIBIT III

Survey of Japanese Investors in U.S. Real Estate

"What do you think are the main factors that are encouraging Japanese investors and lenders to sell their U.S. real estate assets?"



Percent of Respondents by Category
Source: E&Y Kenneth Leventhal Real Estate Group

Investment Report

Regarding the increase in Japanese sales activity, the survey was consistent with the E&Y KL Group's 10th annual report on Japanese investment in U.S. real estate (*1994 Japanese Investment in U.S. Real Estate*). The report, published in July 1994 , analyzed sales results for that year and forecast sales activity for 1995. According to the report, Japanese owners and lenders were likely to sell between $5 billion and $10 billion of U.S. assets during 1995.

Reasons

More than half the lenders and owners surveyed were primarily selling assets to repatriate capital to Japan. In addition, Japanese banks and other lenders need to assume a more active role in addressing their nonperforming loan problems. Japanese construction companies, the largest investors in U.S. trophy properties, are disposing of their assets to repatriate capital to Japan and focus on their core business opportunities (e.g., rebuilding infrastructure destroyed or badly damaged by the Kobe earthquake along with new public works projects). (See Exhibit III)

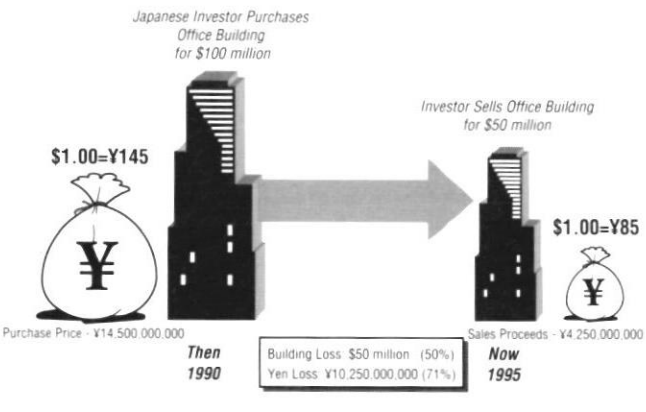
Survey participants indicated that the weak dollar created favorable conditions for selling assets. Because of the dollar's decline against the yen, owners who originally financed their U.S. investments in dollars have realized lower yen-denominated losses in selling their properties. By selling the Japanese can effectively reduce their losses from 50 percent (in dollars) to as low as 30 percent (in yen). (See Exhibit IVa)

Perception

The Japanese are disposing of their real estate assets despite a perception that U.S. real estate markets and property values have not fully recovered. According to the survey, about 60 percent of

EXHIBIT IVa

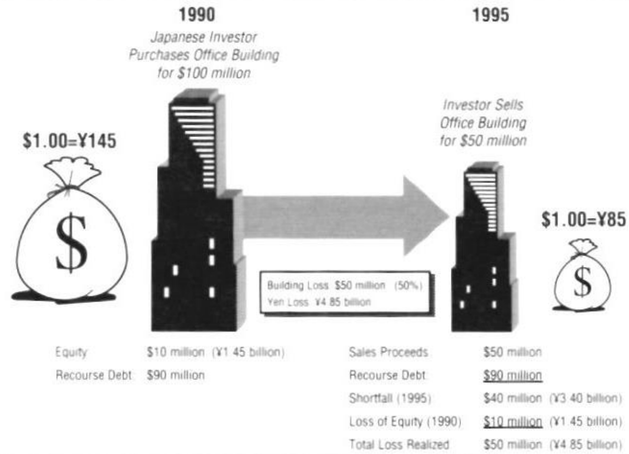
Japanese Disinvestment of U.S. Real Estate
Yen-Based Transaction



Source: E&Y Kenneth Leventhal Real Estate Group

EXHIBIT IVb

Japanese Disinvestment of U.S. Real Estate
Dollar-Based Transaction



Source: E&Y Kenneth Leventhal Real Estate Group

the lenders and half the owners do not expect such a recovery until 1996 or 1997.

Moreover, rather than waiting for U.S. real estate markets to recover, Japanese sellers believe they should look to the window of opportunity created by the strong yen and dispose of their assets now. Reinforcing this is the changed attitude of the Japanese who no longer feel stigmatized at recovering less than their original investment. According to the survey, about 45 percent of the lenders and owners would consider selling their U.S. real estate investments if they could recover $.60 for every $1 invested. About one-third of the lenders and owners would think of selling only if they could recover $.70 or $.80 on the dollar. The 1995 survey reflects somewhat lower expectations for recovery. When the same survey was conducted in 1994, only about 22 percent of the Japanese lenders and owners were willing to sell if their recovery was less than 70 percent of the original cost.

Motivations

As the survey suggests, now is an ideal time for U.S. investors to acquire properties from the Japanese. Before approaching Japanese owners or lenders and attempting to negotiate deals, U.S. investors need to be well prepared. They should understand the evolution of Japanese investment in U.S. real estate, the motivations and expectations of the Japanese in owning U.S. properties and their strategies for holding or selling these assets.

While 10 years ago the Japanese were considered novices in the U.S. real estate market, they now are seasoned veterans with total investments of more than $77 billion. Their history in the U.S. market can be divided into two phases: investment and disinvestment. From 1985 to 1992, the Japanese were major investors in U.S. real estate, investing a record $16.54 billion in 1988. Subsequently, the U.S. economy fell into a recession, U.S. property values declined and Japan's bubble-like economy collapsed. In 1992, Japanese investment in U.S. real estate was only $810 million. (See Exhibit IVb)

In 1993, the Japanese entered the disinvestment phase. By the end of that watershed year, they had:

- sold $2.6 billion of properties,
- contracted to sell another $800 million of properties,
- deeded $1.4 billion of properties back to lenders,
- restructured $12.7 billion of problem assets.

While the Japanese sold, contracted to sell or restructured $17.5 billion of assets, their new investments totaled only $710 million. During 1994, the Japanese finished restructuring the bulk of their troubled assets and focused on sales of assets they had targeted for disinvestment.

