

REAL ESTATE ISSUES

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Editor's Statement

Homer Hoyt, a living legend in the field of real estate economics, starts off this number of *Real Estate Issues* with a brief and powerful characterization of the 37-year housing boom we have experienced since the end of World War II, hinting clearly that the boom may now be over. To this writer, whose professional career spans a little less than thirty years but who clearly remembers the Great Depression of the 1930s, Hoyt's warning comes as a not unexpected shock—unpleasant, unwelcome and probably overdue. I thank him for delivering it so forcefully.

Maury Seldin expands upon this theme in the current installment of "Seldin On Change." In his broad-spectrum evaluation of the current economic scene, Seldin points to a number of concerns that have bothered many of us for some time now—concerns that may force a reconsideration of numerous long-held and well-cherished assumptions about where we are and where we are going.

One highly visible trend, the growing tendency toward institutional involvement in real estate ownership and development, is examined by Charles F. Floyd and Nicholas Wakeley in an article that seeks to draw upon the British experience in evaluating America's future. The implications for real estate professionals are interesting and likely to be challenging to developers and Counselors alike.

An intelligent response to this trend and its implications is offered by L. Dickson Flake, who shows how Counselors can serve corporate and institutional developers on a professional basis. As the sophistication of such developers grows, more and more they are calling on real estate professionals outside their own organizations for advice, planning and support services of the kind the Counselor is — or should be — well equipped to deliver. Both Counselors and clients will benefit from the growing frequency of these arrangements.

The rest of this number is devoted to explorations and discussions of current practical issues affecting the real estate market and the position of the real estate investor. Creative financing, home equity conversions, lease indexation, the new Subchapter S corporation and the implications of prepayment concessions now beginning to surface are among the topics discussed. We close as usual with the Richard Ellis summary of world rental levels.

However fast it may be changing, the world is still with us and seems likely to remain so for a while. Your own thoughts and actions can influence the ways in which it will evolve. Why not share them with us?



Fred Shlans

Editor-in-chief

The Housing Market in the United States since World War II
Homer Hoyt, Page 1

This distinguished author recognizes that the United States has been in a prolonged real estate cycle since 1946, with the greatest volume of new housing in world history during this 37-year period. Public and private housing starts from 1900 through 1981 are presented and are broken down according to single-family and multifamily housing.

Seldin on Change: An Era of Transition

Maury Seldin, CRE, Page 3

Continuing with his series on change, the author focuses his fifth article on some of the dramatic changes taking place in real estate investment. He looks at the type of property being produced today and compares it with previous decades. He cites various underlying forces determining current household formation, and speculates on economic trends in such areas as unemployment, inflation, oil pricing, the U.S. deficit, etc.

Pension Funds and the Future of the Independent Developer: Will America Follow the British Experience?

Charles F. Floyd and Nicholas Wakeley, Page 8

Will the increasing movement of pension funds into real estate investment signal the end of the independent developer? In Great Britain, where most developers do not retain equity ownership but function largely as project managers, this phenomenon has already taken place. Although developers in the United States may not operate as independently as in the past, they probably will continue to be in strong demand as providers of expertise and as development partners to institutional investors.

Can the Developer Find Happiness as a Counselor?

L. Dickson Flake, CRE, Page 12

Recent market conditions are prompting more corporate office project sponsors to desire and seek ownership or development control. The lack of development expertise in the typical corporate organization and the willingness of investment developers to provide the service are expanding the practice of development management. It is questioned, however, whether the investment developer—an entrepreneur and independent soul—can embrace the development objectives and accept the procedural constraints of the corporate client.

California Mandates Disclosure in Creative Financing Arrangement: Implications for Real Estate Professionals

Leonard V. Zumpano and Gene A. Marsh, Page 15

Some of the major provisions of a creative financing disclosure statute and its implications for the real estate industry are described in this article. The consumer protection statute was recently enacted by the State of California as an attempt to mandate disclosure and at the same time to define the limits of potential liability for the real estate industry.

Tax Implications of Mortgage Principal Reduction in Return for Prepayment

Patricia M. Rudolph, Page 17

Many mortgage lenders are offering borrowers a reduction in the principal on their mortgage to encourage prepayment. This reduction in the principal is considered forgiveness of debt and is taxable income to the borrower. In making the decision to prepay, an individual should weigh the benefits

against the costs, and both must be put in after-tax terms. A simple example of the calculations involved in weighing the after-tax costs and after-tax benefits of prepayment in return for reduction in the balance outstanding is presented.

New Tax Rules Benefit Family Members and Joint Owners of Residential Rental Property

Charles P. Edmonds and Rudolph Lindbeck, Page 19

In an effort to open another avenue for creative financing, Congress passed the Black Lung Benefits Revenue Act of 1981, which changed the tax consequences of renting property to family members and/or joint owners. The change allows for parents, other relatives and joint owners to engage in rental and shared equity agreements without sacrificing tax benefits. The illustrations presented in the article reveal that the impact of this new Act can result in a significant improvement in an investor's annual cash flows and rates of return.

Limited Partnerships vs. the New S Corporation: A New Alternative for Real Estate Investors?

Stanley R. Stansell and William D. Wallace, Page 24

Limited partnerships, which combine liability exposure limitation and an ability to fully flow through tax shelters, have been a preferred ownership form for real estate investors for a long time. The new S Corporation, which combines the attributes of a corporation and a partnership's ability to flow through tax shelters, may be attractive to certain investors. Both the advantages and disadvantages of the new S Corporation are presented and are compared to those of the limited partnership.

Home Equity Conversion: Increasing the Private Incomes of the Elderly

George Kaufman and Jon Paulsen, Page 28

The population of the United States is aging at a rapid rate. The percentage of persons 65 years or older was 11 percent in 1980 and is expected to reach 20 percent by 2020. The private incomes of the elderly are low on the average, and they often require governmental financial support which is an increasing burden on taxpayers. But all elderly are not poor in wealth. About 75 percent own their homes, and many own them outright. The authors explore how the elderly can convert the nonliquid equity in their homes into streams of income.

The CPI and Indexed Leases: A New Dawn?

Mark J. Shrader and Paul R. Goebel, Page 34

Escalation clauses in multiyear leases indexed to the Consumer Price Index commonly have been used in past periods of rapid inflation. The recent change in the "all-urban" CPI has raised the question of whether the CPI will continue to be useful in indexed leases. The authors examine this issue by contrasting the old and revised CPI, and they offer an alternative to the all-urban CPI.

World Rental Levels: Offices

Richard Ellis, Inc., Page 38

Office rents for prime office space in 21 cities throughout the world, including five major U.S. cities, are given in the local currency and have been converted into dollar amounts for comparison. A graph illustrates these rental levels and shows additional charges and taxes. The report also charts rental growth and inflation in selected cities from the trough of the last world recession (1975) through May 1983.

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THE HOUSING MARKET IN THE UNITED STATES SINCE WORLD WAR II

by Homer Hoyt

Few real estate professionals realize that the United States has been in a prolonged real estate cycle of 37 years from 1946 to 1982, with a million or more housing units started every year and no substantial setback. The U.S. has had the greatest volume of new housing in world history during this time period.

Statistics from the files of the National Association of Home Builders and the U.S. Bureau of the Census show a total of 56,147,000 housing starts, of which 39,577,000 were in single-family structures. This is compared to a total of only 19,226,000 new housing units in the 46-year period from 1900 to 1945.

A housing cycle is usually defined when there is finally a sharp break in housing prices, as in 1933. In the case of this long current cycle, there was one setback after 1972. This is when there was a slump with foreclosures in 1974. But prices rose higher than ever afterwards.

According to the U.S. Census Bureau¹, median house prices rose from \$10,000 in 1950 to \$70,000 in 1982. During this period the median national family income rose from \$5,620 in 1960 to \$11,116 in 1972 and to \$22,388 in 1981, as interest rates rose from 6 percent in 1960 to 15 to 17 percent in 1982. The question now is to what extent will houses and apartments hold their present peak values. There have been slight declines in sales prices of 10 to 15 percent.

The long home building period started in 1945, when millions of soldiers returned from Europe and Japan. They had a great desire to marry and live in single-family homes. The land for this housing was mostly available in the suburbs of large, densely-packed cities.

See Table on page 2.

The baby boom had its beginnings in 1946, and from 1946 to 1959, 17,365,000 single-family homes were started. The building sites were made available by sewer and water plants financed in the suburban counties by the increasing use of automobiles and the rapid increase in radial and circumferential highways leading to national freeways financed by highway taxes. To provide convenient access to retail stores, 160,000 suburban shopping centers were built. Of these, 1,168 were regional centers with department stores, clothing and other stores found in the downtown areas.

The home building movement continued with ever higher prices of homes and interest rates, sustained by the continued rise in wage rates and family incomes. The question now is whether prices of houses will be sustained at present high levels with only slight declines or will there be a final sharp reduction in home prices. So far there have been slight declines of 10 to 15 percent and concessions in interest rates.

The amazing feature of this long cycle of 37 years has been the continued advance of annual household income. In 1965, 20 years after 1945, 83.7 percent of the families in the U.S. had household incomes of less than \$12,500 per year and could buy houses at \$10,000 or slightly more. These families have made a profit on their investment.

As incomes continued to advance to a median of \$22,388 in 1981, 82.7 percent of households in the U.S. had incomes in excess of \$12,500 a year, and house prices rose to a median of \$70,000, with many over \$100,000. The early buyers have made a huge profit, estimated as high as \$1.5 trillion. The last buyers face a possible loss.

Homer Hoyt, JD, LL.D., PhD, MAI, is chairman of the board of the Homer Hoyt Institute, an independent not-for-profit land economics organization in Washington, D.C. He is the creator of the Hoyt Sector Theory and author of numerous books and monographs.

NOTE

1. U.S., Bureau of the Census, *Money Income and Poverty Status of Families and Persons in the United States: 1981*, Series P-60 No. 134.

TABLE

Total Public and Private Housing Starts 1900-1981 (units in thousands)

Year	Total Public & Private	Total Public	Total Private	Private Housing Starts				
				Single Family	Multi- Family	Percent Distribution		
						Total	Single Family	Multi- Family
1900	189	—	189	123	66	100.0%	65.1%	34.9%
1901	275	—	275	177	98	100.0	64.4	35.6
1902	240	—	240	171	69	100.0	71.3	28.7
1903	253	—	253	175	78	100.0	69.2	30.8
1904	315	—	315	207	108	100.0	65.7	34.3
1905	507	—	507	336	171	100.0	66.3	33.7
1906	487	—	487	316	171	100.0	64.9	35.1
1907	432	—	432	291	141	100.0	67.4	32.6
1908	416	—	416	286	130	100.0	68.7	31.3
1909	492	—	492	328	164	100.0	66.7	33.3
1910	387	—	387	251	136	100.0%	64.9%	35.1%
1911	395	—	395	249	146	100.0	63.0	37.0
1912	426	—	426	258	168	100.0	60.6	39.4
1913	421	—	421	264	157	100.0	62.7	37.3
1914	421	—	421	263	158	100.0	62.5	37.5
1915	433	—	433	262	171	100.0	60.5	39.5
1916	437	—	437	267	170	100.0	61.1	38.9
1917	240	—	240	166	74	100.0	69.2	30.8
1918	118	—	118	91	74	100.0	77.1	22.9
1919	315	—	315	239	76	100.0	75.9	24.1
1920	247	—	247	202	45	100.0%	81.8%	18.2%
1921	449	—	449	316	133	100.0	70.4	29.6
1922	716	—	716	437	279	100.0	61.0	39.0
1923	871	—	871	513	358	100.0	58.9	41.1
1924	893	—	893	534	359	100.0	59.8	40.2
1925	937	—	937	573	365	100.0	61.2	39.0
1926	849	—	849	491	358	100.0	57.8	42.2
1927	810	—	810	454	356	100.0	56.0	44.0
1928	753	—	753	436	317	100.0	57.9	42.1
1929	509	—	509	316	193	100.0	62.1	37.9
1930	330	—	330	227	103	100.0%	68.8%	31.2%
1931	254	—	254	187	67	100.0	73.6	26.4
1932	134	—	134	118	16	100.0	88.1	11.9
1933	93	—	93	76	17	100.0	81.7	18.3
1934	126	—	126	109	17	100.0	86.5	13.5
1935	221	5	216	182	34	100.0	84.3	15.7
1936	319	15	304	239	65	100.0	78.6	21.4
1937	336	4	332	266	66	100.0	80.1	19.9
1938	406	7	399	316	83	100.0	79.2	20.8
1939	515	57	458	373	85	100.0	81.4	18.6
1940	603	73	530	448	83	100.0%	84.5%	15.7%
1941	706	86	620	533	86	100.0	86.0	13.9
1942	356	55	301	252	49	100.0	83.7	16.3
1943	191	7	184	136	47	100.0	73.9	25.5
1944	142	3	139	115	24	100.0	79.4	20.6
1945	326	1	325	290	35	100.0	89.2	10.8
1946	1,023	8	1,015	937	78	100.0	92.3	7.7
1947	1,268	3	1,265	1,152	113	100.0	91.3	8.9
1948	1,362	18	1,344	1,180	164	100.0	87.7	12.2
1949	1,466	36	1,430	1,229	201	100.0	85.9	14.1
1950	1,952	44	1,908	1,689	220	100.0%	88.5%	11.5%
1951	1,491	71	1,420	1,275	145	100.0	89.8	10.2
1952	1,504	58	1,446	1,304	142	100.0	90.2	9.8
1953	1,438	36	1,402	1,251	151	100.0	89.2	10.8
1954	1,551	19	1,532	1,397	135	100.0	91.2	8.8
1955	1,646	19	1,627	1,494	132	100.0	91.8	8.1
1956	1,349	24	1,325	1,195	130	100.0	90.2	9.8
1957	1,224	49	1,175	980	195	100.0	83.4	16.6
1958	1,382	68	1,314	1,048	266	100.0	79.8	20.2
1959	1,554	37	1,517	1,234	283	100.0	81.3	18.7
1960	1,296	44	1,252	995	257	100.0%	79.5%	20.6%
1961	1,365	52	1,313	974	339	100.0	74.2	25.8
1962	1,492	29	1,463	991	472	100.0	67.7	32.3
1963	1,635	32	1,603	1,012	591	100.0	63.1	36.9
1964	1,561	32	1,529	971	558	100.0	63.5	36.5
1965	1,510	37	1,473	964	509	100.0	65.4	34.6
1966	1,196	31	1,165	779	386	100.0	66.9	33.1
1967	1,322	30	1,292	844	448	100.0	65.3	34.7
1968	1,545	37	1,508	889	608	100.0	59.6	40.3
1969	1,500	33	1,467	811	656	100.0	55.3	44.7
1970	1,469	35	1,434	813	621	100.0%	56.7%	43.3%
1971	2,085	33	2,052	1,151	901	100.0	56.1	43.9
1972	2,379	22	2,357	1,309	1,048	100.0	55.5	44.5
1973	2,058	13	2,045	1,132	913	100.0	55.4	44.6
1974	1,353	15	1,338	888	450	100.0	66.4	33.6
1975	1,171	11	1,160	892	268	100.0	75.9	23.1
1976	1,547	10	1,538	1,162	376	100.0	75.6	24.4
1977	2,002	15	1,987	1,451	536	100.0	73.0	27.0
1978	2,036	13	2,020	1,433	587	100.0	70.9	29.1
1979	1,760	15	1,745	1,194	551	100.0	68.4	31.6
1980	1,313	21	1,292	852	440	100.0%	64.9%	35.1%
1981	1,100	16	1,084	705	379	100.0	65.0	35.0

Note: Details may not add to totals due to rounding.

Source: Bureau of the Census, U.S. Department of Commerce

REAL ESTATE ISSUES, SPRING/SUMMER 1983

Seldin On Change

AN ERA OF TRANSITION

by Maury Seldin, CRE

The next few years are likely to bring about dramatic changes in real estate investment. These may well be of the magnitude of those experienced in the last half century. We are in an era of transition, and only the character of the transition and the emerging real estate investment opportunities are uncertain.

If one considers the forces at work and the trends of the post-World War II era, there can be little doubt that we will not have a mere extrapolation of recent trends. Real estate investments will be remarkably different, and that is the point of this commentary.

Types Of Real Estate

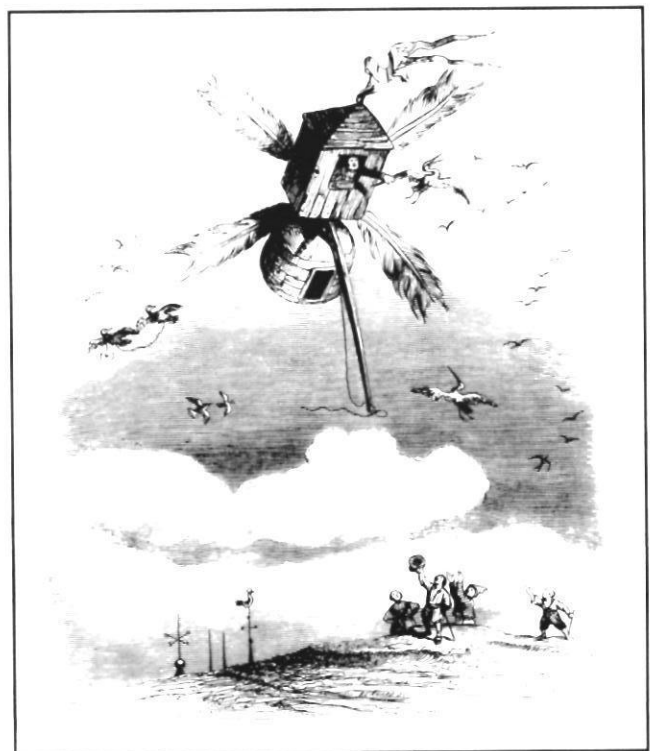
One way to look at transition is to view the changes in what was produced by type of property. Mass production of detached housing, on-site and off, produced the substantial boom of the 1950s. The ever-increasing size of unit has turned around.

The '60s and early '70s brought a great boom in construction of garden apartments for rental, followed in the '70s by a boom in high-rise construction. How many apartments are being built today for rental? Not many and most of those being built are subsidized.

This article is the fifth in a series by Dr. Seldin, which will focus on the problem of change in the real estate industry.