Strategies

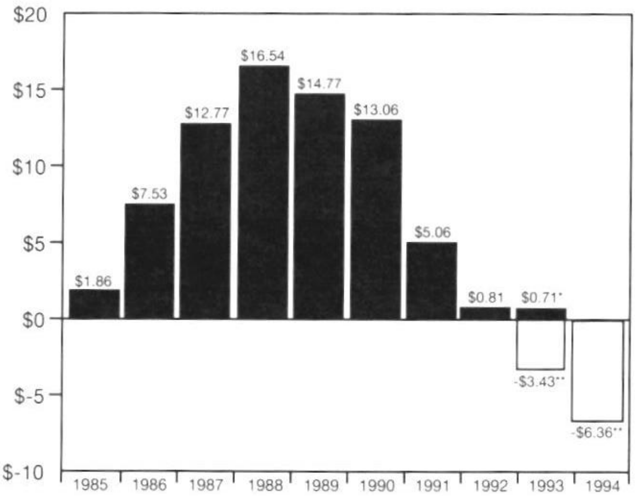
In managing their U.S. real estate assets, Japanese owners and lenders have followed three basic strategies:

- hold and wait;
- sell and liquidate; or
- hold and sell (hybrid).

The particular strategy adopted by individual owners and lenders is determined by a number of considerations, including the economic outlook and property market conditions in both Japan and the United States, the need to repatriate capital, the strength of the yen and the prices the Japanese expect to receive for U.S. properties.

EXHIBIT V

Japanese Investment in U.S. Real Estate
($ in Billions)



*** Investment, ** Disinvestment**
Source: E&Y Kenneth Leventhal Real Estate Group

Economy

Japan's economy has been growing at its slowest rate in decades. Even the country's unemployment rate, low by world standards, was at a record high of 3.2 percent in Fall 1995. The country's banks are burdened with as much as $500 billion in bad loans, a by-product of their financing speculative property investments during the bubble economy. In the third quarter of 1995, Moody's Investors Service downgraded the credit ratings of 50 Japanese banks, thereby increasing their costs of capital. That same month, the government rescued two failing credit unions, revealing the vulnerability of other financial institutions.

In an attempt to stimulate the economy, the government took a series of actions. The Bank of Japan cut its discount rate to a record low 0.5 percent. Also, in a series of pump-priming measures, the government boosted public spending by a total of $450 billion over the past three years. Billions more in public expenditures will be needed to repair the damages from the Kobe earthquake and to complete a major retrofitting of the infrastructure throughout Japan. But even stronger measures may be called for, including additional public spending, tax cuts, opening the economy to more foreign investment and, most importantly, restructuring Japan's troubled banking system.

Financial System

Reflecting a long overdue change in policy, the government began to address the banking problem. Sumitomo Bank announced a proposed $8 billion writedown in bad loans, resulting in a $2.8 billion pretax loss for the fiscal year ended March 31, 1995. Sumitomo's loss was the first reported by a major Japanese bank since World War II. Until Sumitomo's action, Japanese banks had always covered losses by selling off their stock portfolios as the end of the fiscal year approached. Previously, the government had pressured banks not to report tax-deductible losses because it feared undermining public confidence in the financial system. Sumitomo's announcement, the most candid admission yet of loan-quality problems in Japan, was presumably made after close consultation with the Finance Ministry and Bank of Japan. This may signal a change in governmental policy which enables banks to disclose such losses. In fact, most analysts expect at least 3 of Japan's 21 largest banks to report losses in the fiscal year ending March 31, 1996. Few banks have the capital to withstand massive writedowns in a single fiscal year, although government support would enable banks to gradually implement programs for taking writedowns, reporting losses and disposing of problem loans. Last June, the Finance Ministry reported that the Japanese banking system had almost $500 billion in nonperforming and restructured loans. Some outside analysts recently have suggested that the real amount of troubled loans is closer to $1 trillion.

U.S. Market

The economic and regulatory climate in Japan has affected Japanese owners and lenders in the United States. Under mounting pressures to repatriate capital, Japanese banks and other lenders have been increasingly aggressive in selling their U.S. real estate assets accounting for $3.7 billion or 58 percent of 1994's disinvestment activity. In 1995, the banks continued to be very active, selling properties individually or in bulk through a competitive bidding process that has proved highly successful.

Outlook

Japanese owners and lenders will continue to sell assets over the next several years at a rate of about $5 to $10 billion per year.

Several reasons are as follows:

- the need to repatriate capital to Japan,
- uncertainty over the continuing volatility of the yen,
- the continuing recovery of U.S. real estate markets,
- increased demand from U.S. buyers for Japanese-owned properties,
- the opportunity to sell properties at higher prices than at the bottom of the U.S. real estate cycle.

Japanese owners and lenders must carefully consider how long the window of opportunity for selling assets will remain open. The continued increase in U.S. property values has been coupled with a continued decline in yields. If this trend persists, some real estate investors may elect to withdraw from the market and seek higher yields in other types of investments, leaving fewer buyers in the market.

For their part, U.S. investors have opportunities to buy three types of assets from the Japanese: properties, loans secured by real estate and real estate loans in which Japanese banks have participating interests. There is strong competition for Japanese assets, and investors may need to move quickly. In the market for Japanese-owned U.S. real estate, this is an opportune time for the Japanese to sell and for U.S. investors to buy.

WHEN IS A TAXPAYER A REAL ESTATE DEALER?

by J. Russell Hardin and Morris H. Stocks

With the anticipated reduction in the capital gains tax making headway in Congress, the correct classification of real estate transactions once again is being regarded with renewed interest and importance. When the Internal Revenue Service determines that a taxpayer is a real estate dealer and not an investor, the income generated from the taxpayer's real estate transactions is considered as ordinary income rather than capital gain income. This tax issue has been litigated numerous times throughout recent tax history. Chief Judge Brown previously stated that the problem of real estate capital gains vs. ordinary income is "old, familiar, recurring, vexing and ofttimes elusive."[1]

The issue remains complicated since neither the Internal Revenue Code nor the Treasury regulations include an authoritative list of criteria to differentiate the real estate dealer from an investor. Consequently, the various courts have had to generate their own list of identifying factors to make a proper determination based on the facts presented. Since numerous cases on the same tax issue have produced inconsistent decisions, this suggests that a specific factor or combination of factors does not always control such decisions. In *United States v. Winthrop,* the judge said that the factors identified in the law do not separate "sellers garlanded with capital gains from those beflowered in the garden of ordinary income."[2]

Without the existence of an authoritative list of differentiating factors, the various court opinions must be looked at for critical criteria. This article presents a list of those factors used by the courts to distinguish a real estate dealer from an investor. The information it provides should prove useful in tax planning for real estate transactions.