Maury Seldin, CRE, is president of Metro Metrics, a real estate research and counseling firm in Washington, D.C. He is professor of finance and real estate at the Kogod College of Business Administration of The American University, and president of the Homer Hoyt Institute. His books include *Real Estate Investment for Profit through Appreciation*, *Land Investment*, *Real Estate Investment Strategy* (co-author), *Housing Markets* (co-author), and *The Real Estate Handbook*. He received his M.B.A. from UCLA and his doctorate in business administration from Indiana University.

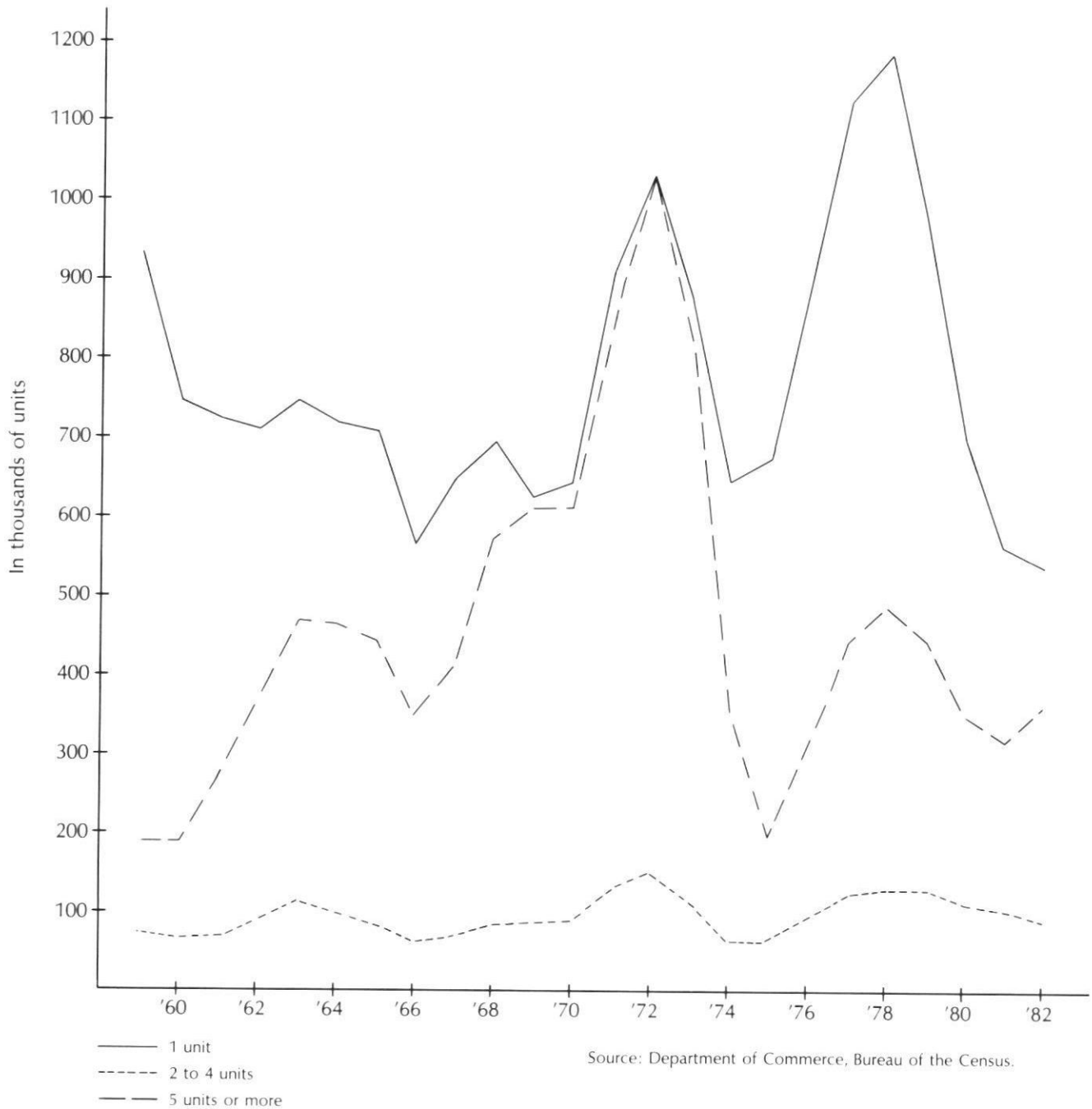


The most recent boom was condo construction which may be at the end of its era. What comes next? Figure 1 shows the wide swings in construction by type of unit.

It is not intended here to forecast what the change will be, but to consider how the existing stock may be used more intensely. Maybe conversions, especially of one-family units to two, is where the action is. There also may be hundreds of thousands of illegal conversions because the market is moving faster than the local political leadership who are charged with regulatory responsibilities.

FIGURE 1

New Private Housing Units Authorized (1959–1982)



The action in the construction of retail facilities has also changed. At the end of World War II, there was a continuation of the old style strip developments in suburbia, which were street-front oriented. But it did not take long before the shopping centers were in, and the earlier ones had the street-front orientation. What was different was the setback and parking. Then the design changed substantially, and the stores faced inward.

Also, the type of centers which were being built kept increasing in size and changed from neighborhood centers to community and then regional centers. Then came the mini-covered malls, the multi-story malls and, of course, the unique specialty centers of San Francisco, Boston and Baltimore. The only thing consistent about the types of facility being constructed is that they change.

At today's land prices and construction costs, do the numbers work? Maybe they do, if one can find a niche in the market. But how much more net new space is really needed now?

The answer for emerging investment opportunities may not be net additions to space but different space. And it may not be new construction. Conversions or reuse may be where the activity is.

As for office space, a great boom in low rise suburban offices took place and lagged the suburban residential movement. That was followed by the resurgence of high rise, but it was not confined to downtown. And it wasn't just suburban concentration serving local population. Major basic employment types of office buildings were built out of the center city. Some of these clustered near airports; others simply reflected a redistribution of the location of activity, which recognized inter-urbia as a new force of urban development. The skyline transition looked as dramatic as it did in the 1920s.

Now for industry. At the end of the War, the location of industry was at close-in break-in-transportation points. But the changing character of production in our society and the increasing reliance on rubber-wheeled transport moved the location of production including distribution services toward the beltways and interstate highways. In addition, the clustering of production in new varieties of industrial parks provides a spatially different allocation of basic employment activities and a different type of physical facility. Figure 2 shows variations in volume independent of the type of construction.

Considering these dramatic changes, how can one boldly assert that some of the most dramatic changes may now be taking place? Easy, if one looks at the underlying forces. How are they changing?

Underlying Forces Of Household Formation

The demographics which gave us suburbanization have faded. The baby boom which was associated with suburbanization has now passed into the bulge of the young adult population. That population has been marrying later and having fewer children. The labor force participation rate is up and the birth rate which had gone down dramatically with the advent of the pill has been taking a turn.

Who dares to speculate on the birth rate of the next decade? Indeed, on the marriage rates or even the correlation.

Marriage rates used to be more closely related to household formation. Now, to some, they seem to be a lag indicator. The key is households, not simply in the demographics but in the willingness and the ability to spend for the establishment of a household.

Household formation is volatile. Jobs and the expectation of increased incomes are strong deterrents. What one expects with the economy is, in some measure,

what one expects in household formation.

Let's not forget the demand from the elderly. The population has been aging not only because of increased life expectancy but also because of the demographic bulge. The amount and the affluence of that population will impact its demand for units.

Thus, if there is a great prosperity, a modern day "era of good feeling," we could have a boom for additional units on the order of the post-World War II boom, or could it be greater? It would not simply be demographics as a force in establishing households but it could be households looking for a second or even a third housing unit—the second and third house market. If there is a resurgence of inflation, who among us would want to be left out of homeownership? And with affluence, the second home market would boom.

How much production for new construction exists compared to modernization, rehabilitation, and conversion? Tell us what the lifestyles will be. Do not dismiss a reversal of the birth rate, a movement to nonmetropolitan areas and a change in lifestyles somewhat akin to the suburbanization of the 1950s. It doesn't mean that the user will leave the workforce. What it means is different housing at new locations.

There are indications of a return to old-fashioned values. Family life is on the rise again. Attitudes and expectations change. We could get a strong market for family homeownership. There may be two working parents. But housing may be in smaller metropolitan areas or even nonmetropolitan areas.

If that happens it is associated with a set of scenarios in retail, office, and industrial land uses. The most important is the change in location of employment. We are in a sense beginning to return to the cottage industry—an ability to work at home, if not all the time, then part of the time.

Some of these changes in employment have taken place. And if the population really wants life in smaller communities, then it may be possible for industry, or really employment, to follow. Employees are a resource. So with high tech and other foot-loose industry, there is a wider range of location choices than the old style smokestack industry.

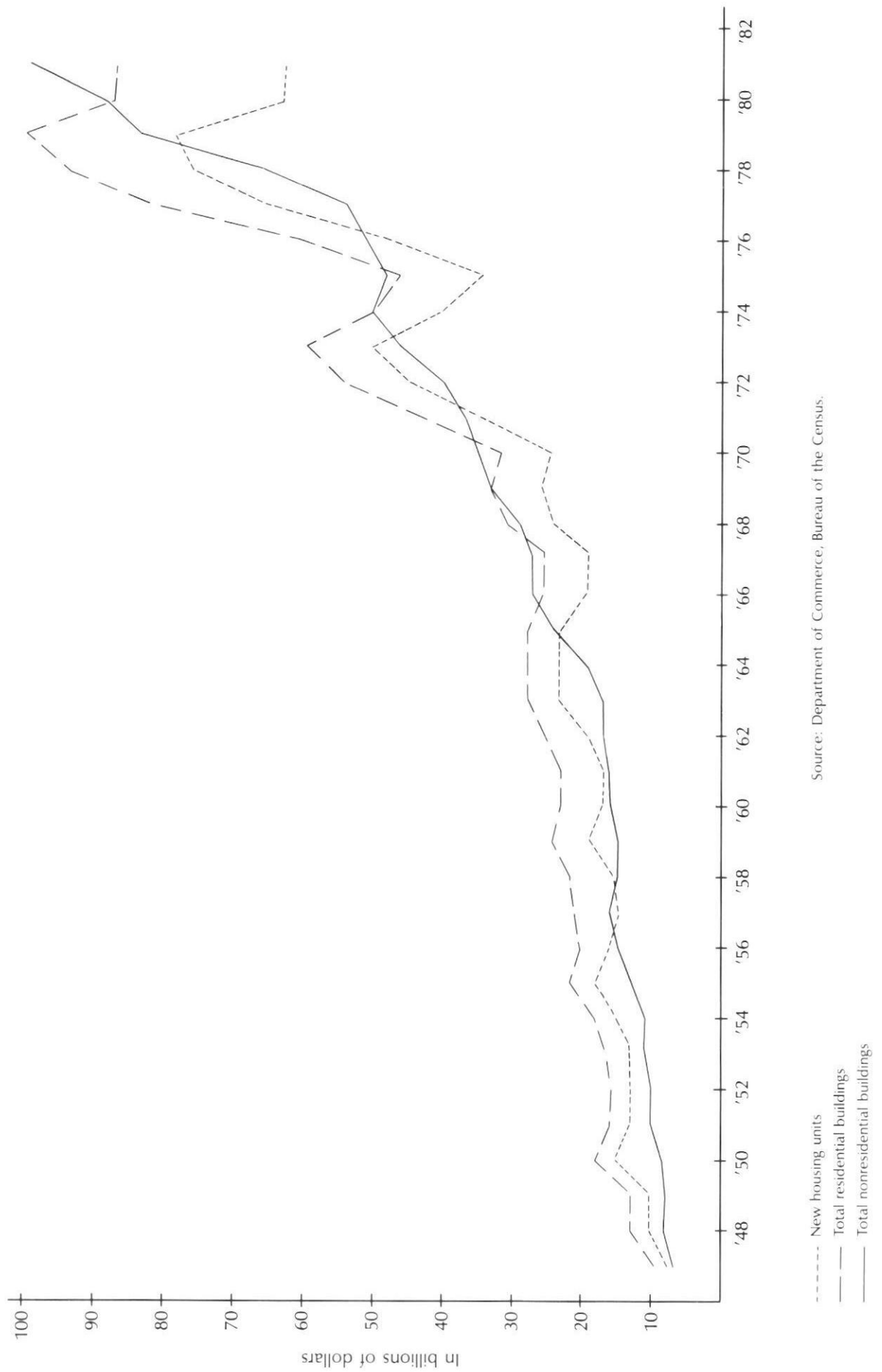
But there is also an alternative scenario. If it takes a long time to get most of that underutilized one-third of our production capacity back to work, and, if some of the facilities will never be used again, then the employment will be in other industries. It could take a long time to get more housing and other spaces developed. If that is the case, then we can do a great deal of economizing in housing and there would be fewer locational changes.

The Economy

As this is being written, recent reports indicate that unemployment dropped from 10.9 percent to 10.4 percent and then held steady at 10.4 percent.

FIGURE 2

Private New Construction Activity (1947–1982)



How far down is unemployment going to be driven? Who knows. But one of the great forces which have caused employment to rise, both in the United States and internationally, has reversed itself.

Oil reversed its price trend. The official price at \$34 a barrel is history. It is not going back to the few dollars a barrel it was before this whole international disaster started, but it is going down. That down trend will aid a recovery internationally, as well as nationally.

Yes, we are becoming more dependent on the international economy. That means that we have less control today over our own destiny. And we didn't do too well then, at least not in the last quarter century. Before that, except for the Great Depression, our economic prosperity was the great feat of modern times.

The great productivity increase of the earlier eras produced the rapidly rising standard of living. Although we were hurt in the last decade or two with declining productivity, it seems to be turning around.

Sooner or later we had to come to a discussion of inflation. The cartels and productivity are only part of the causes. Also, the deficits, monetary policy, and indexing were and/or are present.

The U.S. deficit is obscene. It is one of the great shames of our time. Can we overcome it? Perhaps, but not quickly.

That is, we can't get to a balanced budget quickly, but since the deficit is so large we could get dramatic drops which would reduce the inflationary pressures.

The drops come not only because of changes in the spending side but also in revenues. A revitalized economy would do wonders for enhancing revenues.

The Federal Reserve Bank shift in emphasis back in October 1979 to watching monetary aggregates went too far too fast. The disruption to the economy was horrendous.

It seems as if they have eased off a bit because of the unemployment situation. And, actually, the emphasis on monetary aggregates is not a bad idea, if, and it is an important if, the inflationary cause is the classic too much money chasing too few goods.

Realistically, however, that was not the cause and the aggregate control was bad medicine. Now, if the other causes of inflation such as cost push, productivity declines, and deficits are diminished, it becomes a different ball game.

The indexing of prices and wages contributes to the spiral. There is some backing away from the indexing. And, if the other forces are also mitigated, inflation could really be brought into line.

Now what does that mean? Does it really mean that we will achieve high levels of income, output and employment with price stability?

We might! But, it could be a long slow road rather than a quick transition after a painful adjustment. However, a successful rapid transition to get the necessary institutional reform could give the economy a boom the likes of which we have never seen.

Will it happen? I don't know. We have a resilient society. Some signals are discouraging yet others give us great hope. Thus, while the character to change is uncertain, we do know that it is totally unrealistic to extrapolate the underlying forces which have been giving us the great changes in recent years. So we will not get more of the same.

The changes in the underlying forces necessary to bring the economy back into line will necessitate some dramatic changes in the supply of real estate. We can expect substantial innovative changes in order to provide real estate investments. What is the character of these changes?

Well, let's consider some recent innovations in real estate investment . . . maybe next time?

PENSION FUNDS AND THE FUTURE OF THE INDEPENDENT DEVELOPER: WILL AMERICA FOLLOW THE BRITISH EXPERIENCE?

by Charles F. Floyd and Nicholas Wakeley

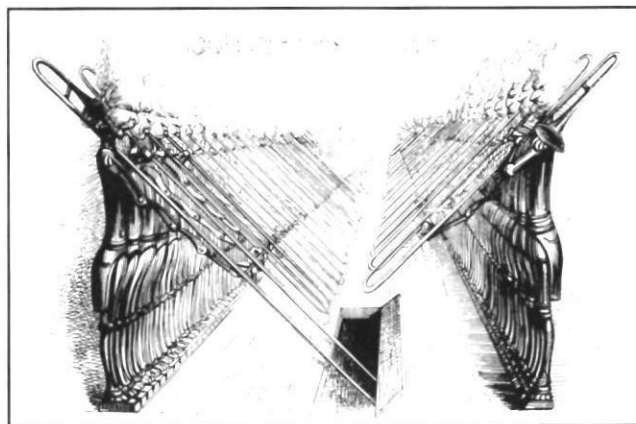
With the dramatic changes that have occurred in the financing of commercial real estate in recent years, the development industry is justifiably concerned about its future. Where will the money come from to finance its projects, and on what terms? Will the pension funds move heavily into real estate, and will this move signal the end of the independent real estate developer?

In answering these questions, it is helpful to examine how the British property market in the past has adapted to problems which are similar to those currently facing U.S. investors and developers, principally, high interest rates and, historically, high rates of inflation. Will the U.S. follow a similar pattern in coping with these twin challenges?

An examination of the British developer's experience is not encouraging for his/her American counterpart. However, a number of differences between the real estate and financing markets in the two countries leads to the conclusion that the U.S. developer is unlikely to follow a comparable path.

Changes In United Kingdom Property Markets

Until the early 1960s real estate developers in the United Kingdom (U.K.) normally could obtain fixed-rate mortgage financing for their commercial projects. Often the completed development would be appraised at a sufficient margin above costs for the developer to avoid the need to actually put cash into a project. Then, however, a combination of high interest rates and rising inflation led to a change toward equity investment by financial institutions, particularly the large



pension funds and life assurance companies that were the major real estate lenders in the U.K.

Rising inflation had led to substantial growth in property values, but this increase was going only to the developer who held the equity ownership. The institutions eventually realized that if they were to capture part of this growth in value, they would need to acquire an equity stake in the projects financed. Furthermore, when a number of highly leveraged development companies defaulted on mortgages, the institutions recognized that they were carrying much of the risk without gaining commensurate profit opportunities. As a result, they began to demand a share in the equity through such devices as participating mortgages. They soon moved from this intermediate stage to full equity investment.

Institutional purchases of real estate have tended to follow an evolutionary cycle. Property unit trusts, similar to open-ended commingled funds in the U.S., have offered a relatively low risk introductory step for the institutions to enter the market. Many institutions moved directly to purchase completed and leased buildings. As their experience grew, they began to give forward com-

Charles F. Floyd is professor of real estate at the University of Georgia in Athens, Georgia. He is the author of numerous articles on development and land use as well as the book *Real Estate Principles*.

Nicholas Wakeley is a chartered surveyor from London and Chester, England. In the summer of 1982 he studied at the University of Georgia on a scholarship provided by the British chapter of the International Real Estate Federation (FIABCI).

mitments on development projects, where they would agree to purchase a completed project from the developer, subject to certain specified conditions such as successful leasing. In these cases, the funds would sometimes agree to provide construction financing at lower than prevailing market rates.

Direct development is the final stage in this cycle. The Coal Board Pension Fund and the Prudential Assurance Company are examples of two of the largest institutions which have followed this route. Although direct development is still relatively uncommon, it has resulted in the independent developer losing a significant portion of the institutional market.

Changes in the Role of the Developer

The development industry in the U.K. has undergone some fairly radical changes in the past two decades. Essentially, the developer has changed from an owner/borrower to, in many instances, a fee developer. Correspondingly, the funds have switched from being lenders to being owners.

In contrast to the U.S., where the development company usually retains at least part of the equity in its projects, most U.K. developers operate largely as project managers. They find a site, obtain the necessary governmental planning approvals, and then sell the project to an institution. A sale may be in advance of construction or after the development is built and leased.

Few opportunities remain for independent developers to build up equity portfolios. The tax system is quite unfavorable for public development companies; they must compete with tax-exempt pension funds without such advantages as depreciation allowances used to shelter income from taxation in the U.S.

U.S. Institutional Investment In Real Estate

A review of the recent U.K. experience raises three questions of great importance for the American developer:

- 1) Will the U.S. pension funds significantly increase their real estate investments?
- 2) Will these investments continue to contain an element of debt, or will the funds move toward full equity ownership?
- 3) What will be the impact of an increase in pension funds investment on the future role of the developer?

United States pension funds currently hold three to four percent of their total assets in real estate, mostly in the form of mortgages. On the other hand, the U.K. pension funds hold approximately 20 percent of their assets in real estate, the vast majority as equity ownership. These holdings increased from only \$2 billion in 1974 to \$110 billion in 1982.

A number of U.S. pension funds have set targets similar to those reached by the U.K. funds, and some already have reached these levels. The real issue is whether the

majority of U.S. pension funds will increase the proportion of real estate holdings in their portfolios to a significant degree.

The entire concept of investing in real estate is relatively new to many funds. The recent rise in rates of inflation undoubtedly helped focus fund managers' attention on real estate as an inflationary hedge. They also seem to have recognized the merits of real estate as a means of diversifying their portfolios.

Historically, the institutions have lent money to developers on fixed-rate mortgages. The change to a blend of debt and equity and to full equity ownership is comparatively recent. Perhaps the most important reason for the funds staying with mortgages is that a debt instrument is readily understandable to a financial mind trained in dealing with stocks and bonds.

Mortgage lenders often place proportionately greater emphasis on the mechanics of a loan and the financial strength of the borrower than on the location and quality of the project. Successful equity investment, on the other hand, requires extensive knowledge and understanding of the latter two considerations, a different type of expertise to that traditionally found in the ranks of the pension funds. A shortage of this expertise would seem to be one of the main barriers to the expansion of real estate equity investment by pension funds.

Institutional investors have realized that it would be unwise to rush headlong into extensive real estate equity investment without first gaining more knowledge of real estate markets. Many funds currently are absorbing information and keeping a watchful eye on the market. Once they have overcome these educational constraints, it seems likely that they will gradually move more and more of their assets into real estate. It would be imprudent to predict whether the U.S. institutions will reach the level of investment attained by the U.K. funds; much will depend on returns available from alternative investments.

The Future Role Of Pension Funds

Will the U.S. pension funds follow a similar path to that taken by their counterparts in the U.K.? Fixed-rate mortgages for commercial projects have almost completely disappeared. In this respect, both markets are similar. The main issue, therefore, is whether the funds will eventually drop the mortgage element entirely and move exclusively to equity investment. Although a number of funds have already gone to full equity investment, it appears likely that some will choose to remain with a mixture of debt and equity such as participating and convertible mortgages.

With these features, institutional investors may feel that they are less exposed to risk than they would be with an all-equity transaction. The mortgage philosophy is well engrained in the minds of many funds managers, and they may initially feel more comfortable with retention of an element of debt. It seems probable, therefore,

that a significant number of pension funds will remain with the debt/equity mix over the next few years.

As funds managers build up their experience of the real estate market, an increasing number may wish to follow the equity route. As long-term investors, they will be able to reap the benefits of rental growth directly and be more in control of their own destiny.

Investment Options For Pension Funds

In securing equity positions in real estate, the pension funds have four options:

- Purchase existing properties
- Enter into joint ventures
- Employ the developer for a fee
- Develop directly themselves

Each option carries an increasing amount of risk and offers a higher potential return. Deciding upon the route to follow largely depends upon the investor's attitude toward risktaking. As they obtain experience in real estate and gain confidence in the market, funds managers may be prepared to accept an increasingly higher level of risk.

One of the key issues in this debate is the availability of expertise. Although a small number of funds have already undertaken direct development, most will be content to use the services of an independent developer, at least in the near future.

Comparison of Options

Institutions usually gain their initial exposure to real estate equity investment through commingled funds, enabling them to purchase a share in a well-diversified real estate portfolio for a relatively small outlay. Once funds begin to step up their investment in real estate, they may decide to invest in specific projects. Initially, to minimize their risk exposure, they purchase completed and leased buildings in prime locations.

Once investors have established a diversified portfolio of completed buildings, they may consider investing in new projects. To many funds with limited experience in development, the joint venture enables the funds to make full use of the developer's expertise. In a potentially risky area of real estate investment, the funds may feel more confident with an experienced partner. With fiduciary liability concerns on the minds of some funds managers, an outside partner to share the blame for unsuccessful projects may be attractive.

Some developers may fear that funds managers will learn the tricks of the trade from them and then drop them at a later stage when the funds begin to develop directly for their own account. However, in development one cannot underestimate the value of local knowledge and experience. Development is a risktaking business, and the entrepreneurial flair of a developer is often essential in recognizing and exploiting development opportunities. Institutional investors who recognize this may be content to remain at the joint venture

stage. Careful selection of the developer and the project should enable them to do at least as well as they would as the direct developer.

In some cases an institution may be prepared to agree to buy the completed project before construction starts. In this case the developer is working for a fee and has the security of knowing he/she can obtain long-term financing.

The main issue a fee developer faces is deciding at which stage in the development process an institution is willing to commit money to the project. Some funds may be prepared to give forward commitments to buy regardless of leasing progress. Others may agree to purchase only after the project is completed and fully leased. In this case, the developer must assess whether he/she is able and prepared to accept the construction and leasing risks. Developers may decide that the potential return in the form of a fee and perhaps a small slice of the equity is insufficient to justify carrying these risks.

Large developers with a proven track record will probably be in great demand and able to dictate terms to avoid full risk exposure. The less experienced developer may have to accept a higher degree of risk in order to obtain long-term financing.

Direct development is currently undertaken by a relatively small number of institutional investors. Typically these funds have extensive experience in real estate investment and have developed confidence in both their advisers and the future of real estate markets. Once the institutions have reached this stage, they often desire to play a more active role in managing and developing their portfolios. Experience in the U.K. has shown that this notion of independence may be stronger in funds with an in-house team of real estate professionals.

Outlook For The U.S. Developer

The possibility of a growing trend toward direct development by the institutions would seem to indicate a narrowing market for the independent developer. However, it is unlikely that even the funds engaged in direct development will sever all contact with developers. Developers with extensive local knowledge and contacts often have an advantage over institutional investors in recognizing opportunities, securing the better locations, and gaining zoning approvals. Furthermore, the local developer is in a more advantageous position to manage the development process and lease the completed project than is an institutional investor who may be operating out of regional or national offices miles away. However, a joint venture partnership combining the developer's entrepreneurial flair and local knowledge and the institution's cautiousness may prove to be the ideal combination.

Perhaps the developer faces a bleak future of curtailed freedom and increasing dependence on institutional investors. When U.S. developers look at the fate of

their U.K. counterparts, they may be concerned about their continuing ability to build up equity portfolios.

Certainly developers are unlikely to ever again have the freedom afforded them with fixed-rate mortgages. Yet in a market where the availability of financing often had a far stronger influence on new development than did supply and demand, the forward thinking developer may welcome the added stability from institutional investors.

Even in the days of easily obtainable fixed-rate mortgages, developers were still painfully dependent on obtaining adequate financing. Developers currently seeking a source of permanent financing to refinance their construction loans are only too aware of this point. A dependence on institutional investors committed to real estate as a long-term investment medium probably makes the developer more secure today than during the heyday of fixed-rate mortgages.

Finally, working with institutions will not preclude developers from building up an equity portfolio. Most funds will desire the developer to put up a portion of the equity to ensure his/her interest in the continuing success of the project. Fee developers may also be able to accumulate some equity by reinvesting part of their fees. Furthermore, partnerships with tax-exempt investors should enable the developer to make efficient use of depreciation allowances.

Conclusions

If the pension funds become the dominant force in financing commercial real estate, developers will be forced to rely, to a large extent, on earning a significant part of their income from projects financed by institu-

tional investors. Institutional respectability will be the key to their long-term survival.

In practice this means that developers must have a proven track record and have sufficient financial standing to avoid being a risk in their own right. It is inevitable that some form of discrimination against the smaller unproven developers will occur. The big will probably grow bigger and become more corporate in nature.

Smaller developers are likely to find it harder to gain a foothold without the availability of fixed-rate mortgage financing. In addition, they will be operating from a weaker bargaining position than some of their larger and more experienced colleagues. As a result, institutional investors will expect them to carry a larger amount of risk, a factor which may eventually preclude the smaller developer from the institutional market.

Most developers have already seen the need to forge closer links with the funds. They realize their activities will come under increasingly close scrutiny from institutions. Developers have always tended to live by their reputations, but this is likely to become an increasingly crucial factor in the future.

Many developers have already proven themselves to be worthy institutional partners. The institution's need for their expertise and the quality of the service provided would seem to indicate that the developer is unlikely to be forced exclusively into the role of fee developer, or indeed, forced out altogether by the institutions. In a country where entrepreneurial spirit is woven into the fabric of society, one must conclude that reputable developers will continue to be in strong demand as providers of expertise and as development partners to institutional investors.

CAN THE DEVELOPER FIND HAPPINESS AS A COUNSELOR?

by L. Dickson Flake, CRE

Preparing for the development of a corporate headquarters or subsidiary office facility is an organizational challenge that many executives have faced with discomfort. Their uneasiness is understandable. The task is typically outside of the officer's experience and not within the mainstream of the company's business activity.

Sponsors of the large landmark projects have been able to resolve this dilemma quickly. The scope of the development is so overwhelming that it necessitates the involvement of a large development organization with its professional staff.

Many of the smaller office users have been able to forego ownership and become the identity tenants for an investor-developer. A good number, however, want more development control and all or part of the ownership. The management of this latter group must decide how to organize its development project.

One alternative for the corporate sponsor of an office project is to manage the development internally with its own personnel. Even if the sponsor is engaged in a capital-intensive industry and regularly involved in development projects, it faces two difficult problems with the internal management approach:

- 1) There is probably no senior staff member experienced in office development. The expert in other types of capital projects would be as unprepared as an office developer attempting to manage a process-control project.
- 2) It diverts a valuable senior member of management from the company's business for two to

three years. This not only adversely affects the sponsor company, but it is unfair to the individual whose career is interrupted while he/she manages an unfamiliar endeavor, thus risking unsatisfactory performance, to gain experience that will probably never be used again.

Primarily due to the problem in utilizing internal management, the project oversight may be assigned to someone who lacks the capacity to manage perhaps the company's most significant capital investment.

Role Of Development Manager Extended

The need for corporate and professional office users to obtain the in-house development capability for a single office project has extended the role of the development manager into the medium-sized facilities. In this role, the development manager acts as an officer of the sponsor company, replacing the corporate employee who would otherwise be assigned. The sponsor compensates the development manager solely by an agreed fee, and the manager has no ownership position in the project.

In describing the job assignment, it is appropriate to distinguish between the development manager and a construction manager. The construction manager controls or assumes the role of the general contractor. The development manager is the alter-ego of the owner and may manage the project with or without the involvement of a construction manager. Under ideal circumstances, the development manager, or owner's representative as he/she is sometimes called, limits the time involvement of company management to policy issues and decisions peculiar to specialized features of the sponsor's business.

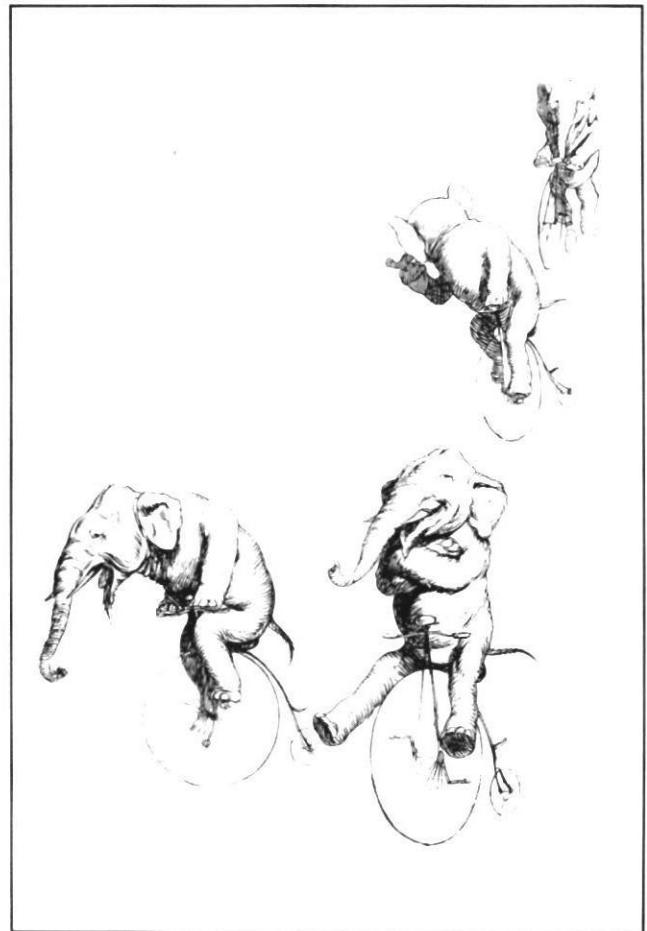
The specific duties of the development manager will vary by client and project. In general, they include anything a knowledgeable owner would do in implementing the project such as:

L. Dickson Flake, CRE, is a partner of Barnes, Quinn, Flake & Anderson, Inc., a real estate firm in Little Rock, Arkansas, which provides a range of services to businesses and investors. He also holds the SIR and CCIM designations, and was the 1982 recipient of the annual Snyder award, given by the Realtors® National Marketing Institute for its "Exchange of the Year."

1. *Prepare the development program.* Working with company management, define the proposed project—types of space, size, budget, sponsor's objectives. Guide the sponsor in considering not only his/her specialized requirements but the marketability 1) of excess space; 2) of excess land held for future expansion; and 3) of the entire facility in the event of relocation. Office users tend to focus on their own requirements; the development manager should reconcile specialized requirements with general marketing considerations.
2. *Prepare the development schedule.* Integrate physical planning with financing, government approvals and sponsor requirements.
3. *Negotiate contracts for services and work.* Representing the owner, assume responsibility for arranging contracts with the design professionals—engineering, architecture, and interior design. The written development program and schedule will form a basis for these negotiations and should be incorporated as a part of the ultimate contracts. Depending upon the method of purchasing construction, the development manager will work with the design professionals in bidding or negotiating these contracts.
4. *Negotiate the financing.* Work with the owner's financing service or lender to complete external financing arrangements, if any. Participate with the owner's attorney in reviewing all financing documentation.
5. *Control the development schedule.* Monitor the total development process including preconstruction planning. One of the most frequent causes of delay in project development is owner indecision. Adhering rigidly to a schedule allows the owner to know precisely when decisions will be required and reinforces the significance of critical dates to the project team members. The development manager should know enough about the client that information can be presented in a manner that facilitates quick decision-making.
6. *Control the budget.*
7. *Represent the owner in negotiating disagreements.*
8. *Coordinate project completion and closing.*

In utilizing a development manager, the sponsor may avoid personnel problems and achieve several other advantages such as:

1. It gives the project a distinct focal point. The owner avoids the informal, circuitous reporting relationships which evolve when team members must fill a vacuum created by the inexperience of the employee-manager.
2. It puts the owner in control of project detail. The development manager should chair all project meetings; his/her active project involvement and experience allows for catching mistakes and pinpointing responsibility.



3. It reduces legal expenses. The inexperienced corporate developer typically utilizes the attorney to coordinate financing arrangements and contracts with other members of the project team, rather than limiting his/her involvement to legal advice.
4. It controls the costs of design professionals. Uncertainty and the lack of a firm development program by the owner inevitably result in false starts and wasted professional effort. Increased professional time means increased costs.
5. It controls the costs of construction. Working with a pre-agreed cost model, the role of the development manager is to guide the design team to meet the owner's budget. A systems approach to design is instrumental in avoiding "bid surprises."
6. It reduces development time, thus reducing financing costs.

Expanded Use Of Development Manager Forecast

Given the established need and the numerous advantages to the corporate sponsor in utilizing a development manager, one would expect the practice to expand. Recent market conditions have increased the

expanded use and higher awareness of the development management service. Significant rises in rental rates have pushed the users of office space toward better long-term control over occupancy costs. Financing requirements have frequently made it necessary for the large space user to be involved in the project financing, giving that user the incentive and opportunity to obtain ownership and control.