Legislative History Of Capital Gains Taxation

When the language of a federal statute is not clear and the intent of Congress needs to be determined, Congress plays a decisive role in interpreting tax laws.[3] The taxation of profits on the sale of real property and other capital assets in the year of realization originated with the Revenue Act of 1864. However, the capital gains provision was first introduced with the 1921 Revenue Act, and it has remained in the Internal Revenue Code although modified many times. The purpose of the capital gains provision was to save the taxpayer/investor from excessive taxes on profits derived from the sale of capital assets where the profit was

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incremented over a period of time. The first capital gains provision provided for reduced taxes of assets held more than two years. Under prior law, capital gains were taxed as ordinary income.[4]

The 1939 Code, as amended by the Revenue Act of 1939, continued to provide for preferential tax treatment of capital gains. However, a significant provision of the 1939 Act specified that stock in trade or inventory, property held primarily for sale to customers in the ordinary course of a trade, or business and depreciable property used in a trade or business are not considered as capital assets for purposes of taxation. The 1939 Act also set the holding period for long-term capital gains at 18 months.[5]

There were adjustments to the capital gains tax provisions between 1939 and 1976, but the basic law remained the same throughout that period. The Tax Reform Act of 1976 established the capital gains taxation rules that remained in effect until the repeal of preferential treatment by the Tax Reform Act of 1986. The 1976 Act set a $3,000 limit on deduction of capital losses against ordinary income. The act also set the holding period for long-term capital gain treatment at 12 months and established the 60 percent deduction for long-term capital gains of non-corporate taxpayers. The 1986 Act effectively repealed preferential treatment of long-term capital gains except for setting the maximum tax rate at 28 percent for non-corporate taxpayers. The original intent of the capital gain holding period provisions was to encourage taxpayers to invest in long-term investments.[6]

Current Capital Gains Tax Law

Sections 1201–1288 of the 1986 Internal Revenue Code deal with property transactions and capital gains and losses. The code sections 1221, 1222, 1223, and 1237 are mentioned most often in court decisions relative to transactions involving real estate and the capital gain/ordinary income question.

Section 1221 defines a capital asset as property held by the taxpayer, but it differentiates capital assets from depreciable property or real property used in trade or business and from stock in trade or inventory. Section 1222 essentially defines long-term vs. short-term and other related capital gains terms. A long-term capital gain results from the sale or exchange of property held for more than one year. Section 1223 further describes the holding period for capital assets. It also includes a discussion of the holding period for special situations such as involuntary conversions and sale of a personal residence.

Section 1237 deals specifically with subdivided real property. The topic of subdivided real estate has been the basis for many court cases. Section 1237 can be very important, because it provides an exemption from ordinary income taxation for certain subdivided real estate. Section 1237(a) states that just because a taxpayer, other than a corporation, subdivides real estate, the resulting sales do not automatically generate ordinary income. The rules for this exception are found in Section 1237(a) paragraphs 1, 2, and 3. Paragraph (1) of subsection (a) states that no part of the property may have been previously held primarily for sale to customers in the ordinary course of business. Paragraph (1) goes on to say that the taxpayer must not have held any other realty for sale to customers in the ordinary course of business at any time during the year of sale. In addition, paragraph (2) states that the taxpayer must not have made substantial improvements to the property so that the value of the property was substantially enhanced. Paragraph (2) also says that improvements made by a family member or other related party, by a lessee, or by a governmental entity shall be treated as if they had been made by the taxpayer. Paragraph (3) concludes subsection (a) by stating that the property must have been held by the taxpayer for at least five years unless acquired by inheritance or devise.

With reference to the foregoing code sections, the various courts have indicated that three questions must be answered to resolve the question of capital gain—ordinary income on real estate transactions: "1. What was the taxpayer's trade or business? 2. Did the taxpayer hold the property primarily for sale in that business? 3. Were the sales ordinary in the course of business?"[7] Once these questions are answered, capital gain or ordinary income also must be addressed. In answering these questions, the courts have considered a number of specific factors to determine whether the taxpayer sold real property in the ordinary course of business or as an investor. One approach, macro-case analysis, has been used to identify the factors that are critical to deciding a given case.

Research Methodology

In macro-case analysis, a number of cases are analyzed over a time period for a tax topic. The cases are grouped by whether they result in positive or negative consequences to the taxpayer. Next, a preliminary set of cases are analyzed to identify the apparent relevant factors or those factors that are mentioned frequently in the cases. Next, the factors are analyzed to determine which are critical to winning or losing a court case. Factors identified in this way can provide a pattern of information that is useful in tax planning.[8]

The critical factors for the capital gain/ordinary income question in real estate transactions were determined by first selecting 60 cases at random from

1970-1992. These cases were then divided into two samples of 30, assigning numbers to each and using a random number table for the division. The cases in the first sample (listed in Appendix 1) were analyzed and the relevant factors in each were noted. Nine relevant factors were identified as a result of this process including:

1. The nature and purpose the property was acquired and held (intent).
2. The extent and nature of the taxpayer's efforts to sell the property.
3. The number, extent, continuity and substantiality of the sales.
4. The extent of subdividing, developing and improving the property to increase sales.
5. The use of a business office for the sale of the property.
6. The character and degree of supervision or control exercised by the taxpayer over the representative selling the property.
7. The time and effort the taxpayer habitually devoted to the sale of the property.
8. The duration of ownership (proximity of the sale to the purchase).
9. The extent of advertising and solicitation by the taxpayer or others on his/her behalf.

The second sample of 30 cases (listed in Appendix 2) was then analyzed to verify the list of factors developed from the first sample. The same nine factors were identified from Sample Two. The cases in the second sample were further divided into two subgroups. Subgroup One consisted of cases in which the taxpayer was considered by the courts to be a real estate dealer and Subgroup Two consisted of cases in which the taxpayer was determined to be an investor in real estate rather than a dealer. In 11 of the cases (Subgroup Two) the taxpayer was allowed the preferential capital gains treatment. In the other 19 cases (Subgroup One) the taxpayer was held to be a real estate dealer with ordinary income.

Each case in the two subgroups was analyzed to identify which factors the courts held important in determining the issue for that particular case. Scores were assigned to each factor according to the following coding scheme:

+1 a factor in favor of the taxpayer
−1 a factor against the taxpayer
0 if the factor was deemed irrelevant by the court or the factor was not mentioned by the court.