Concurrent with the forces pushing the sponsor-user to desire ownership, market conditions have influenced developers, previously independent, to offer their services. Initially, the cost of money and volatile interest rates caused some investment developers to reduce their own activity. Subsequently, the overbuilt condition of most major office markets encouraged developers or their lenders to curb their appetite for producing speculative office space, resulting in an increased availability of qualified talent willing to accept fee employment.

The willingness and ability of the investment developer to perform the development management service are not at issue. What is at stake is more fundamental and a question of basic attitude and personality. An independent developer normally fits the stereotype of the pure entrepreneur, who accepts and even enjoys the risk of development in the anticipation of creating value and realizing the reward from it. He/She is used to accounting only to self and grudgingly to a lender.

His/Her personality profile seems to call for a "free-spirit" occupation, and the development practice satisfies that call.

The only similarity between development management and development for one's own account is that both involve the development process. The development manager is performing a professional service for a specific client, subordinating his/her own development objectives and adopting those of the client. Financial risk is highly limited, usually being compensated by a fixed-fee or minimum fee plus an incentive, but having no exposure of loss. Not only must the development manager sacrifice independence in establishing basic criteria, but he/she also is subject to the discipline of the corporate manager, documenting justification for actions and practicing effective internal communication.

To appreciate the adjustment required of the developer, we need only review the duties of the development manager listed earlier. The development manager must utilize the ability of the developer in the role of the real estate counselor, that of implementer for the client. The counselor regularly engages in planning, organizing and implementing the real estate assignments of the corporate client. Whether the independent developer will be comfortable as a counselor remains to be proven. Those who are will help to satisfy an expanding demand and add to the relatively few who have traditionally engaged in the practice.

CALIFORNIA MANDATES DISCLOSURE IN CREATIVE FINANCING ARRANGEMENTS: IMPLICATIONS FOR REAL ESTATE PROFESSIONALS

by Leonard V. Zumpano and Gene A. Marsh

In the past year a number of articles have appeared in newspapers concerning litigation that has involved the creative financing of real estate.¹ These lawsuits are apparently more common in California where the move toward creative financing with significantly large balloon payments started several years ago.² While there are no reported appellate decisions dealing with this phenomenon as it has been practiced recently in California,³ the concern over potential liability in this area did prompt the California Association of Realtors® to sponsor a piece of legislation that will mandate disclosure in creative financing sales transactions.

The law, Chapter 968, Statutes of 1982 (Assembly Bill 3531), will become operative on July 1, 1983. The bill was promulgated as a response to the demand for disclosure to both the seller and purchaser in real property transactions involving creative financing. The primary purpose of the bill is to provide disclosure of specified information to both vendors and purchasers with respect to purchase money liens on dwellings for not more than four families, with certain exceptions.

Those parties required to make the specified disclosures are the buyer, the seller and those who fall within the definition of "arranger of credit," as defined by Section 2957 of the bill. "Arranger of credit" is defined as including a person who is involved in developing or negotiating credit terms, participates in the completion of the credit documents, and directly or indirectly receives compensation for arrangement of the credit or from any transaction or transfer of the real property



which is facilitated by that extension of credit. The definition does not apply to an attorney who is representing one of the parties (buyer or seller) to the credit transaction. A licensed attorney would fall within the definition of arranger of credit if he or she were a party to a creative financing transaction—a buyer or seller.

The act applies to any transaction where the vendor will extend credit including an outright purchase, a lease with an option to purchase or where the facts demonstrate intent to transfer equitable title. Section 2959 requires that the disclosures be made before execution of any note or security documents, that the disclosure statement be receipted by the purchaser and vendor, and that the arranger retain a true copy of the executed statements for three years.

The information specified to be disclosed to the vendor and purchaser is detailed in Section 2963. There are 15 required disclosures in the section. Among the most noteworthy are the following:

2963(d)—A warning that if refinancing were required as a result of lack of full amortization under the terms of any existing or pro-

Leonard V. Zumpano is an associate professor of finance and real estate at The University of Alabama. His articles have appeared in several publications including Real Estate Issues, the Appraisal Journal, the American Real Estate and Urban Economics Association Journal, and Housing Finance Review.

Gene A. Marsh is an assistant professor of legal studies at The University of Alabama. His works have been published in The UCC Law Journal and The Tax Executive.

posed loans, such refinancing might be difficult or impossible in the conventional mortgage marketplace.

- 2963(g)— If the financing being arranged or that represented by a prior encumbrance could result in a balloon payment or in a right in the lender under such financing to require a prepayment of the principal balance at or after a stipulated date, a disclosure of the date and amount of any balloon payment or the amount which would be due upon any prior call and a statement that there is no assurance that new financing or a loan extension would be available at the time of such occurrence.
- 2963(i)— A disclosure on the identity, occupation, employment, income, and credit data about the prospective purchaser, as represented to the arranger by the prospective purchaser; or, specifically, that no representation as to the credit-worthiness of the specific prospective purchaser is made by the purchaser.
- 2963(j)— A statement that loss payee clauses have been added to property insurance protecting the vendor, or that instructions have been or will be directed to the escrow holder, if any, in the transaction or the appropriate insurance carriers for addition of such loss payee clauses, or a statement that, if such provisions have not been made, that the vendor should consider protecting himself or herself by securing such clauses.

Section 2964 of the bill defines the potential liability for failure to comply with the provisions of the law. The section provides that any person who willfully violates any provision of the article shall be liable in the amount of actual damages suffered by the vendor or purchaser as the proximate result of the violation. Furthermore, the section provides that no person shall be held liable in any action under this article if it is shown by a preponderance of the evidence that the violation was not intentional and resulted from a bona fide error notwithstanding the maintenance of procedures reasonably adopted to avoid any such error.

The California statute addresses most of the issues which have been raised in the lawsuits involving creative financing. Much of the litigation has developed between the buyer and seller when balloon payments came due and the obligor (buyer) was not able to make the payment. Buyers allege that they were not warned of the potential difficulty of refinancing the original loan.

The failure to adequately investigate the credit-worthiness of the buyer has also been an issue in the resulting litigation. According to a recent survey of 80 Realtors®, conducted by the Federal Reserve Bank of Atlanta, it is not common to run adequate credit checks on potential buyers in creative financing arrangements.⁴ When they are performed, someone unskilled often does the job. The potential for litigation in the Southeast on this issue is evident, at least among the Realtors® surveyed by the Federal Reserve.

The extent of the liability of the real estate professional in arranging creative financing packages is now being defined and tested by cases in litigation. The California disclosure statute, sponsored by the California Association of Realtors®, is an attempt to mandate disclosure and at the same time define the limits of the potential liability for the real estate industry. The alternative, should this kind of litigation become more common in other jurisdictions, is to have the limits of liability established in cases alleging fraud, negligence and breach of fiduciary duty on behalf of the agent. While Section 2964 of the California statute makes it clear that actions based on fraud, misrepresentation or deceit are still maintainable by the parties in these transactions, the statute will provide the standards against which the actions of the real estate professional will be measured. Without such standards, the potential for liability is probably more broad.

Since the state of California has often preceded other states in enacting consumer protection statutes, it would not be surprising to see other jurisdictions follow suit. While such statutes may help limit lawsuits, no single disclosure statement can possibly cover all the potential sources of legal liability real estate professionals may be exposed to when helping arrange real estate transactions that are creatively financed. Consequently, Realtors®, attorneys and real estate consultants are advised to familiarize themselves and their clients with the risks, effective cost and tax consequences of alternative creative financing arrangements.

NOTES

1. "'Creative Financing' Ends in Foreclosure for More Home Buyers," *Wall Street Journal* (February 26, 1982), 1; "Suits Against Realtors Grow as Financing Balloons Burst," *Wall Street Journal* (September 1, 1982), 17.

2. "Lawsuit Foreclosures Rise as 'Balloon' Notes Burst in California," *The Washington Post* (October 31, 1982), F1.

3. Letter from W. Jerome Thomas, chief legal officer, State of California, Department of Real Estate to Gene A. Marsh (January 20, 1983).

4. D. Koch, D. Steinhäuser and K. Inanfeldt, "The Risks of Creative Financing," *Economic Review*, Federal Reserve Bank of Atlanta, (December 1982).

TAX IMPLICATIONS OF MORTGAGE PRINCIPAL REDUCTION IN RETURN FOR PREPAYMENT

by Patricia M. Rudolph

Mortgage lenders holding large amounts of mortgages which carry below-market yields are encouraging borrowers to repay the debt by offering to reduce the balance outstanding. This reduction in the principal or "forgiveness of debt" is considered part of taxable income, and the borrower will be required to pay taxes on it at ordinary income tax rates [Regs. Sec. 1.61-12(a)]. This taxability of the reduction in principal significantly reduces the benefit to be derived by the borrower from prepayment. In this brief article, the after-tax costs and benefits of prepayment are compared.

The holder of your mortgage offers to reduce your outstanding balance if you will prepay. The lender is willing to reduce the balance because the mortgage carries a below-market rate. In evaluating this offer, the reduction in the outstanding balance must be weighed against the interest that could be earned by investing the principal. Although this calculation seems entirely straightforward, several tax implications must be included to obtain a clear picture of the costs and benefits involved. Obviously, the interest received from investing the principal as well as the interest paid on the mortgage must be put in after-tax form. Equally important is the fact that the reduction in principal is a forgiveness of debt and therefore part of taxable income.

The benefit of the decreased debt is received in the current period. The interest which could be earned by investing the principal less the interest paid to the mortgage holder would be received in the future. To compare the two, calculate the present value of the after-tax net interest earned and compare this with the after-tax reduction in the principal. If the reduction in the after-tax balance is greater than the present value



of the after-tax net interest earned, it is worthwhile to repay the debt.

To illustrate, suppose the loan balance of \$1,000 is to be repaid with three annual payments of \$402. The mortgage holder offers to reduce the balance to \$940 if the loan is prepaid. The marginal tax rate is 40 percent. If the loan is not prepaid, the outstanding principal can be invested at 15 percent in each year, but interest at 10 percent on the mortgage must be paid. The difference between earned interest and interest paid is

Patricia M. Rudolph is an associate professor of finance at The University of Alabama. She has published in the areas of housing finance, financial institutions and corporate finance.

TABLE
Present Value of Net Investment Payments

(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Loan Balance at Beginning of Period	Payment	Principal Reduction	Interest Paid	Earned Interest = .15(1)	Net Interest Before Taxes (5) - (4)	Net Interest After Taxes (1-t) (6)	Present Value of (7)
\$1,000.00	\$402	\$302.00	\$100.00	\$150.00	\$50.00	\$30.00	\$26.09
698.00	402	332.20	69.80	104.70	34.90	20.94	15.83
365.80	402	365.42	36.58	54.87	18.29	10.97	7.21
							<u>\$49.13</u>

the net interest before taxes. By multiplying the pretax net interest by (1-t) where t is the marginal tax rate, the after-tax net interest is calculated. Next, calculate the present value of this income using the 15 percent return on alternative investments as the discount rate.

$$PV = \sum_{t=1}^N \frac{(1-t) [\text{Earned Interest}-\text{Interest Paid}]}{(1+r_E)^t}$$

where r_E is the interest rate which can be earned if the balance is invested. The actual calculation is contained in the Table.

The after-tax value of the net interest income is \$49.13. The lender has offered to reduce the loan balance by

\$60. However, this \$60 is taxable income which must be converted to after-tax terms. If the marginal tax rate is 40 percent, then the \$60 will be \$36 in after-tax income. This \$36 benefit is less than the after-tax value of the interest, \$49.13, and it is not worthwhile to repay the loan.

From this example it is clear that taxes have a significant impact on the decision to prepay a mortgage in return for a reduction in principal. If the before-tax reduction in the loan balance, \$60, is compared with the value of the interest, \$49.13, it appears that prepayment would be advantageous to the borrower. However, when the taxability of the debt reduction, \$36, is considered, the borrower will lose by prepaying.

NEW TAX RULES BENEFIT FAMILY MEMBERS AND JOINT OWNERS OF RESIDENTIAL RENTAL PROPERTY

by Charles P. Edmonds and Rudolph Lindbeck

In 1981 Congress passed the Black Lung Benefits Revenue Act (the Act) which was intended to stimulate more creative financing especially among members of a family and joint owners. This article shows how the provisions of the Act provide significant investment incentives for residential investments.

The Act relaxes provisions of the Internal Revenue Code of 1954 (IRC) which limit tax deductions on vacation homes, rentals to family members, and rentals to joint owners. This exposition first examines the circumstances of a typical rental dwelling, then the provisions which have limited deductions, and finally the effects in two situations of the new tax rules. One situation involved a rental to a family member; the second one is the rental of a dwelling unit to an individual with an ownership interest in the property.

Typical Rental Circumstances

It is typical for a rental unit to produce a net loss and a tax benefit which are illustrated as follows:

Total rental income received	\$4,000
Minus expenses:	
Fire insurance	\$ 250
Mortgage interest	1,000
Real estate fee	297
General repairs	175
Real estate taxes	400
Total expenses	2,122
Balance	\$1,878
Minus:	
Depreciation	5,400
Net rental loss	(\$3,522)
Potential tax benefit (40%)	\$1,409

The property in the preceding illustration must not be used for personal purposes. The IRC provides that if a dwelling unit is used as a personal residence by the owner for even one day during the tax year, expenses of the unit must be allocated between the rental use and the personal use. A day of personal use includes any day, or part of a day, that a dwelling is:

- 1) Used for personal purposes by an owner;
- 2) Used by a member of an owner's family [family includes brothers and sisters, ancestors, and lineal descendants (IRC Sec. 267(c)(4)); or
- 3) Used by anyone at less than fair rental.

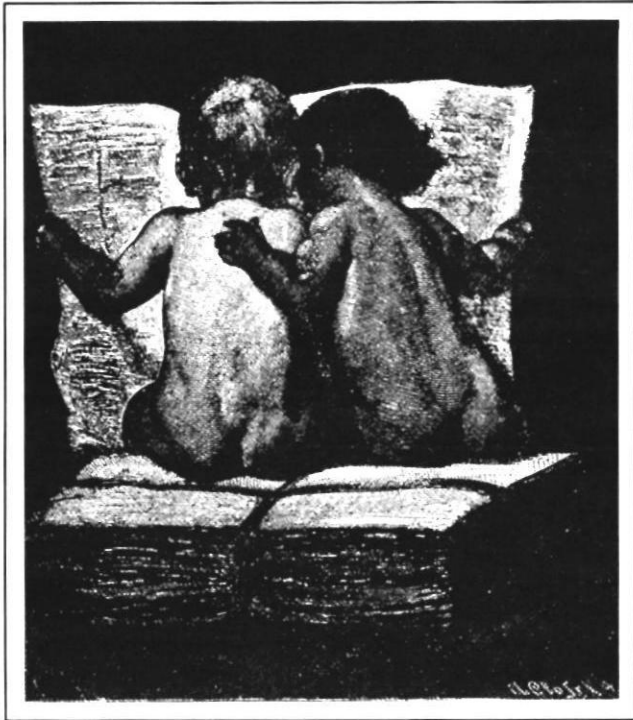
If family members and owners are included in the definition of personal use, the tax advantages of investing in such rental property as vacation homes, houses rented to relatives, or jointly owned property are severely limited.

In addition, special tax rules apply when rental property is used for personal reasons for more than 14 days or more than 10 percent of the number of days the unit is rented during the year, whichever is greater. In this case the house is considered a residence and expenses are deducted in the following order:

- 1) Interest, taxes, and casualty losses that are for the rental use.

Charles P. Edmonds is associate professor of real estate and finance at Auburn University in Auburn University, Alabama. He received his doctorate degree from the University of Arkansas and specializes in the areas of real estate, managerial finance and consumer credit. A member of numerous professional organizations, he is the author of a textbook and workbook on personal finance, and his articles have appeared in such publications as *Real Estate Review*, *the Banking Law Journal*, *Business Horizons*, and *the National Savings and Loan League Journal*.

Rudolph Lindbeck is a professor of accounting at Auburn University. He holds a doctorate degree from the University of Alabama and is a Certified Public Accountant specializing in the areas of governmental accounting and income taxation. He has had articles published in *The Financial Planner*, *The National Public Accountant*, *The Journal of Financial Planning*, *Taxation For Accountants*, *Taxation For Lawyers*.



- 2) Operating expenses, except depreciation and other basis adjustments, but only to the extent rental income exceeds the deductions in 1). *No loss is deductible.*
- 3) Depreciation and other basis adjustments, but only to the extent rental income exceeds the deductions in 1) and 2). *No loss is deductible.*

The tax consequences of making personal use of rental property are shown in Examples 1 and 2 which follow.

New Tax Rules

The new tax rules allow investors in certain situations to deduct all ordinary and necessary expenses connected with dwelling units rented to either a family member or a joint owner.

Rental to Family Members

The new tax rules of the Act relax the limits imposed upon expenses which may be deducted on a dwelling unit rented to a family member. These rules provide that an owner of a dwelling unit is not using such unit for personal purposes if the unit is rented to any person at fair rental for use as that person's principal residence [Sec. 280A(d)(4)]. Thus, a dwelling unit rented to a member of the owner's family does not constitute personal use by the owner, provided that the dwelling unit is rented at a fair rental for use as the family member's principal residence. This new rule permits parents, for example, to gain the same tax advantages from rental to a son or daughter, as from rental to a third party.

The new tax rules do not apply if a dwelling unit is rented to the family member at less than a fair rental. The vacation home rules illustrated in the preceding

section still apply. If the family member pays a fair rental, the new tax rules entitle the owner of the dwelling unit to deduct all ordinary and necessary expenses as shown at the beginning of this paper. Fair rental is determined by consideration of such factors as whether the rent paid is comparable to other rentals in the area and whether substantial gifts were made to the family member either when a lease is executed, or periodically during the year (Congressional Record, pages S15, 476-15, 477, 12-16-81).

Furthermore, the new rules are effective for taxable years beginning after December 31, 1975, but claims for refunds are subject to a three-year statute of limitations, so that amended returns for calendar year 1979 must have been filed by April 15, 1983 (Sec. 113(e), Public Law 97-119).

Assume that an investor purchases a house for \$60,000 and finances \$50,000 at 15 percent for 25 years. The land is valued at \$10,000. Now assume that the house is rented at a fair market rate to a family member as a principal residence. According to old tax laws, renting to a family member is considered personal use by the investor. As a consequence, the tax rules for vacation homes would have applied.

Table 1 shows the investor's cash flows and internal rate of return based on old tax laws. These results should be compared with Table 2, which is based on the same assumptions and the new tax changes contained in the Black Lung Benefits Revenue Act. While this illustration is based on a rental house, the same rules now apply on a prorated basis to property in which a family member rents only a portion, say two rooms in the residence of the investor.

Rental to Joint Owners

A dwelling unit is not used for personal purposes under the new rules if it is rented at a fair rental to a co-owner under a shared equity agreement [Sec. 280A(d)(3)(B)]. If two or more persons acquire a qualified interest in a dwelling unit, one or more of such owners is entitled to occupy the property for use as a principal residence provided that fair rental is paid. Qualified interest means an undivided interest held in fee simple or for a term longer than fifty years. Rent must be paid in proportion to the shared equity. Prior to this change, joint owners could rent the property, but for tax purposes the rules for "vacation homes" applied. Realizing the restrictive nature of this situation, Congress sought to open the doors to more creative financing.

The new rules, for example, permit parents to help children obtain an interest in a home by sharing equity with them. Table 3 illustrates how such an arrangement has become more appealing. Assume the same house used in Tables 1 and 2 is jointly owned by a father and son. Each has a 50 percent interest, and each pays half the \$602 monthly mortgage payment. Because of the provision in the Black Lung Act, the father's first year cash flow increases from -\$1,545 to -\$105.

TABLE 1

Cash Flows for a House Rented to a Family Member:
Previous Tax Laws¹

	Year			
	1	2	3	4
Gross rental income	\$4,800	\$4,800	\$4,800	\$4,800
Minus:				
Interest	7,034	6,994	6,958	6,914
Taxes	600	600	600	600
Net rental income	(\$2,834)	(\$2,794)	(\$2,758)	(\$2,714)
Tax benefit (40%) ²	\$1,134	\$1,118	\$1,103	\$1,086
Gross rental income plus tax benefit	5,934	5,918	5,903	5,886
Minus all cash expenses ³	9,024	9,024	9,024	9,024
After-tax cash flows	(\$3,090)	(\$3,108)	(\$3,121)	(\$3,138)
Cash Flow From Sale of House				
Selling price ⁴	\$87,846			
Less: mortgage balance	48,995			
taxes	4,455			
Net sales proceeds	\$34,396			
Tax on Sale of House				
Selling price	\$87,846			
Minus adjusted base	60,000			
Gain on sale	\$27,846			
Less 60% exemption	16,708			
Taxable gain	11,138			
Tax 40%	4,455			

IRR = 16.61%

1. The house is assumed to be sold in four years.

2. Assume investor is in 40 percent tax bracket.

3. Mortgage payments and operating expenses are assumed to be \$7,224 and \$1,800, respectively.

4. Assume the house appreciates in value an average of 10 percent each year.

Example 1: You own a summer home and used it for 10 days during the year. You rented the home at a fair rental for 110 days during the year. Your rental income is \$5,400. Your total expenses are as follows:

Interest	\$1,800
Taxes	1,200
Operating expenses	2,400
Depreciation	1,500

Because you used the summer home for less than 15 days, and 10 percent of 110 days in only 11 days, you did not use the home as a residence. However, you must divide the total expenses between the rental use and the personal use of the home. You figure that eleven-twelfths (110 days of rental use divided by 120 days of total use) of the total expenses are for the rental use of the property. You figure your rental income and expenses as follows:

Gross rental income	\$5,400
Minus:	
1) Part of interest for rental use (\$1,800 x 11/12)	\$1,650
2) Part of taxes for rental use (\$1,200 x 11/12) ¹	1,100
3) Part of operating expenses for rental use (\$2,400 x 11/12)	2,200
4) Part of depreciation for rental use (\$1,500 x 11/12)	1,375
Net rental loss	6,325 (\$ 925)

Example 2: You own a cabin that you rented for two months, lived in for one month, and tried to rent the rest of the year. Your rental income for the two

TABLE 2

Cash Flows for a House Rented to a Family Member:
Current Tax Laws

	Year			
	1	2	3	4
Gross rental income	\$4,800	\$4,800	\$4,800	\$4,800
Minus:				
Interest	7,034	6,994	6,958	6,914
Taxes and other operating expenses	1,800	1,800	1,800	1,800
Depreciation	6,000	5,000	4,500	4,000
Net rental income	(\$10,034)	(\$8,994)	(\$8,458)	(\$7,914)
Tax benefit (40%)	\$4,014	\$3,598	\$3,383	\$3,166
Gross rental income plus tax benefit	8,814	8,398	8,183	7,966
Minus all cash expenses ¹	9,024	9,024	9,024	9,024
After-tax cash flows	(\$210)	(\$626)	(\$841)	(\$1,058)
Cash Flow From Sale of House				
Selling price	\$87,846			
Less: mortgage balance	48,996			
taxes	9,056			
Net sales proceeds	\$29,794			
Tax on Sale of House				
Selling price	\$87,846			
Minus adjusted base	40,500			
Gain	\$47,346			
Taxed as ordinary income ²	6,167			
Taxed as capital gain	\$41,179			
Tax	9,056			

IRR = 27.25%

1. Includes mortgage payment, taxes, and other operating expenses.

2. The accelerated cost recovery system is used for depreciation, which requires \$6,167 in excess of straight line to be recaptured as ordinary income.

TABLE 3

Annual Cash Flow for the Father:
Assuming Old Laws and then the New Laws

	Old		New
Gross rental income	\$2,400	Gross rental income	\$2,400
Minus:		Minus:	
Interest (50%)	3,517	Interest (50%)	3,517
Taxes (50%)	300	Taxes and other operating expenses (50%)	900
		Depreciation (50%)	3,000
Net rental income	(1,417)	Net rental income	(5,017)
Tax benefit (40%)	567	Tax benefit (40%)	2,007
Gross rental income plus tax benefit	2,967	Gross rental income plus tax benefit	4,407
Minus 50% of all cash expenses ¹	4,512	Minus 50% of all cash expenses ¹	4,512
After-tax cash flow	\$(1,545)	After-tax cash flow	\$ (105)

1. Half the annual mortgage payment is \$3,612, and half the operating expenses are \$900.

months was \$2,800. Your total expenses for the cabin were as follows:

Interest	\$1,500
Taxes	900
Utilities	760
Maintenance	300
Depreciation	1,200

You must divide the expenses between the rental use and the personal use. Because you rented the cabin for two months, two-thirds (two months of rental use divided by three months of total use) of the total expenses are for the rental use of the cabin. You figure your rental income and expenses as follows:

1) Gross rental income		\$2,800	
2) Minus ²			
a) Part of interest for rental use (\$1,500 x 2/3)	\$1,000		
b) Part of taxes for rental use (\$900 x 2/3)	600	1,600	
3) Gross rental income that is more than the interest and taxes for rental use		\$1,200	
4) Minus			
a) Part of utilities for rental use (\$760 x 2/3)	\$ 500		
b) Part of maintenance for rental use (\$300 x 2/3)	200	700	
5) Gross rental income that is more than the interest, taxes, and operating expenses for rental use		\$ 500	
6) Minus depreciation limited to the part for rental use (\$1,200 x 2/3 = \$800) or line 5, whichever is less		500	
7) Net rental income		\$ 0	

Conclusion

In an effort to open up another avenue for creative financing, Congress passed the Black Lung Benefits Revenue Act of 1981. The basic provision of the Act changed the tax consequences of renting property to family members and/or joint owners. An investor will no longer be considered as using a dwelling for personal purposes for renting, at a fair rent, to any person for use as such person's principal residence.

Because of the change, parents, other relatives, and joint owners are free to engage in rental and shared equity agreements without sacrificing tax benefits. The illustrations presented in this paper reveal that the impact of this new Act can result in a significant improvement in an investor's annual cash flows and rates of return. The Act will not solve all the problems currently facing the residential real estate market, but it will help. Individuals now have another potential way to finance the purchase of a residence.

NOTES

1. The additional interest (\$150) and tax (\$100) can be deducted if a person files an itemized return. Source: *Rental Property*, IRS publication 527, November 1981, 11.

2. The additional interest (\$500) and tax (\$300) can be deducted if a person files an itemized return. Source: *Rental Property*, IRS publication 527, November 1981, 11.

LIMITED PARTNERSHIPS VS. THE NEW S CORPORATION: A NEW ALTERNATIVE FOR REAL ESTATE INVESTORS?

by Stanley R. Stansell and William D. Wallace

In recent years an extraordinary increase in real estate investment has occurred. Rapidly appreciating property values and generous tax shelters have combined to form an asset with wide investor appeal. Since real estate is generally not easily divisible and usually requires a substantial amount of investment, some form of fractional ownership is necessary.

Limited partnerships have become increasingly important as an investment ownership form. The ability to fully flow through tax benefits to investors is critically important. In spite of their inherent drawbacks, including the cost and time required to set one up, limited transferability, limited lifetime and cumbersome management structure, the partnership's ability to flow through tax savings to investors and their limited liability exposure to investors have resulted in their widespread use in real estate investment.

Real estate brokerage firms are actively beginning to market limited partnership shares in large public syndications. Preliminary data indicates that such sales exceeded \$4 billion in 1982, up from \$293 million in 1977.¹ Some of the public partnership syndications have produced extremely attractive rates of return in recent years.

Information on privately-owned limited partnerships is difficult to obtain. It is safe to say that they are widely used, and the amount of assets owned is substantial.

Stanley R. Stansell is a professor of economics and finance and chairholder of the Tom B. Scott Chair of Savings and Loan at the University of Mississippi in University, Mississippi. A practicing real estate appraiser and consultant, he holds the SRPA designation of the Society of Real Estate Appraisers. He is the author of numerous articles and cases in real estate and finance.

William D. Wallace is associate professor of accountancy at the University of Mississippi. A member of several professional organizations, he is a Certified Public Accountant specializing as a tax practitioner, and is also the author of numerous articles.

The objective of this study is to examine the use of the newly authorized S Corporation, a modification of the old Subchapter S Corporation. Recent changes in tax laws have created an opportunity for the use of this ownership vehicle which will combine some of the best attributes of both a limited partnership and a corporation.

A Comparison Of The Attributes

The comparative advantages and disadvantages of the various ownership forms are summarized in the Table². Comparisons between a limited partnership and the new S Corporation are perhaps the most appropriate for this study. Both have the significant advantage of allowing full flow through of tax benefits from passive



income, an area in which the new S Corporation is a distinct improvement over the old Subchapter S Corporation.

Theoretically, the S Corporation has an unlimited life, an advantage over a limited partnership. Shares in an S Corporation, while not highly liquid due to the small number of allowed shareholders, are more easily transferable than an ownership position in a limited partnership. Control in an S Corporation is based on proportionate shares of ownership, unlike a limited partnership where the investor typically has little if any voice in the operation of the investment. Establishing an S Corporation is almost certain to involve less time and cost than establishing a new limited partnership. Liability exposure to a stockholder in an S Corporation is at best as limited as that of a limited partner.

In general, the S Corporation seems to offer the best of both worlds to the investor if the maximum number of stockholders limitation is not critical. The chief disadvantage is that income cannot be allocated on any basis other than a proportionate share of ownership. Partnerships have some flexibility in that respect.

Changes Due To The Revision Act

The Subchapter S Revision Act of 1982 makes significant changes regarding the way shareholders of Subchapter S Corporations (officially termed "S Corporations" by the Act) are taxed. Generally, the taxation of S Corporations and shareholders is the same as that of general partnerships and general partners. In essence, the taxpayer may now choose the corporate form of organization for nontax purposes and the partnership form for tax purposes. In addition, the Act establishes rules that are more lenient in allowing the formation, eligibility, and maintenance of an S Corporation. Changes having the most impact upon shareholders are discussed in detail and may be categorized as follows:

- 1) Eligibility of the corporation to be an S Corporation;
- 2) Cessation of the corporation to be an S Corporation;
- 3) The passive income test; and
- 4) Taxation of the shareholders and corporation.

Eligibility

Changes in the requirements of corporations eligible to become S Corporations involve the relaxation of restrictions pertinent to the equity of the ownership. The first change is the increase in the maximum number of shareholders allowable in an S Corporation from 25 to 35.¹ In essence, this allows a "small business corporation" to be larger.

The second change involves a restriction that a small business corporation can have only one class of stock. That one-class restriction is still in effect, but shares of stock that have different voting rights will not be construed as two classes of stock.² In addition, "straight debt" will not be classified as a stock class, but is

defined as being any written unconditional promise by the corporation to pay on demand on a specified date a definite sum as long as the instrument meets certain conditions defined in Section 1361(c).

Cessation as an S Corporation

The S Corporation may cease to qualify due to actions of the shareholders, whether the actions be voluntary or involuntary. In either event, when a corporation ceases to be an S Corporation, the effective date is the date that the voluntary revocation specifies,³ or the day the corporation ceases to qualify as an S Corporation.⁴

Prior to the 1982 Act, the shareholders could not specify the effective date of the revocation: Timing of the revocation determined whether the effective date was the first day of the tax year in which the revocation was made or the next tax year. Also, prior to the Act, the cessation of the corporation to qualify as a small business corporation made the termination effective the beginning of the tax year in which the cessation occurred.

The Passive Income Test

An important change relevant to investors real estate is the change in the "passive income" requirements of the S Corporation. Prior law stated that the S Corporation was to be terminated involuntarily if more than 20 percent of income was passive income. Excess passive income, that is, over 25 percent, will be taxed at the highest corporate tax rate (currently 46 percent).⁵ However, termination may still result if the corporation has passive income over 25 percent of gross receipts for each of three consecutive tax years and the corporation has accumulated Subchapter C earnings and profits at the end of each of the three tax years.⁶ Since Subchapter C earnings and profits occur only to "regular corporations," an S Corporation that has never been a Subchapter C regular corporation will have no concern about termination of S Corporation status due to excessive passive income.

Two more notes concerning termination of the S Corporation are important: First, prior law stated that a new shareholder could force termination of the small business corporation election by affirmatively refusing to consent to the election. This was possible due to and consistent with the requirement that all shareholders must have consented to the Subchapter S election. Both provisions have been changed. The new shareholder no longer has the ability in all cases to foul up the plans of the other shareholders, since only shareholders collectively owning more than 50 percent of the stock may elect the revocation.⁷

The second factor involves inadvertent termination. The Internal Revenue Service may treat an inadvertent failure to meet the requirements of a small business corporation as though the failure had not occurred.⁸ There should be no tax avoidance intent from continued S Corporation status in order for the IRS to ignore the violation of the small business corporation rules.⁹

TABLE

A Comparison of Organizational Attributes

Organization Type	Tax Status	Duration (Life)	Transferability	Management Form	Method of Formation	Liability Exposure
Individual	Full flow through ¹	Terminated by death	Transferable	Personal management	Personal	Unlimited
General partnership	Full flow through ¹	Terminated by withdrawal of partner, death, or bankruptcy	Nontransferable	By agreement; usually each partner has equal power	Partnership agreement	Unlimited
Limited partnership	Full flow through ¹	Specified in agreement	Limited transferability	By agreement; general partner manager	Partnership agreement	Limited to limited partners
Ordinary corporation	No flow through ²	Unlimited	Easily transferable	Shareholder control	State charter	Limited
Subchapter S Corporation (Old Law)	No flow through ¹	Unlimited ⁴	Easily transferable ⁵	Stockholder control	State charter	Limited
S Corporation (New Law)	Full flow through ¹	Unlimited	Easily transferable ⁶	Stockholder control	State charter	Limited
Land Trust	Full flow through ¹	Specified in agreement; can be terminated by trustees	Transferable	Beneficiaries	Trust agreement	Limited
REIT	Partial flow through ³	Unlimited	Easily transferable	Managed by trustees	State charter	Limited

1. Subject to taxation at only one level

2. Subject to taxation at two levels

3. Tax losses can't exceed distribution of cash

4. Could be terminated by election of only one shareholder

5. Maximum number of stockholders was 25

6. Maximum number of stockholders is 35

Taxation

Prior to the 1982 Act, undistributed taxable income was taxed to the shareholder on the last day of the tax year of the S Corporation. Choice of the tax year was unrestricted, allowing the taxpayer to choose the timing of the recognition of his/her share of income of the corporation. The Act restricts the choice of the tax year of new S Corporations to the calendar year. Existing S Corporations may maintain existing tax years, but may not have free rein on changing the tax year. They have the same restrictions as new corporations.¹² This change and the change requiring that the taxpayers' shares of income be prorated on a daily basis¹³ reduce tax-planning opportunities available under prior law.

There are favorable changes, however, that allow the taxpayer to report on his/her separate return on any item of income, loss deduction, or credit that can affect the computation of tax liability. The tax treatment is now parallel to the tax treatment provided partnerships. If an S Corporation incurs a net long-term capital gain in 1983, each shareholder will now report on his/her individual return his/her share of the net long-term capital gain.

An important change regarding the taxation of the shareholders involves the treatment of net operating loss passthrough. Prior to the Act, the taxpayer could deduct his/her share of loss only to the extent of ad-

justed bases in stock plus any debt owed him/her by the corporation. If the shareholder's loss share exceeded the total of the adjusted bases of stock and debt, it was forever lost as a deduction.

The Act now allows the taxpayer to carry the excess over to later tax years and to deduct it in a year in which the basis of the stock and/or debt has increased above zero. One should note that the carryover period is indefinite as long as the S Corporation election is in effect. Even after the S Corporation status is terminated, the shareholder may have a limited carryover of any unused loss deduction.¹⁴

At the corporate level, there are two instances in which the corporation will be subject to a tax liability. As under prior law, the corporation possibly will still have a tax liability if capital gains are significant. As mentioned earlier, there may be a tax due if passive income is present.

The passive income tax rate is the maximum rate for a Subchapter C corporation and is imposed if more than 25 percent of gross receipts are "passive investment income" and the corporation has Subchapter C earnings and profits. If the corporation has never been a Subchapter C Corporation, this tax would never be imposed. The tax rate is applied against the taxable income of the corporation or the "excess net passive income," whichever is less. Net passive income is

defined to be passive income less expenses attributable to earning the passive income. Excess net passive income is best defined by the following formula:¹⁵

$$\left[\frac{(\text{Passive investment income}) - .25 (\text{gross receipts})}{\text{Passive investment income}} \right] \times \text{Net passive investment income}$$

Advantages Afforded By The 1982 Act

As far as the real estate profession is concerned, there are two major advantages afforded by the Subchapter Revision Act of 1982: 1) The passive income provisions; and 2) The provisions concerning the net operating loss carryforwards.