The scores for each subgroup were summed and divided by the number of cases in the subgroup to arrive at an average score for each factor.[9] A factor in Subgroup One with a high negative score indicates a factor that will more than likely work against the taxpayer by helping to define the taxpayer as a real estate dealer when capital gains treatment was sought. A factor in Subgroup Two with a high positive score indicates a factor that will usually work for the taxpayer in defining the taxpayer as an investor eligible for capital gains treatment.

Research Results

Exhibit 1 provides a summary of the scores assigned to each factor for each subgroup. While the courts have consistently mentioned the nine factors listed in the previous section, only a few of these have been critical to the court's decision in most cases. The pivotal issue, consistently, has been the purpose for which the taxpayer held the property *immediately prior* to sale. This means that property purchased originally as an investment may be considered, by the courts, as having been converted to inventory. Alternatively, property purchased originally for sale to customers in the ordinary course of business may have been, in the opinion of the court, converted to investment property.

Another critical factor in identifying a taxpayer as a dealer appears to be the extent to which the property was subdivided, developed and improved in order to increase sales. If the taxpayer subdivides real property or makes substantial improvements to the property so that its value is greatly enhanced, then the taxpayer will most likely be deemed a real estate dealer. The courts also have frequently noted the number, extent, continuity and substantiality of sales. The greater the number of real estate sales the taxpayer makes, the more likely the taxpayer will be designated a real estate dealer.

Several factors identified in the cases do not appear important in classifying a taxpayer as a real estate dealer. For example, the degree of supervision over the representative selling the property was only used in one case out of 30. Also of minor importance was whether or not a business office was used to sell the property.

EXHIBIT 1

Relative Scores of the Nine Factors

	Taxable as Ordinary Income	Capital Gain
1. Purpose and intent	−1.000	+.909
2. Extent of efforts to sell	− .368	+.818
3. Substantiality of sales	− .526	+.545
4. Extent of subdividing	− .737	+.727
5. Use of a business office	− .053	+.182
6. Supervision over sales rep.	− .000	+.091
7. Time and effort devoted	− .158	+.455
8. Duration of ownership	− .158	+.727
9. Extent of advertising	− .316	+.636

Conversely, seven of the nine factors appear to be important or fairly important in designating the taxpayer as an investor with the resulting capital gains treatment. The purpose or intent (Factor 1), the extent of efforts to sell (Factor 2), the extent of subdividing (Factor 4) and the duration of ownership (Factor 8) were all important in the cases where the taxpayer was allowed capital gains treatment. In addition, the substantiality of sales (Factor 3) and the extent of advertising and solicitation (Factor 9) appear to have lesser importance. The taxpayer awarded capital gain treatment had put forth very little effort to sell with little or no advertising. Finally, the time and effort the taxpayer devoted to selling the property was important (Factor 7). Again, the taxpayer had put forth little time and effort or had engaged a licensed real estate broker to sell the property.

Tax Planning Implications

There are at least three reasons why tax planners and tax practitioners should continue to help their clients properly structure real estate transactions. The first reason is because there is a real possibility that Congress will enact some sort of capital gains tax break in the near future. According to a recent *Journal of Accountancy* article, the probability that Congress will pass a capital gains tax reduction appears to be quite high.[10] If enacted, the Republican's Contract with America would allow a non-corporate taxpayer to exclude 50 percent of their capital gains.

This potential 50 percent tax savings makes the real estate investor vs. real estate dealer question even more important than it is under the current tax law. However, even under current tax law, the distinction remains important. Currently, the maximum tax rate on capital gains of non-corporate taxpayers is 28 percent while the maximum tax rate on ordinary income is 39.6 percent. The difference in tax liability can be substantial when a net long-term capital gain is reclassified by the IRS or courts as ordinary income. The exact difference will obviously depend on the taxpayer's particular tax situation. Two examples, however, demonstrate the potential tax savings under the current tax law when real estate transactions are deemed the result of investment rather than ordinary income (See Exhibit 2). The single taxpayer in Example 1 would, under current tax law, save $4,000 in federal income taxes. The married couple in Example 2 would reduce their federal tax burden by more than $11,000. Obviously, even without the enactment of the proposed capital gains tax cut, proper planning in real estate transactions can result in significant tax savings.

EXHIBIT 2

Potential Tax Savings from Net Long-Term Capital Gains Tax Treatment

Example 1 –	A single taxpayer with $175,000 of taxable income. Taxable income includes a $50,000 net long-term capital gain.	
	Real estate dealer ordinary income tax liability	$52,371*
	Real estate investor net capital gains alternative tax liability	48,371
	Tax savings	4,000
Example 2 –	A married taxpayer filing jointly with $350,000 of taxable income. Taxable income includes a $100,000 net long-term capital gain.	
	Real estate dealer ordinary income tax liability	$114,289*
	Real estate investor net capital gains alternative tax liability	102,923
	Tax savings	11,366

*Tax liability in each example determined using 1995 enacted tax rates.

The third reason tax planners should continue to help their clients properly structure real estate transactions is that real estate prices have fallen dramatically in some parts of the country. "Real estate values have fallen by as much as 30 percent throughout New England and by 50 percent in parts of the South and Southwest."[11] A taxpayer living in one of these areas could structure real estate sales so that the taxpayer could *purposefully* be classified as a real estate dealer. Thus, a loss on the sale would be deductible in full as an ordinary loss in the year of sale rather than being subject to the $3,000 per year limitation on offsetting capital losses against other income. By demonstrating the intent to be a dealer and/or by subdividing and improving the property, a taxpayer could take advantage of substantial capital losses.

Finally, a word of caution to taxpayers who are actually full-time realtors. The courts have frequently said that a dealer can also own property as an investor. "However, a dealer is subject to a greater burden of proof than a nondealer. Segregation of the property on his books and records is important for the dealer in obtaining his capital gain treatment."[12]

Conclusion

The nine factors enumerated by the courts over the last 22 years have remained basically the same. This suggests that the tax planner or taxpayer may place a reasonable degree of reliance on the continued use of these factors. In approximately one-third of the cases analyzed, the taxpayer was successful in being granted capital gains treatment by the court.

The most important factor was the intent of the taxpayer in holding the property immediately before the sale. The other two factors of primary importance were the extent of subdividing or improving and the extent of efforts to sell the property. These factors should be kept in mind when planning the disposal of real estate. In addition, when representing a client in litigation concerning the real estate dealer/investor question, it may prove useful to understand the factors that the various courts have identified as critical in the decision. Finally, the tax planner or taxpayer should remember that the burden of proof in these matters is on the taxpayer. The Supreme Court has "admonished that courts should narrowly construe the definition of a capital asset"[13] because the preferential treatment accorded capital gains has always been an exception to the ordinary income provision found in Section 64 of the Internal Revenue Code.

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APPENDIX 1

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BUILDING AND FINANCING A LOW-INCOME HOUSING PROJECT

by Lawrence F. Sherman and Bradley Smith

Low-income housing credit, under Section 42 of the Internal Revenue Code, was developed by Congress and presented in the Tax Reform Act of 1986. The IRS Code provides tax credits for acquisition, rehabilitation and construction of low-income housing. The Low-Income Housing Tax Credit Program allows investors, typically limited partnerships, a dollar-for-dollar tax credit for qualifying low-income housing projects. This tax credit is determined by the applicable percentage of the qualified basis of each low-income housing project and reduces tax payments over a ten year period.

Overview Of Rules

IRS Code 42 provides tax credits for projects which follow the guidelines for low-income housing projects. The tax credits are taken annually over a ten year period and are based on calculations of the applicable percentage. This percentage represents 70% present value credit for certain new buildings, 70% present value of rehabilitating buildings and a 30% present value credit for the acquisition of existing buildings. Only a 30% tax credit is available for projects receiving other additional federal subsidies.

The true amount of credit depends on a number of other factors including: the amount invested in the low-income housing project, the portion of low-income housing units, whether the project is a new building or an existing building, whether federally subsidized financing was used and the set-aside percentage of credit provided by the state. It is important to note that each state has credit limitations which may be allocated to the state and that state approval is often the hardest obstacle in the building of low-income housing. State approval in many states has become easier to obtain, but in a number of states it is a major stumbling block to obtain low-income credit. This article considers this process in the state of California as an example of how the low-income tax credit works.

California Tax Credit Committee

Specifically, the tax credit is computed by applying the applicable credit percentage to the qualified basis of the low-income building. The qualified basis is the portion of the eligible basis of the low-income units in the building. Qualifications include: a minimum percentage of units occupied by low-income tenants and rent restrictions based on

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unit size and area median income. Also, the project must meet the low-income rental requirements for at least 15 years, but more likely for 30 years. Failure to uphold these requirements results in a recapture of the administered tax credits.

Rental Requirements

The low-income housing tax credit is available to projects which qualify under one of the two tests of the minimum set-aside requirements. The two tests are referred to as the 20/50 test and the 40/60 test; minimum set-aside tests. Under the 20/50 test, 20% or more of the project's residential units must be rent restricted and occupied by families with incomes equal to 50% or less of the area's median gross income, adjusted for family size. Applying the 40/60 test, 40% or more of the units are rent restricted and the families of those units must have incomes equal to 60% or less of the area's median gross income, adjusted for family size. Once the project is placed into service, the owner of the project must elect, irrevocably, the minimum set-aside test that will apply to the project. This percentage must be achieved before the end of the credit period's first year.

Beginning in 1990, to determine the income used for calculating the maximum unit rent, each unit is presumed to be occupied by a specified number of persons based on unit size, regardless of the actual number of occupants. Ultimately, a unit will be considered rent-restricted if the gross rent charged for the unit does not exceed 30% of the income limitation applicable to the imputed number of occupants.

Determination of area median gross income is to be made under Section 8 of the United States Housing Act of 1937. Adjustment to area median gross income is to be made for family size under rules similar to the adjustments under Section 8 of the United States Housing Act of 1937.

Also, the project must not only be rent-restricted, but must be occupied by a qualifying low-income family throughout the 15-year period. Even if the occupant's income increases by as much as 40% of the applicable income limitation, the unit will continue to qualify as a low-income unit.

Rent restrictions include gross rent which covers the tenant's utilities costs (other than telephone). Also, rental assistance payments made by governmental agencies on behalf of tenants are not included as part of gross rent. Once the project owner decides on the set-aside requirement that he will meet, the election is irrevocable and must be put into action within the first year after the project is completed.

Projects must observe the unit size when determining the maximum unit rent. For example, a unit without a separate bedroom is presumed occupied by one person, while a unit with one or more bedrooms is presumed occupied by 1.5 persons for each separate bedroom. Thus, under the income limitation, a unit will be considered rent-restricted if the gross rent charged for the unit does not exceed 30% of the income limitation applicable to the imputed number of occupants.

Eligible Basis

In general, the eligible basis of a qualified low-income building, which is the maximum amount upon which the tax credit is based, is equal to the adjusted basis of the building, with certain modifications, at the completion of the first taxable year the building is placed in service or, at the election of the taxpayer, the next succeeding taxable year. Land cost is not included from the eligible basis.

Amenities such as stoves, refrigerators, air conditioning units and other equivalents provided in low-income housing units, are included in the eligible basis if the cost of such amenities are comparable to the costs of the amenities in any non low-income housing units.

Also, common areas such as swimming pools, recreational facilities and parking areas are included in the eligible basis provided there are no separate fees for their use and the facilities are made available to all tenants on a comparable basis. The adjusted basis of a low-income building is also reduced by other subsidy items in determining the eligible basis.

In addition, the computation of eligible basis is dependent upon whether the low-income housing consists of an existing building or new construction. The eligible basis for a new building is the adjusted basis of the new building as of the close of the first taxable year of the credit period. This allows for costs incurred after the building is placed in service. To qualify for an increase in eligible basis the project must be in a high-cost and difficult development area. These projects are reviewed for a 30% increase in tax credit. To qualify, the project must be located in either a qualified census tract or a difficult development area.

A qualified census tract is defined as any census tract where 50% or more of the households have an income which is less than 60% of the area's median gross income. Also, the project cannot be in an area where 20% or more of the metropolitan population is included.

Credit Computation

The amount of available tax credit is computed using one of two percentages, the 70% credit and the 30% credit. Costs incurred in the construction of a new building and in the considerable rehabilitation of an existing building are eligible for the 70% credit when the building is not federally subsidized. The annual credit is available for 10 years in an amount that will yield a present value of 70% of the qualified basis of the building over the 10-year period.

For the acquisition costs of an existing building and the construction costs of a new building using federally subsidized financing, an annual credit is available for ten years, equal to an amount that yields a present value of 30% of the qualified basis of the low-income building over the 10-year credit period.