Since the definition of passive income for purposes of the S Corporation includes rental income, few S Corporations were used as a business form for real estate ventures. The presence of excess passive income would terminate the small business corporation status, leaving only the partnership and Subchapter C corporate forms as viable alternatives. The 1982 Act changes allow excess passive without terminating the small business corporation status. Since the corporation must have Subchapter C earnings and profits to be subject to the tax on passive income, a newly-formed S Corporation escapes any penalty due to passive income. The end result is that the taxpayer involved may use the legal form of a corporation, avoid personal liability and still have the simplicity and flow-through attributes of a partnership taxwise.

Under prior law, if a corporation's taxable income produced a net operating loss, the deduction passed through to an individual shareholder was limited by the total of the adjusted bases of his/her stock and any debt owed him/her by the corporation. If the shareholder let the bases mentioned above be exceeded for any one year by his/her share of a net operating loss, the loss deduction was gone forever. New law, however, allows a carryforward of the unused loss until the bases are enough to allow deductibility of the loss. This should be attractive especially to investors interested in real estate ventures for tax shelter purposes.

Conclusions

The new S Corporation offers real estate investors some advantages and a few disadvantages relative to limited partnerships, which are summarized below.

Potential advantages of S Corporations:

- 1) Quicker and less costly to establish
- 2) All investors have limited liability exposure (not just limited partners)
- 3) Easier and less costly to transfer
- 4) Unlimited lifetime
- 5) Control based on proportionate voting

Features common to both S Corporations and limited partnerships:

- 1) Full flow through of tax benefits
- 2) Limited liability exposure to limited partners (but not general partners)

Potential advantages of a limited partnership:

- 1) Some flexibility to allocate income on some basis other than ownership share
- 2) Virtually no limit on number of investors (partners)

NOTES

1. See "Luring The Little Guy Into Big Projects," *Business Week* (January 24, 1983), 68.
2. This table is an extension of a similar table in A. J. Jaffe and C. F. Sirmans, *Real Estate Investment Decision Making* (Englewood Cliffs, N.J.: Prentice-Hall, Inc., 1982), 110.
3. IRC 1361(b).
4. IRC 1361(c) (4).
5. IRC 1362(d)(1)D.
6. IRC 1362(d)(2).
7. IRC 1375.
8. IRC 1362(d).
9. IRC 1362(d)(1).
10. 1362(f).
11. *Subchapter S Revision Act of 1982; Law and Explanation* (Commerce Clearing House, 1982), 117.
12. IRC 1378(a); 1378(b).
13. IRC 1366.
14. IRC 1366(d).
15. IRC 1375.

HOME EQUITY CONVERSION: INCREASING THE PRIVATE INCOMES OF THE ELDERLY

by George Kaufman and Jon Paulsen

As has been amply documented in recent years, the U.S. population is aging. In 1980, 11.2 percent of the population was 65 years or older. In 1970 the percentage was 10.2, and in 1940 it was only 6.8. Moreover, the population is projected to continue to age. In 2020 the elderly are expected to account for almost 20 percent of the population.

Because the elderly generally are not employed, their average income from private sources is considerably lower than the income of the younger employed population, and is also lower than what they had earned prior to retirement. Moreover, the elderly are living longer. In 1960 only 5 percent of the elderly were 85 years of age or older. By 1980 the percentage had nearly doubled to 9 percent.

These "senior elderly" are even further past their previous productive earning years. As a result, a large variety of government programs are directed at improving their incomes. The share of the federal government budget directed at the elderly has jumped from 2 percent in 1940 to about 25 percent today and is expected to continue to increase as the proportion of elderly in the population continues to increase.

While many elderly are income poor, they own a significant number of assets purchased during their earning

years in order to provide later income support. These financial and nonfinancial assets generate a stream of income and can be sold to finance expenditures. Foremost among these assets are residential dwellings. Equity in homes represented 42 percent of the total dollar amount of assets of all elderly in 1975, and 70 percent of those who owned homes.¹ About three-quarters of the elderly own a home, up from two-thirds in 1970,² and considerably higher than the 63 percent proportion of homeownership among nonelderly. Moreover, about 80 percent of the elderly homeowners have paid off mortgages on their homes and own them outright. In contrast, only about 25 percent of the nonelderly own their homes outright, reflecting primarily the shorter time in which they have been repaying their mortgage loans. Thus, many elderly who may be relatively income poor, may be relatively wealth rich.

But unlike most other assets which are divisible and may be sold piecemeal in order to provide the amount of income required at the time, homes are nondivisible and cannot be sold a square foot or even a room at a time. The elderly have become accustomed to their homes and neighborhoods and are more fearful than younger persons to embark on a new adventure, like moving with unknown results to a new house and neighborhood. Thus, the elderly do not want to sell their homes to acquire funds, if this means having to move out.

Society's challenge is to determine how to transform or convert the equity that the elderly have stored up in residential housing into a stream of income, without requiring them to move in order to reduce both the burden of their income support on the budget and the possibility of nonelderly income and wealth poor taxpayers subsidies going to the income poor but wealth rich elderly. It is necessary to examine and evaluate a number of alternative home equity conversion plans that have been proposed.

George Kaufman is the John F. Smith, Jr. professor of finance and economics at Loyola University in Chicago. He received his doctorate degree from the University of Iowa and is the author of numerous articles and textbooks including *The U.S. Financial System: Money, Markets, and Institutions* and *Money, the Financial System, and the Economy*.

Jon Paulsen is assistant professor of finance at Loyola University in Chicago. He has published many articles in the areas of real estate and corporate finance, including in the *Real Estate Appraiser* and *Analyst*.

Description Of Equity Conversion Plans

Home equity conversion plans permit elderly homeowners to slowly "consume" during their retirement years the equity that they had built up in their homes before retirement without having to move out of their homes. The plans may be divided into two basic types: Those that borrow against the equity, generally in the form of debt that does not have to be repaid until the death of the surviving member of the elderly household; and those that sell the equity and simultaneously lease-back the home until the death of the surviving member of the household.

The preference for one plan over another depends on a number of factors, including the age of the household, market rates of interest, and the expected appreciation in the market value of the home. The next section examines the general nature of these plans, followed by numerical simulations in order to provide more concrete examples of their operation.

Debt equity conversion plans are sometimes referred to as reverse mortgages (RM), since the homeowner is borrowing to consume rather than to purchase the home. But in both cases, the home is being used as collateral. In its simplest form, the plan involves either receiving a stream of monthly payments from the lender over the remainder of the borrower's life, adding up to the loan value of the home (rising debt RM), or, more likely, since many financial institutions specializing in residential housing finance are not in the annuity business, receiving a single payment from the lender, which is immediately used to purchase an annuity from a life insurance or similar institution (fixed debt RM). The principal of the loan generally is not repaid until the death of the surviving elderly person in the household, at which time the house is sold and the proceeds used to pay off the loan. Any remaining funds from the sale belong to the homeowner's estate.

Although the principal is not repaid during the borrower's lifetime, the interest on the outstanding balance is paid so as to prevent the value of the loan from increasing above the value of the home. Thus, the net payment to the borrower is the difference between the monthly income from the annuity and the monthly interest payment on the loan. Because the return on an annuity should be roughly of the same magnitude but, to provide a profit for the institutions involved, somewhat smaller than the rate on a loan of the same dollar amount and term to maturity, it is evident that the net payment to the homeowner is approximately equal to the amortization of the equity investment.

As the term to maturity of either the loan or the annuity is lengthened, the size of the monthly payments decreases. Moreover, as the spread between the higher loan rate and the lower annuity rate widens, or as the general level of interest rates increases, the net monthly payments decrease. At current interest rates, these factors tend to make simple debt equity conversion useful only to the "older" elderly.



Depending upon interest rates and house prices, the monthly payments can be enlarged by delaying the payment of part of the loan so that the amount of the debt increases through time, or by renegotiating the size of the loan if the market value of the home increases during the life of the loan. In addition, the beginning of the annuity payments may be deferred until a later date. Nevertheless, Professor Bruce Jacobs, who has analyzed these plans closely, estimated that only about 10 percent of all elderly would be able to net more than \$600 per year from reverse mortgage plans.³ However, the percentage increases to about one-third for those elderly who are 75 years of age or older.

Sale-leaseback type equity conversion plans, sometimes referred to as split-equity plans, frequently permit larger monthly payments to the elderly resident. In these plans, the homeowner sells the home to an investor with a provision that he or she is able to rent the dwelling for the remaining life of the surviving elderly member of the household at a predetermined rental rate that is either fixed or may vary according to a schedule. The elderly seller invests the proceeds from the sale in an annuity. The difference between the monthly annuity income and rental payments is the net income to the seller. Thus, the mathematics of sale-leaseback plans do not differ greatly from those of the debt plans. However, these plans may generate higher net monthly payments to the homeowner primarily because the seller receives the total value of the house

rather than a percentage of its value as in the loan, and because the investor is likely to be in a higher income and also higher tax bracket than the elderly homeowner.

The transfer of ownership entails a number of tax benefits which are shared by the investor and the seller and which are greater for the investor than for the seller. These benefits include deductions of depreciation on the house, which are not available at all to owner-occupants but are permissible to investor-owners. At the same time, the elderly homeowner's lower income reduces the value to him/her of the exclusion of the implicit rental value on the home from income taxes. The elderly seller is also able to take immediate advantage of the \$125,000 one-time tax exemption on any capital gain on the sale of the house. The investor will receive any appreciation (or loss) on the home at the time of the previous owner's death. The greater the expected appreciation relative to the expected rate of inflation, the lower may be the rental charge in compensation. The new owner also accepts all responsibility for repairs and maintenance. On the other hand, the old owner surrenders the usual proprietary rights of owners to do with their property as they wish, for example, remodel, let it run down, paint it any outside color, etc. Jacobs estimates that because of these advantages sale-leaseback plans are likely to generate the highest additional incomes to the largest number of elderly.

Examples Of Equity Conversion Plans

As discussed, the net proceeds to an elderly homeowner from equity conversion is the difference between the monthly proceeds from the annuity and the monthly loan repayments or lease payments. The amount of the monthly annuity receipt is dependent upon the interest rate paid by the insurance company that sold the annuity, the current age of the elderly, his/her expected remaining life, and the dollar amount of the annuity purchased.

Different insurance companies offer approximately the same annuity plans at widely differing yields. Inspection of *Bests' Retirement Income Guide* for April 1982, which lists the current returns on annuities offered by major insurance firms, shows that the differences between the highest and lowest paying plans exceed 100 percent. The highest paying annuity is chosen for the examples in the analysis below. Table 1 shows the

TABLE 1

Annuity Payment Rates for Different
Age Homeowners Assuming a
12 Percent Annuity Interest Rate

Homeowner Age (years)	55	60	65	70	75	80
Expected Remaining Life (years)	19.7	16.1	12.9	10.1	7.8	5.9
Annuity Payment Rate (percent)	13.5	14.4	15.8	18.0	20.6	23.7

annual payments as a percentage of the face value of a single premium (payment) immediate annuity (SPIA) scheduled to begin at different starting ages and continue through to the end of the annuitant's life. For the sake of simplicity, the data for only a single male elderly are shown. This is not the interest rate (internal rate of return) on which the annuity is calculated, which is a lower rate since it excludes the repayment of the principal of the annuity. For the annuities shown, the implied annuity rate is about 12 percent. It is evident that the payment rates increase with the annuitant's age, so that an annuity starting at the age of 80 years (with an expected remaining life of about 6 years) pays almost twice the rate of one starting at the age of 55 years (with an expected remaining life of almost 20 years). The payment rate represents the highest interest rate that an individual could afford to pay on an interest only reverse mortgage or on lease payments.

Reverse Mortgage Loans

Given the annuity payments schedule, the net benefit to the elderly fixed-debt borrower is the difference between the annuity payment rate and the monthly interest payments multiplied by the size of the loan. For example, if the interest rate on a single payment fixed-debt mortgage loan—a loan in which the payment is made in a single lump at the beginning and is invested in an annuity that pays an annual amount equal to 20.6 percent of its face value—were 13 percent, the net annual benefit to a 75-year-old male who receives a reverse fixed-debt mortgage loan would be 7.6 percent,

TABLE 2

Annuity Payment Rates for Alternative
Mortgage Rates, Annuity Interest Rates,
and Age of Homeowner

Mortgage Interest Rate	Percentage Point Spread Between Mortgage and Annuity Rates		
	.03	.04	.05
Age of Homeowner: 65 (Expected Remaining Life 12.9)			
.09	.1136	.1067	.1000
.10	.1200	.1136	.1067
.11	.1271	.1200	.1136
Age of Homeowner: 70 (Expected Remaining Life 10.12)			
.09	.135	.128	.121
.10	.141	.135	.128
.11	.148	.141	.135
Age of Homeowner: 75 (Expected Remaining Life 7.81)			
.09	.164	.158	.152
.10	.172	.164	.158
.11	.178	.172	.164

or \$3,040 on a \$40,000 loan collateralized by a \$50,000 home. If the mortgage rate increased to 15 percent, the annual net benefit would decline to \$2,240.

The net benefit rate also varies with the annuity rate but directly, so that the higher the annuity rate, the higher the benefit rate. Table 2 shows how the payments ratio varies with the mortgage interest rate and the spread between the mortgage rate and the annuity rate for a hypothetical annuity plan and different starting ages for the elderly program participant. Thus, an 11 percent fixed-debt mortgage loan rate and a 6 percent annuity rate would provide a 65-year-old who had a life expectancy of nearly 13 additional years an annual annuity payment rate of 11.4 percent. This same combination would provide an annual annuity payment rate of 16.4 percent to a 75-year-old having a remaining life expectancy of only 8 years.

If the borrower dies soon after obtaining the fixed-debt loan, the entire value of the equity in the home would be lost.⁴ An alternative arrangement to protect against quick loss of equity is to have the loan proceeds paid each month up to the full amount of the loan rather than all at once at the beginning in the form of a rising debt loan. Part of the monthly proceeds are used as income by the borrower and the remainder is invested in a deferred annuity that begins to make payments only when the full loan value is reached. As with the regular annuity purchased with the proceeds of a single payment fixed-debt loan, the income from the deferred annuity is used both as income and to pay the current interest expense on the loan. The net proceeds to the elderly homeowner are likely to be roughly similar for both the fixed-debt and rising-debt plans.

Sale-Leaseback Plans

Sale-leaseback plans generally permit the purchase of a larger annuity because the proceeds from the sale of the entire equity of the house may be used rather than only the proceeds of the loan against the equity. To safeguard the value of the loan, lenders typically lend less than the full value of the equity, for example, 80 percent.

As discussed earlier, other than any differences in dollar amount, the major differences between the loan and sale plans involve the transfer of certain tax expenses and of the financial responsibility for maintenance and upkeep of the house from the elderly homeowner to the investor. Because these expenses are tax-deductible, they are worth more to the assumed higher tax bracket buyer/investor than to the lower tax bracket elderly homeowner and thus increase the value of the transaction relative to the loan plans were the tax "benefits" to stay with the elderly homeowner.

An example of a sale-leaseback is given in Table 3. It is assumed for this table that the annuitant is 65, has a remaining lifespan of 15 years, receives the entire proceeds of conversion with a home having a value of \$50,000, and invests the proceeds in an immediate annuity of 15.8 percent which will yield annual payments of \$7,900. The buying investor/lessor in turn borrows 90 percent of the home's cost at 13 percent and determines the lease payments to the seller in order that he/she receives an after-tax return of approximately 10 percent. The 10 percent after-tax return is equivalent to a 6.5 percent after-tax return (assuming a tax rate of 50 percent) earned by the financial institution financing the 90 percent loan at 13 percent plus a risk premium

TABLE 3

Major Characteristics of Hypothetical Sale
and 15-Year Leaseback for 65 Year Old Homeowner
for \$50,000 Home Assumed To Appreciate 1.5 Percent Annually
(Annual, Dollars)

Years	Home-owner Annuity Income	Home-owner Lease Payments	Mainte- nance	Depre- ciation	Investor's Loan Interest	Investor's Principal Payments	Investor's Profit	Investor Cash Flow	Value of Future Cash Flow
1	\$7,900	\$4,817	\$500	\$3,333	\$5,850	\$1,113	\$4,317	\$ -310	\$ -702
2	7,900	4,817	500	3,333	5,705	1,258	4,317	-380	-810
3	7,900	4,817	500	3,333	5,542	1,422	4,317	-458	-922
4	7,900	4,817	500	3,333	5,357	1,607	4,317	-547	-1,039
5	7,900	4,817	500	3,333	5,148	1,815	4,317	-647	-1,159
6	7,900	4,817	500	3,333	4,912	2,051	4,317	-761	-1,285
7	7,900	4,817	500	3,333	4,645	2,318	4,317	-889	-1,416
8	7,900	4,817	500	3,333	4,344	2,619	4,317	-1,033	-1,554
9	7,900	4,817	500	3,333	4,003	2,960	4,317	-1,197	-1,698
10	7,900	4,817	500	3,333	3,619	3,345	4,317	-1,381	-1,849
11	7,900	4,817	500	3,333	3,184	3,780	4,317	-1,590	-2,008
12	7,900	4,817	500	3,333	2,693	4,271	4,317	-1,826	-2,175
13	7,900	4,817	500	3,333	2,137	4,826	4,317	-2,093	-2,351
14	7,900	4,817	500	3,333	1,510	5,453	4,317	-2,394	-2,537
15	7,900	4,817	500	3,333	801	6,162	4,317	42,273	42,273

of 3.5 percent. The risks of the lease include the uncertainty of the maintenance costs of the home and its future appreciation.

Maintenance costs for the home are assumed to be 10 percent of the home's value per year. For tax purposes, straight-line depreciation was used over 15 years (\$3,333 per year) and capital gain treatment is applied to the proceeds from the sale of the home when the elderly lessee dies. The home was assumed to appreciate at 1.5 percent per year and to be sold at the end of the fifteenth year, the expected life of the lessee.