Obtaining The Credit

The credit is taken over a 10-year period, known as the credit period, which begins with the taxable year in which the building is placed in service or, at the election of the taxpayer, the succeeding taxable year. The taxpayer can defer the credit period in order to incur additional costs that will qualify for the credit or to have more time to increase the low-income occupancy rate.

The credit also is based on the taxpayer entering into an extended use commitment with the state or local credit granting agency. This commitment must extend the low-income occupancy of the project for a minimum of 15 additional years beyond the close of the 15-year compliance period. To obtain low-income housing credits, a project developer must file IRS Form 8609 with the state and local housing agency. The housing agency may accept or reject an application based on factors such as local need and alternate available means of project financing to equity based tax credit dollars. Form 8609 also serves as an annual statement to the IRS that the project's building or buildings are complying with the low-income set-aside and restricted rent requirements of Section 42.

Low-Income Tax Credit Market

For a number of years there has been a developing market for the sale of low-income tax credit. As a tax credit, the benefit is a direct reduction from individual taxes. The sale of tax credit programs primarily has utilized the limited partnership structure, and the partnerships are in general nonpublic partnerships. Shares in the partnerships are many times sold through seminars and through financial planners. With the availability of the limited liability company, there may be an opportunity to provide a vehicle in which to sell the low-income credits that meets the requirements of retirement plans and certain investors.

In that case, shares are sold rather than partnership units, and there may be less problem with the abuses that previously occurred due to the partnership type of organization. However, state law is evolving in this area, and the growth in popularity of the limited liability company is uncertain. The marketplace is a unique niche market and, while the market has been growing for Section 42 Low-Income Housing Credit, it is sufficiently technical with many specialized problems that have prevented growth, plus the partnerships are generally small. Syndicators that arrange the low-income housing credit programs often specialize and sell the tax credits through multiple programs. To attract clients or customers, they often develop unique marketing programs and acquire customers through word of mouth and past reputation. Tax credits are sold to individuals who are in middle to high tax brackets.

Conclusion

The Low-Income Housing Tax Credit Program is a success for developers, investors and the low-income population which needs decent housing. It is anticipated that the success should cause the program to expand in future years. The tax credits enable developers to make a reasonable profit from projects, and investors who provide the capital receive valuable tax benefits. The program ensures that affordable housing projects will be developed in areas where they are most needed. Overall, the Low-Income Housing Tax Credit Program is a win/win situation for developers, investors and the low-income population.

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AN ANALYSIS OF ITALIAN PROPERTY MARKETS

by Alberto M. Lunghini, Jr., CRE

Editor's Note:
In recent years, the number of countries represented in The Counselor's membership has increased significantly. The organization now has members in Canada, England, Mexico, Japan, Italy, Korea, Australia, New Zealand, Austria, France and Switzerland. In concert with this trend, recent editions of Real Estate Issues *have featured articles on Mexico and China. This edition presents an article on the current and future economic conditions in Italy by Dott. Alberto M. Lunghini, CRE. Lunghini is an engineer and architect by education and a Counselor of Real Estate (CRE) by profession.*

Even though Italy is a member of the G-7 and one of the world's major economies (roughly equal in size to those of Great Britain and France), it is often overlooked by international investors and analysts. While we might think of reasons for this lesser degree of attention (political uncertainty, language, et al), the fact remains that the Italian economy, particularly in the North, has been and continues to be strong and stable. The standard of living in northern Italy is among the highest in the world.

Economic recovery is now a characteristic of almost every major industrialized country; in Europe growth has achieved a certain consistency thanks to the newly expanding economies of Germany and France. In Italy the major driver of economic expansion is foreign demand for its exports, even though the worsening exchange rate is making itself felt through higher prices of imported goods and services.

Despite export growth and other positive signals in the economy, employment is not expected to improve before 1998. In large part this is due to the widespread uncertainties in the Italian economy from political instability and the high level of public debt. A study by DRI/McGraw-Hill of GNP trends from 1993-1998 placed Italy (average annually growth of 1.8%) in the lower ranks of major world economies (Figure 1). However, it should be remembered that between 1950 and 1980 Italy's GNP grew faster than the European Union average. Unfortunately, 1.8% of GNP growth is not sufficient to guarantee a significant decrease in the unemployment rate. (The employment absorption threshold for GNP growth is 2.2%-2.3%.)

Italy always has been known for its strong rate of savings largely dedicated to residential

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FIGURE 1

Five Years Of Growth
(Annual % variation of the GNP, 1993-98)

China	8.2
Asia (Japan excluded)	*7.3*
Malaysia	6.9
South Korea	6.6
Taiwan	6.4
Chile	5.7
Mexico	5.6
Argentina	5.1
Latin America	*5.1*
Brazil	4.7
Canada	4.0
Australia	3.3
Ecuador	3.3
World (general average)	*3.2*
Japan	3.1
Great Britain	2.7
U.S.A.	2.6
Europe	*2.1*
Germany	2.1
Sweden	2.1
France	1.9
Italy	1.8

Source: DRI / Mc Graw-Hill

(to a lesser extent, commercial) real estate. Even considering second and third homes, 75 percent of Italian families own their own homes, one of the highest rates in the world. Italians traditionally have invested 50% of their global wealth in real property while the average debt level for new home purchases remains below 30%.

In the next few years Italian household saving levels should decrease as real disposable income falls. A growing part of this savings will not be managed directly but rather entrusted to organized forms of investment, e.g., pension funds, investment funds, life insurance and annuities, etc. This new kind of Italian investor, more professional and financially-minded than the traditional private investor, will approach real estate markets differently. Investments will be directed exclusively toward property and developments that are capable of guaranteeing high yields with primary leases.

History And Forecasts

An analysis of residential real estate prices in constant 1963 lira (Figure 2) illustrates a cyclical progression since 1962. Initially the cycles contained price growth periods shorter than price contraction periods (usually two or three times as long). As the real estate market becomes increasingly sophisticated, the contraction period should shorten until it becomes more or less equal to the growth period. The 1990s represent the turning point of this structural change. The forecast for the next few years in Italy is that prices will continue to fall through 1996 when a discernible recovery should begin.

A comparison of inflation, real estate prices and the yields of BTP treasury bonds from 1970 to the early 1990s shows that real estate prices earned higher yields than Italian treasury notes during periods of high inflation (1970s). In the 1980s BTPs gave higher average annual yields than real estate investments. A comparison of cost of living increases with real estate prices shows that from 1970 through the 1990s the cost of living index rose significantly slower than real estate prices (Figure 3).

Interpretative Model

An analysis of price cycles and transactions from 1962 to the present shows that the Italian experience has followed the general pattern of real estate cycles (Figures 4 and 5). After a crisis prices remain stable for a time as the number of transactions increases. When the equilibrium breaks, the number of transactions continues its upward climb as prices begin to rise. As prices increase demand is suppressed in the medium-to-short-term. The number of transactions falls as prices remain stable and then collapse generating overall stagnation for supply and demand. The crisis ends not when prices stabilize, but when the number of transactions begins to rise. An increase in the number of transitions, even if prices continue to fall, is positive and preannounces the growth part of the cycle. This model is valid for sales transactions and rental contracts. In Italy's 1995 property market, both prices and the number of transactions continued to fall. In 1996, however, it is expected that prices will stabilize and transactions escalate and that by 1997 both prices and transactions will begin to increase.

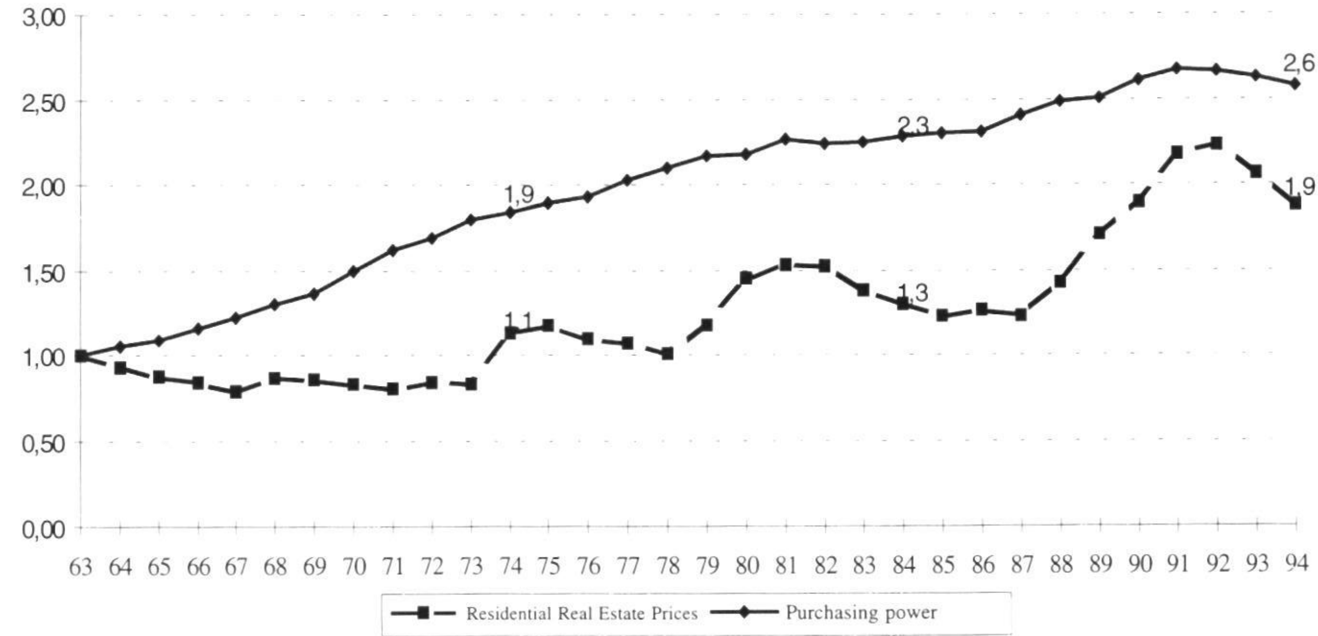
The Residential Market

The variation in real purchasing power (corrected for inflation) of the average worker is a key element in forecasting residential real estate prices. In the last 30 years Italians have increased their real purchasing power by 200 percent and real estate prices have matched every step of that increase.

Forecast data relating to GNP and real purchasing power, taking into account increases in the tax load, justify the hypothesis that private investment development will be less dynamic than in past decades. This also will limit private investments in the non residential sector, particularly for smaller properties (shops, small offices). Unless inflation should explode, a rapid recovery in residential prices is not foreseen in the near future.

FIGURE 2

Residential Real Estate Prices and Average Italian Employee Purchasing Power
(1963-1994, both in real term 1,00=1963 values)