The investor's after-tax return was computed as a compound return so that the future value of the investor's equity (10 percent of the house price) at the end of 15 years would just equal the future value of the sum of the after-tax cash flows (compounded at 6 percent) received by the investor from the lease of the house plus its future sales price. The annual cash flows received by the investor are determined based on the following equation:

$$\text{Cash flow} = (\text{lease} - \text{maintenance})(1 - t) + t(\text{dep} + \text{int}) - \text{loan payment},$$

where: lease = lease payment,
dep = depreciation,
t = ordinary income tax rate,
int = interest.

Based on the reasonable assumption that the investor would require a 10 percent after-tax return in order to make the lease financially acceptable and that $t = 48$ percent, the lease payments equal \$4,817 per year. Thus, the annual net benefit to the elderly homeseller is \$3,013.

To the lessee, the benefits of the lease compared to the loan are the lower cost of the lease and the greater amount of equity that can be borrowed and invested in an annuity. In the example, the annual interest payments on an 80 percent interest-only reverse mortgage loan at 13 percent would have been \$5,200 ($\$40,000 \times .13$) compared to \$4,817 under the above lease. At the same time, the annual income from an annuity that could be purchased would have been only \$6,320 per year for the loan versus \$7,900 for the sale. The annual net benefit to the elderly would have been only \$1,120, or \$1,963 less than for the sale-leaseback. The numbers will, of course, differ for different assumptions but will almost always favor the sale-leaseback plan.

Equity Conversion Experiments Across The U.S.

A number of experiments in equity conversion programs for elderly homeowners have been placed in operation. Most of these programs are community-run with initial funding from various sources. Buffalo's Home Equity Living Plan (HELP) is a modified sale-leaseback arrangement referred to as a "split-equity" plan. It provides a monthly cash annuity payment for life plus payment of property taxes, maintenance and immediate property rehabilitation. In return, the homeowner surrenders title

to his/her home at death. A goal of the program in addition to converting home equity to income is to rehabilitate the elderly homeowner's property plus pay for maintenance expenses.

Some California residents have access to reverse mortgages or sale-leaseback conversion plans. The loan program, developed by the San Francisco Development Fund, provides for a loan to homeowners over 62 years old for a specified time period, generally 10 years. The loan is of the rising-debt type and payments are made to the homeowner monthly. The plan is unique in that during the life of the loan, the homeowner makes no payments whatsoever on either interest or principal. At the end of 10 years, the loan and accrued interest must be repaid, although it may be refinanced at the option of both parties.

A sale-leaseback plan, developed by the Fouratt Corporation in Carmel, California, provides for the senior citizen to sell his/her home to a private party at a discount below appraised value. The size of the discount is primarily a function of the cost of a lifetime annuity which is purchased by the buyer for the seller. The seller receives a down payment and monthly payments from which lease payments are deducted. If the seller lives past the end of the loan period, annuity payments from the deferred annuity purchased by the buyer will begin.

Broadview Savings, a state-chartered savings and loan in Broadview, Ohio, offers several maturity rising-debt reverse mortgage loans. The longest maturity mortgage is for 10 years and provides proceeds equal to 80 percent of the appraised value of the home. At the end of the term of the loan, borrowers have three options: 1) the property can be reappraised to determine if further equity conversion is possible; 2) the loan may be paid off; and 3) the loan may be refinanced. Interest is based on current mortgage rates and is due each month.

Boiling Springs Savings and Loan of Rutherford, New Jersey offers a three-year reverse mortgage loan for up to 70 percent of the home's value. The mortgage provides for an initial lump sum payment and monthly payments and may be refinanced at the end of the three-year term at the option of the homeowner. Interest payments may be paid monthly or accrued to the end of the loan at the option of the elderly homeowner.

Milwaukee's Westside Conservation Corporation offers a 15-year reverse mortgage loan with an option for the lender to buy the home at a specified price at the maturity of the loan or sooner at the option of the owner. The loan may be refinanced at the end of the 15-year term at the option of the owner. To date, no interest has been charged on the loans so that the only payment to which the owner is obligated is the repayment of the principal at maturity. The program is funded by the Retirement Research Foundation, a private, not-for-profit organization in Park Ridge, Illinois.

Conclusions

The elderly have become a rapidly growing segment of the U.S. population in recent years. Because their income from private sources declines sharply after retirement, they require government income support and therefore account for an increasing share of the federal budget. But on the average the elderly are not as poor as is widely believed. Public and private pension support, lower taxes, and reduced prices provide them with a reasonably high standard of living, so that a smaller percentage of elderly than of the population as a whole live below the poverty level. Moreover, many elderly own a significant number of assets, the largest single asset being their home.

Some three-quarters of all elderly own their home and about 80 percent of these own it outright. Homes, however, are not liquid and cannot easily be transformed into a stream of income. Even if they could, the elderly would not want and should not be required to move out. The problem is how to convert the homes owned by the elderly into income without requiring them to move out.

A number of proposed plans have been examined here. These plans basically involve either obtaining a loan against the owner's equity in the home, that is not repayable until after the owner is deceased, or selling the home with a provision to rent the house for the remainder of the owner's life. The proceeds from the loan or sale are used to purchase an annuity that provides a monthly stream of income. Some examples of these plans are developed. The annual income additions to elderly homeowners are computed based on the average value of homes owned by the elderly and the current mortgage and annuity rates.

The figures in these examples suggest that in practice equity conversion programs may not be as appealing as they may appear at first blush, particularly in today's economic environment. In addition, the transformation of housing equity to income may have other limitations.

Most income programs for the elderly, for example, social security, do not include either the value of the home equity or the implicit rental value of the home in the computation of minimum eligibility. On the other hand, they do include the liquid assets in which the proceeds from a house sale may be invested or income from an annuity purchased with the proceeds. Thus, gains from equity conversion may be swept away by equal losses in income support.

These criteria must be reexamined and modified before it becomes reasonable to expect equity conversion programs to become widespread, particularly among lower income elderly. The income from annuities purchased with the proceeds from the sale of a home is also taxed, in contrast to the tax-exemption for implicit rental income obtained from living in one's own home.

Nevertheless, a number of experiments with one or more home equity conversion programs are in operation, and it is still too early to determine their success. But given the importance of the income support problem for elderly both to themselves and to society, it is worthwhile to continue to explore the potential for this promising approach.

NOTES

1. Joseph Friedman and Jane Sjogren, "Assets of the Elderly as They Retire," *Social Security Bulletin* (January 1981), 16-31. It is likely that these figures understate the importance of homeownership. The average home equity reported by elderly homeowners in 1975 was \$17,000. Because, as noted later, most elderly have paid off their mortgage debt, and for those that have not the remaining debt may be expected to be small, the reported values are significantly below the \$35,300 value of the average existing home sold in 1975.

2. Bruce Jacobs, "The Housing of Elderly Americans," Keynote Address to the 1981 White House Conference on Aging, University of Rochester, December 1981.

3. Bruce Jacobs, "An Overview of the National Potential for Home Equity Conversion into Income for the Elderly," *A Report to the Home Equity Conversion Project* (University of Rochester), March 1982.

4. Any increases in the value of the equity after the loan origination would accrue to the borrower's estate.

THE CPI AND INDEXED LEASES: A NEW DAWN?

by Mark J. Shrader and Paul R. Goebel

With the advent of high and extremely variable rates of inflation in the U.S. economy, indexed leases have become increasingly more attractive for the protection of both the lessee and lessor. Such leases are tied to some index of inflation with periodic rate adjustments made accordingly.



Mark J. Shrader is a doctoral candidate and teaching assistant in finance at Texas Tech University in Lubbock, Texas. He specializes in financial markets.

Paul R. Goebel is an investment analyst for The Stribling Company in Lubbock, and an adjunct assistant professor of finance at Texas Tech. He is the author of several real estate articles and books.

One of the most popular and widely referenced measures of inflation at this time is the Consumer Price Index (CPI). Lease escalation tied to the CPI has been recommended as a valid technique in protecting the lessor's and lessee's interest in a long-term lease.¹ However, due to criticism about the ability of the CPI to measure inflation accurately, the "all-urban" CPI index has been revised by the Bureau of Labor Statistics (BLS) as of January 1983.

The all-urban CPI represents the purchases of about 80 percent of the population; the "workers" CPI, to which most wage escalation is tied, will not incorporate the same change until 1985. The basic revision involves the homeownership component of the CPI which has tended, for various reasons, to overstate inflation for the past several years. The revised index uses market rents to supplant the old method of calculating homeownership costs—house prices, interest payments, insurance, taxes, and repairs.

The concept of lease indexation has been around for some time. The major feature of this technique is to protect the real value of a landlord's return against inflation. When a lease allows escalation of rents for such things as operating costs related to fuel and taxes, a "partial" indexation to the CPI may prove beneficial to provide an add-on to escalations. The arrangement of a partial CPI clause with a pass-through of operating and tax cost increases has become quite common. The degree of CPI indexation can be negotiated by the lessor and lessee relative to their bargaining strength. The question arising from the CPI change is: Will this new CPI be an accurate reflection of actual price increases in the economy and thus be appropriate for rental rate adjustments in multiyear indexed or partial indexed leases?

To answer this question, some of the major problems associated with the old CPI are cited, followed by an explanation of the revised CPI. Finally, several alternatives to the CPI are offered, which may be more ap-

appropriate gauges of inflation and thus better suited to indexed lease rent escalations. Specifically, the need for a localized measure of inflation is pointed out for a fair evaluation of rental adjustments.

The "Old" CPI

The CPI uses a fixed-market basket of goods and services to measure average price changes over time. It is designed to measure inflation on a national scale. As such, prices for food, shelter, energy and other goods and services are collected in 85 urban areas throughout the country. The index is constructed using a weighted average of all prices collected. The actual weights were derived in a governmental survey on consumer expenditures in the 1970 to 1971 period and are changed to a relative weight according to relative price changes among items.² Separate indexes are also calculated for four major regions and 28 local areas.³

The main criticism of the CPI is that it does not accurately measure inflation, that is, losses in purchasing power of the dollar. Two reasons most often advanced for this inaccurate measurement are: 1) The CPI does not allow fully for substitution of comparable goods when the price of one rises faster than the other,⁴ which is a problem common to any Laspeyres type index such as the CPI,⁵ and therefore, it is not of major concern here; 2) The homeownership portion of the old CPI has overstated for a variety of reasons the true inflationary rate of the late 1970s and early 1980s.

The homeownership portion of the old CPI consisted of the cost of homes purchased, interest payments, taxes, insurance, and repairs. Again, the weights involved were determined in the early 1970s period when approximately six percent of all households purchased houses. However, the relative weights have increased dramatically. By December 1981, the homeownership component accounted for over 26 percent of the relative weights of the entire index,⁶ and was by far the most important component of the old CPI. In fact, due to increasing house prices and interest rates, it is estimated that this portion alone accounted for a third of the increase in the CPI for the period 1979 to 1981.⁷

One problem with the old method for calculating the homeownership component of the index is that capital gains or price appreciation accruing to homeowners was not taken into account.⁸ If houses do appreciate in price, this tends to lower the effective cost of the house over the period of ownership. In other words, houses are purchased to provide shelter and as an investment. The CPI measures only the costs of the shelter and does not consider the benefits of investment.

The omission of price appreciation was not the only factor that caused the homeownership component to overstate inflation. The deductibility of interest in mortgage payments was also not considered.⁹ Again, if the tax shelter effect were taken into account, the effective cost of homeownership would decline.

It is important to note the difficulties involved in estimating the costs of homeownership. The benefits derived from both the investment in the house and the tax shelter are neither constant for individual homeowners nor over a period of time. Efforts to measure user costs for shelter have been attempted by both the BLS¹⁰ and others.¹¹ However, most of these experimental measurements have been found to be extremely complex and costly, and thus not suitable as inputs into the CPI.

Other criticisms of the way in which homeownership costs are measured exist. While not necessarily addressing the overstatement of inflation, they do call into question the reliability of the homeownership component to measure costs accurately.

One criticism is that the old CPI used the interest cost that accrues during the first half of the life of the mortgage as a current expenditure. The reasoning behind this was that the average house is supposedly sold and refinanced with a new mortgage approximately halfway through maturity.¹² From an intuitive perspective, it seems inappropriate to consider these interest payments as a current expenditure since they are extended over the life of the mortgage. The selection of the first half of the interest payments was somewhat arbitrary, too.

The index has also been criticized for using a constrained sample. Only FHA mortgages were utilized in constructing the CPI input. Due to FHA restrictions, many newer, more expensive homes were deleted from the sample. It is questionable as to whether the FHA sample is truly indicative of the general changes in home costs over time.¹³ But the shortcomings of the old CPI housing component have been recognized, and a change in this component became effective in January 1983.

Revised CPI

Due to the problems identified in the previous section, the BLS has revised its measure of homeownership costs. The old method involved the costs associated with owning a home. The revised measure is referred to as a rental equivalence approach. The basic distinction is that the rental equivalence approach measures the cost of purchasing shelter rather than the costs associated with purchasing a house or asset.

The sample is not limited to individuals who rent housing; in actuality, it excludes them and consists of families who owned homes in the base period. The prices used to compute the index will be implied rents or what it would cost the homeowner to rent a house similar to the one he or she owned. The weights come from the early 1970s survey period and will decrease the homeownership component to about 14 percent of the index, as compared to the current 26 percent.¹⁴

As previously discussed, the old CPI index probably overstated inflation, especially during the period of 1979 to 1981. This was due mainly to rising home prices and mortgage interest rates and the inability of

the index to properly measure effective housing costs. The question still remains as to how well the revised index will perform. There is still some debate as to how well rental costs approximate homeownership costs. A comparison of the two indexes shown in Table 1 indicates that the revised index showed lower inflation rates for the period 1977 to 1981. However, for 1982, the revised index showed a greater rate of inflation than the old index,¹⁵ probably caused by a levelling off of house prices while rental prices continued to climb.

TABLE 1
Comparison of Old and Revised
Consumer Price Indexes⁶

	"All-Urban" CPI	Revised CPI
1970	5.5	4.5
1971	3.4	3.5
1972	3.4	3.3
1973	8.8	8.5
1974	12.2	11.1
1975	7.0	6.6
1976	4.8	5.1
1977	6.8	6.3
1978	9.0	7.9
1979	13.3	10.8
1980	12.4	10.8
1981	8.9	8.5
1982	3.9	5.0

All indexes based on December to December changes, where Revised CPI is the X1 experimental measure calculated by the BLS.

It is not possible to determine which CPI index will have higher inflation rates in the future, since this depends on the behavior of the relative prices of the items in each index. It is conceivable that the revised CPI index will indicate higher inflation than the old CPI index. The decrease in the homeownership component of the revised index is compensated for by increased weights of food, energy, and other goods and services, which could well increase in the future while housing costs and mortgage rates decrease or level off. However, this would not necessarily indicate that the old index is better than the revised index. The purpose of the revision is to provide a more accurate index of inflation. While the rental equivalence approach might not be a perfect solution, it seems to be a viable alternative in that it eliminates some of the discrepancies discussed previously.

A Comparison Of Alternative Indexes

The annual percentage changes in selected local CPIs for the 1970 to 1982 period are compared in Table 2 which includes the old CPI, and local CPIs for Atlanta, Houston, and Pittsburgh. It is interesting to note the wide divergence among the indexes over the thirteen-year period, suggesting that inflation impacts separate areas of the country at different times and with varying magnitudes.¹⁶ This could explain some of the skepticism

surrounding the CPI. Consider the 1979 to 1980 period. The old CPI dropped from a high of 13.3 percent to a 12.4 percent change in inflation. However, the rates for both Atlanta and Pittsburgh increased to highs of 15.7 percent and 14.3 percent respectively in 1980. Individuals and firms in areas such as these would find it hard to believe that inflation dropped in 1980 while this was the very year that localized inflation increases reached their highest point.

The CPI cannot be criticized as a measure of national inflation. Indeed, the revised CPI should provide a relatively good measure of inflation on a nationwide basis, which is its intended purpose. But it is likely that the CPI has been relied on too heavily, and is thus misused for some purposes.

One of these could well be the indexed lease. Between two different metropolitan areas, there are two areas of divergence. The first is the base level of rent. In one particular year, commercial office space, for instance, could lease for \$10 per square foot in one area and \$15 per square foot in another. There may also be a different rate at which these rents should be escalated, as seen in Table 2.

TABLE 2
Comparison of Regional Indexes³

	"All-Urban" CPI	Atlanta CPI	Houston CPI	Pittsburgh CPI
1970	5.5	5.5	4.3	6.0
1971	3.4	3.4	3.3	3.4
1972	3.4	3.4	3.2	3.2
1973	8.8	8.8	9.4	9.5
1974	12.2	12.2	14.6	10.8
1975	7.0	6.6	8.1	6.3
1976	4.8	3.5	6.6	5.4
1977	6.8	7.3	6.9	6.9
1978	9.0	7.8	12.8	12.0
1979	13.3	12.3	13.2	11.7
1980	12.4	15.7	10.5	14.3
1981	8.9	9.3	10.2	7.6
1982	3.9	4.8	5.8	6.8

All indexes based on December to December changes, except 1970 to 1976 regional indexes for Houston and Pittsburgh which are based on January to January changes.

Therefore, for a fair multiyear lease, protecting both the lessor and lessee, an indexed lease tied to a local measure of inflation would seem appropriate. In some areas a local CPI should be considered if it is available. Firms or Chambers of Commerce in some cities across the U.S. are constructing their own cost-of-living indexes.¹⁷ While the breadth and quality of these local measures may not be quite so great as the CPI, they certainly should be considered as an alternative for indexed leases.

Conclusion

While CPI escalation clauses have been appropriate for long-term real estate leases, the recent revision in the

CPI housing component raises the question of continued relevance. This paper suggests that the revised CPI will still be a relevant index on which to base a multi-year index lease. But it may be to the lessor's and lessee's advantage to investigate tying this lease to a regional index compiled by the BLS, or better yet, possibly tying the lease to a locally compiled index. Obviously, both parties to the lease must agree to, and be comfortable with, the index used.

NOTES

1. J. R. Lewis and E. J. Nosari, "Consumer Price Index Escalation Clauses in Leases," *Real Estate Review*, Vol. 10, No. 3 (1980), 101-104.