Source: ISTAT, Centro i

FIGURE 3

Cost of Living and Real Estate Prices

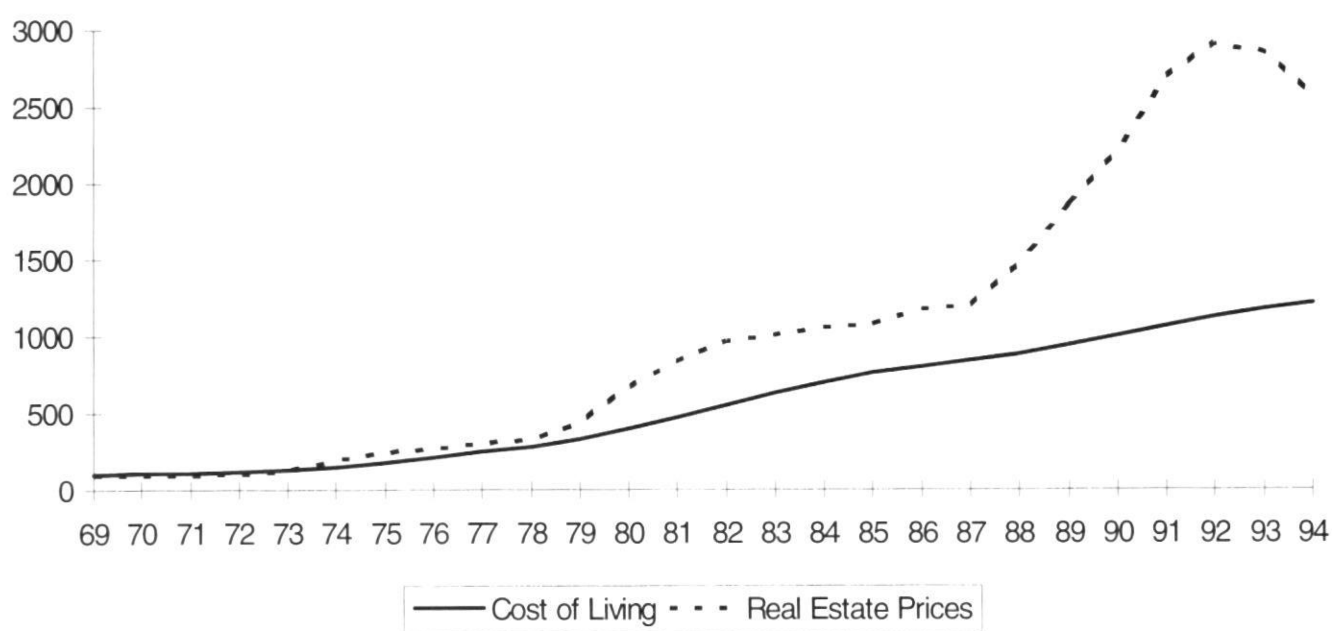
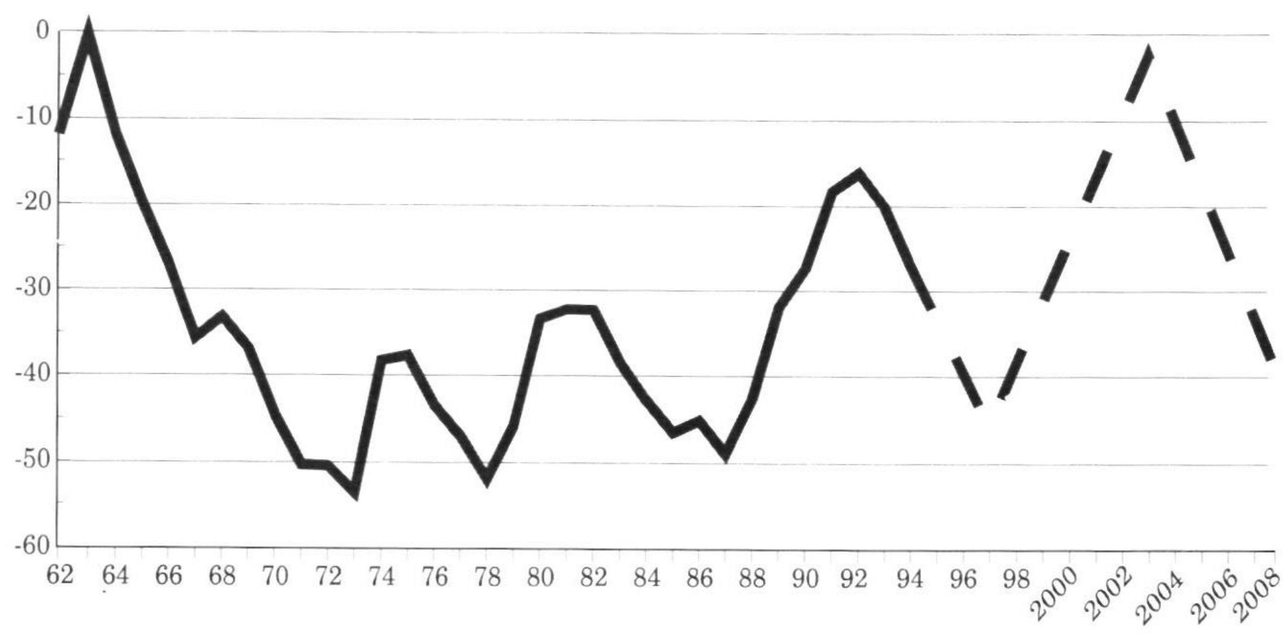


FIGURE 4

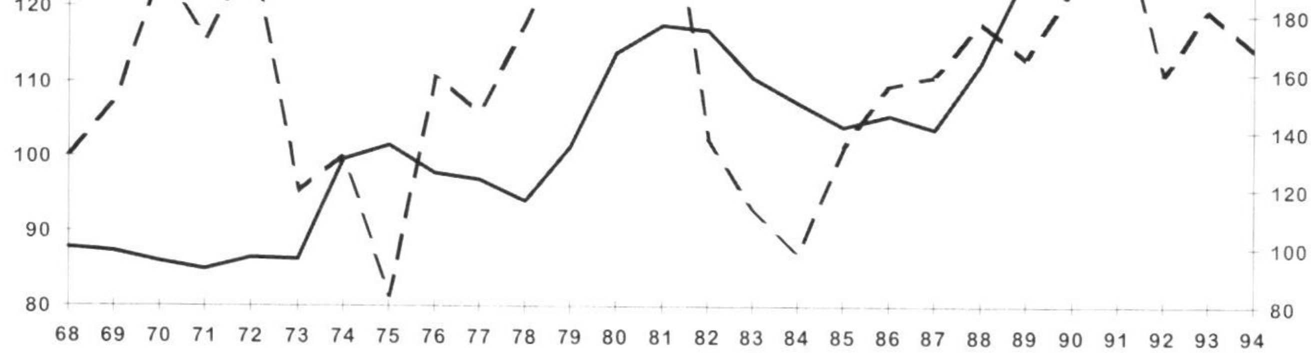
The R.E. Prices Cycles In Italy (1962-1994)
(Without allowing for inflation increase in purchasing power of middle class Italian employees [costant-Lira 1963] [1995-2008: forecast])



Source: Banca d'Italia, ISTAT, Centro i

FIGURE 5

Real Estate Prices Vs. No. of Sales Transactions in Italy (1968–1994)



The Commercial Market

An analysis of trends for office prices, rents and yields in central Milan, Italy's economic and financial capitol, is fundamental to understanding the future of commercial property in the entire peninsula. Economic trends in Milan and in Italy's political and administrative capital, Rome, usually are a precursor of what the future holds for the remainder of the country.

An analysis of price and yield movements illustrates that at the end of a crisis, sale prices tend to remain stable while rents tend to rise. This is the perfect situation for initiating investments with annual yields in the 7 to 8 percent range for centrally located offices. The moment when the crisis in the market is over, sale prices rise rapidly exceeding the increases in the rental price. Subsequently, yields collapse, which, in turn, leads to price corrections in the medium term. This last phase is currently underway in the Italian market. Some sectors currently indicate sale prices 50 percent below 1991 levels or lower. The situation does not appear ready to improve since, in the short term, banks, businesses and public entities are expected to unload numerous properties. This will increase supply and generate price decreases for the next 12 to 24 months, particularly in commercial property. By the year 2000 a solid recovery in sale prices is foreseeable, especially for buildings and complexes that could interest large institutional investors, such as REITs and other real estate investment funds.

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