2. See for example, "Relative Importance of Components in the Consumer Price Index, 1970-71," U.S. Department of Labor, Bureau of Labor Statistics, 1972.

3. *CPI Detailed Report*, U.S. Department of Labor, Bureau of Labor Statistics, January 1970-January 1983, and quotes from the BLS.

4. A. Dougherty and R. V. Order, "Inflation, Housing Costs, and The Consumer Price Index," *American Economic Review*, Vol. 72 (March 1981), 154-164.

5. A. Blinder, "The Consumer Price Index and the Measurement of Recent Inflation," *Brookings Papers on Economic Activity*, No. 2 (1980), 539-565.

6. See note 3, *supra*.

7. E. A. Powell, "Substituting Rent for Homeowner's Costs in the Consumer Price Index Stirs Debate," *The Wall Street Journal* (May 18, 1982), 56.

8. See note 4, *supra*.

9. *Ibid*.

10. See note 3, *supra*.

11. See, for example, J. S. Greenlees, "An Empirical Evaluation of the CPI Home Purchase Index, 1973-1978," *American Real Estate and Urban Economics Association Journal*, Vol. 10, No. 1 (1980), 1-24, as well as notes 4 and 5, *supra*.

12. P. Cagan and G. H. Moore, "Some Proposals to Improve the Consumer Price Index," *Monthly Labor Review* (September 1981), 20-25.

13. See note 5, *supra*.

14. See note 3, *supra*.

15. 1982 figures obtained from the BLS.

16. Some regional indexes do not show much variation, however. An example is the New York City CPI which has varied by less than 5 percent from the all-urban CPI between 1967 and 1981. See "Escalation Clauses in Urban Office Leases," *Real Estate Review*, Vol. 12, No. 2 (Summer 1982), 55-62.

17. For instance, the First National Bank of Lubbock, Texas began a cost-of-living survey in 1982. This index, based on 302 items, is measured for the Lubbock area, and often shows a substantial difference in the rate of price change when compared with the national or regional CPI. As an example, the national CPI index rose an annualized 3.3 percent in August 1982, while the Lubbock index decreased an annualized 4.0 percent in the same period.

WORLD RENTAL LEVELS: OFFICES

Richard Ellis Research compiled a guide to office rents in the business centers of the world as of May 1983. In Table 1, rents for each center are given in column 1 in the way they are quoted locally. Practice varies considerably in that some rents include charges for cleaning, lighting and other services, some include rates and property taxes, and some are on a gross floor area that includes elevators, stairs, restrooms and communal parts of the buildings.

To allow comparison, column 2 converts rents into dollars per sq. ft. per annum excluding charges, rates and taxes and discounts any gross floor areas to net rentable areas. The approximate additions to rent for services, rates and taxes are given in columns 3 and 4, and the total costs to the occupier are shown in column 5. The exchange rate used for columns 2 and 5 was taken

from the *Wall Street Journal* on June 7, 1983. The graph depicts the figures in columns 2 and 5.

Table 2 illustrates rental movements in each business center, except Tokyo where an office rental market is only just emerging and certain other centers where the market has been excessively volatile. The table compares compound growth in local rents with local inflation (Consumer Price Index).

(*Real Estate Issues* also published the 1981 and 1982 guides in the Spring/Summer editions of these years.)

Richard Ellis, Inc. is a leading real estate consulting firm with offices throughout the world. The firm provides real estate advice to institutions, major corporations and individuals in the areas of investment, management and development. Donald H. Bodel, CRE, is president of U.S. operations which are headquartered in Chicago.

FIGURE
Prime Air-Conditioned Offices — Rent and other Occupation Costs

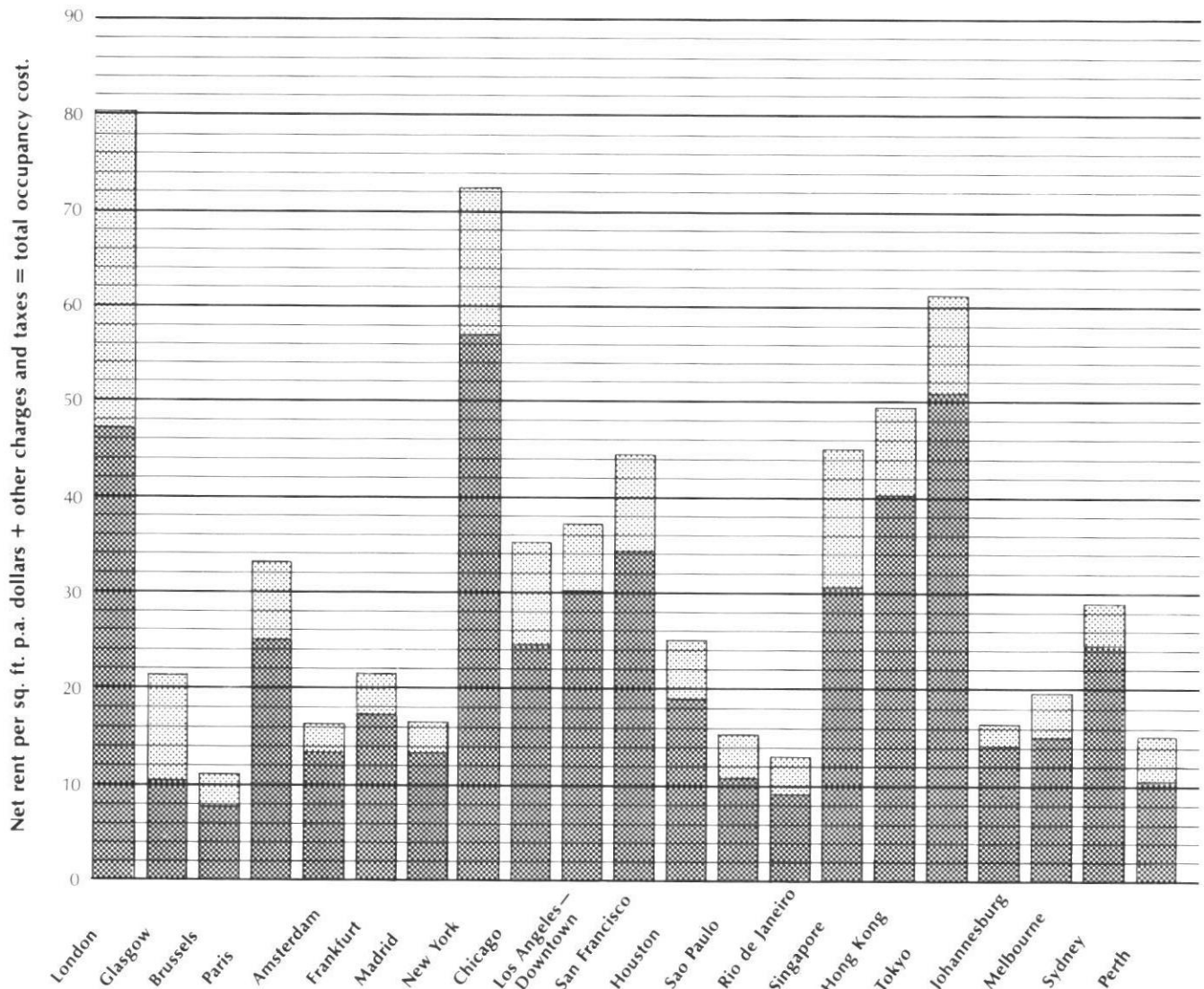


TABLE 1
Prime Air-Conditioned Offices—Rent and Other Occupations Costs
for a Suite of 10,000 sq. ft.

	Rents as quoted locally i.e. floor area as usually measured, services and tax included if customary (January 1983 rents)	Rent in dollars per sq. ft. per annum of net rentable floor area excluding all charges	Service charge	Rates/ Property tax	Total occupation cost
	1	2	3	4	5
London	£30 (£30) per sq. ft. p.a.	\$47.27	15 %	55 %	\$80.35
Glasgow	£6.75 (£6.50) per sq. ft. p.a.	\$10.63	40 %	65 %	\$21.80
Brussels	BF3300 (BF3250) m ² p.a.	\$ 7.96	30 %	12.5%	\$11.34
Paris	FF1800 (FF1800) m ² p.a.	\$25.03	25 %	5 %	\$32.55
Amsterdam	DFL350 (DFL350) m ² p.a.	\$13.28	20 %	0.5% ¹⁾	\$16.01
Frankfurt	DM32 (DM32) m ² p.m.	\$17.38	25 %	0.5% ¹⁾	\$21.80
Madrid	PTS1550 (PTS1550) m ² p.m.	\$13.16	20 %	4 %	\$16.31
New York	\$57.50 (\$57.50) per sq. ft. p.a.	\$57.88	12.5%	12.5%	\$72.36
Chicago	\$28.00 (\$30.00) per sq. ft. p.a.	\$24.66	27.5%	15 %	\$35.13
Los Angeles— Downtown	\$30.00 (\$28.00) per sq. ft. p.a.	\$30.20	17.5%	6 %	\$37.29
San Francisco	\$35.00 (\$35.00) per sq. ft. p.a.	\$34.35	22.5%	6 %	\$44.13
Houston	\$20.00 (\$25.00) per sq. ft. p.a.	\$18.89	20 %	12.5%	\$25.03
Sao Paulo	US\$10.00 (US\$15.00) [†] m ² p.m.	\$11.50	30 %	5 %	\$15.53
Rio de Janeiro	US\$8.50 (US\$11.50) [†] m ² p.m.	\$ 9.78	30 %	5 %	\$13.20
Singapore	S\$6.50 (\$7.00) per sq. ft. p.m.	\$30.25	20 %	30 %	\$45.37
Hong Kong	HK\$23.00 (HK\$26.00) per sq. ft. p.m.	\$40.32	12.5%	10 %	\$49.39
Tokyo	Y11,700 (Y10,000) m ² p.m.	\$51.39*	10 %	10 %	\$61.67
Johannesburg	R13.50 (R13.50) m ² p.m.	\$14.16	15 %	Not quantifiable	\$16.29
Melbourne	A\$220 (A\$215) m ² p.a.	\$15.03	17.5%	12.5%	\$19.54
Sydney	A\$325 (A\$350) m ² p.a.	\$24.44	12.5%	5 %	\$28.71
Perth	A\$165 (A\$165) m ² p.a.	\$10.57	27.5%	12.5%	\$14.79

[†]Rents are quoted in U.S. \$ but converted to Crz in contract

¹⁾Tenants contribution only

*In addition to rent, the tenant makes a deposit equivalent to 15 months rent on which he receives no interest, so that the effective rent is increased by approximately \$4.25 p.a.

TABLE 2
Rental Growth and Inflation through Two Recessions

	1970-1975		1976-May 1983 ^(e)	
	Annual growth rate of local rents	Annual local inflation rate	Annual growth rate of local rents	Annual local inflation rate
London	6%	13%	10%	12%
Glasgow	20%	13%	10%	12%
Brussels	3%	8%	(1%)	7%
Paris	0%	9%	9%	11%
Amsterdam	5%	9%	4%	6%
Frankfurt	0%*	6%	3%	4%
Madrid	37%**	12%	10%	16%
New York	7%	7%	10%	8%
Chicago	11%	7%	10%	8%
San Francisco	3%	7%	13%	8%
Houston	12%	7%	8%	8%
Singapore	14%	10%	16%	4%
Hong Kong	20%	9%	15%	9%
Johannesburg	1%	10%	16%	13%
Melbourne	5%	10%	12%	10%
Sydney	(6%)	10%	16%	10%
Perth	4%	10%	13%	10%

^(e) The Consumer Price Index for May 1983 has been estimated

* Annual growth since 1972

** Annual growth since 1973

Letter to the Editor

My recent 3½-day "vacation" to visit my mother near San Antonio gave me the opportunity to read, while on the plane, the last five issues of your *Real Estate Issues*, and I enjoyed them, as I also mentioned in an earlier note to you.

Had I read the Spring/Summer 1982 issue at the time it was printed, I think I would have sat down and written a rebuttal to one single paragraph of Zell's article. (Editor's note: See "The New Real Estate Math: $1 + 1 = 1\frac{1}{2}$," by Samuel Zell.) On page 11, right column, Zell wrote, "The real estate investor will focus more on current yield as an investment objective, and less on future increased revenues. The internal rate of return methodology, so prevalent in the real estate community today, will lose its appeal. The achievement and maintenance of occupancy will be the foremost concern."

I agree with where Zell is coming from, but certainly not the solution he forecasts. Far too much abuse of IRR has been seen in the last ten years—with forecasts of increasing NOI, say from 1.5 to 5 percent yearly, then all of it discounted at yields appropriate only for constant dollar trends.

In 1975 a Wharton Finance School instructor wrote a short book on real estate investments and mentioned that *with* inflation, the yields on equity investments range between 15 and 25 percent. I agreed as soon as I saw that statement. But yields on constant dollar forecasts remain between 7 and 11 percent depending on quality, price, location, type of property, etc. Or, as Jim Gibbons has implied in things he has written, these yields can be found in the tax-exempt bond markets, after inflation effects have been cranked out of the discount prices.

The attached forms (see the Table and Figure) are not the most typical and representative of more than 150 analyses I've made on various investment properties during the last ten years, but they will reveal what I believe is the importance of analyzing trends in NOI. In my oldest machine, I keep a short program with the mid-year CPA stored in it for all years beginning 1966. And most of my analyses are from seven to ten years, not the five shown here.

This correspondence substitutes for a proper, full-length rebuttal to Zell, and now I've got to get back to work.

McCloud B. Hodges, Jr.
Vienna, Virginia

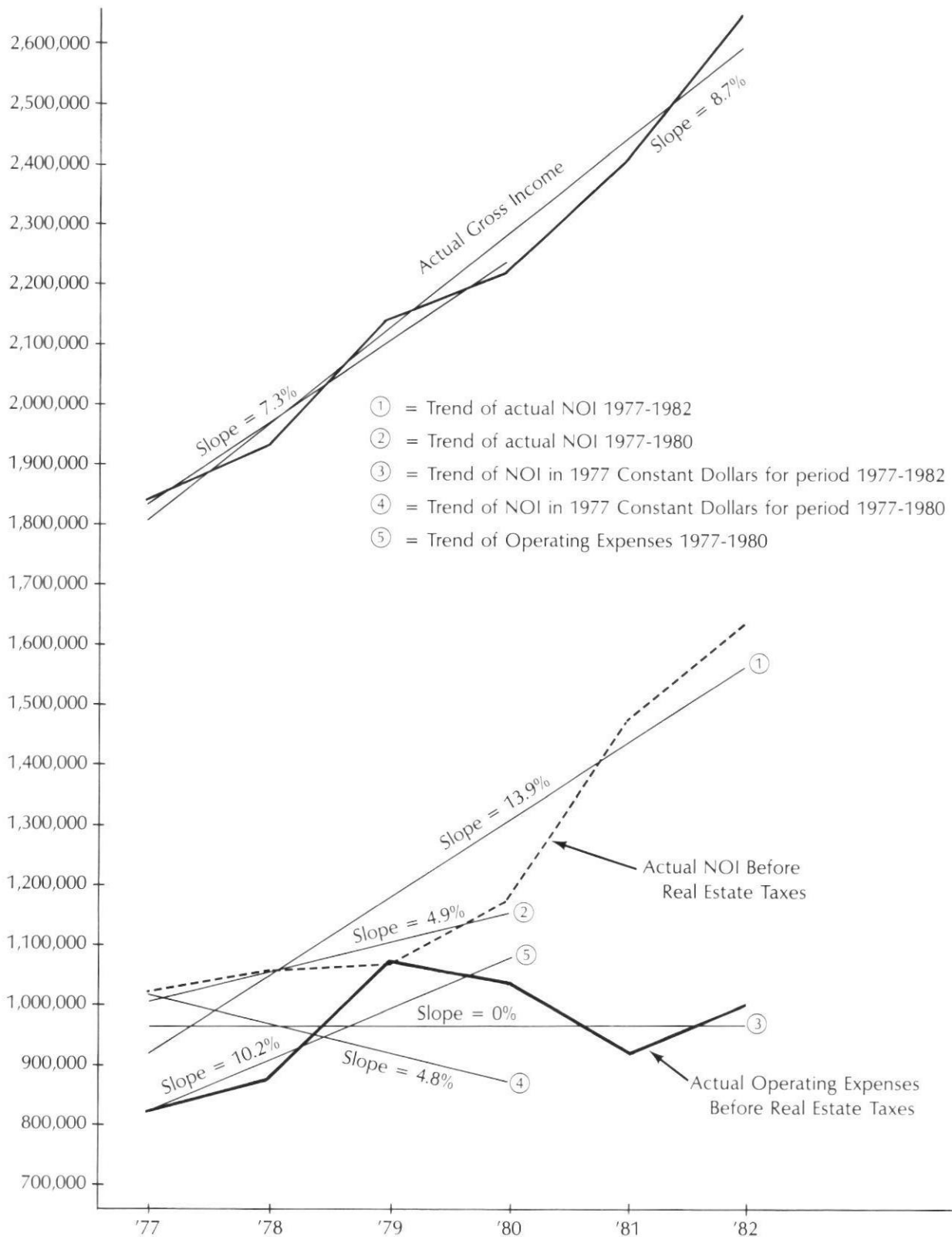
TABLE

Property Identification:
The Brittany
4500 So. Four Mile Run Dr.
Arlington, Virginia

Analysis of past trend in Net Operating Income (actual gross receipts less all operating expenses except debt service and book depreciation), for the fiscal years coinciding with or nearest the calendar years shown, to show changes measured in base year constant dollars and in actual dollars. Conversion of latter years dollars to base years dollars is by the Consumer Price Index, All Items, for the midpoints of the calendar years shown. Rates of change for the total term of years are calculated by linear regression using the sum-of-the-least-squares statistical method.

	Gross Actual Income	Gross Actual Expenses (Before) Real Estate Taxes	Net Operating Income (Before) Real Estate Taxes
	1977	1977	1977
Actual \$	1,843,854	823,561	1,020,293
Constant \$	1,843,854	823,561	1,020,293
	1978	1978	1978
Actual \$	1,932,940	876,842	1,056,098
Constant \$	1,804,077	818,386	985,691
	1979	1979	1979
Actual \$	2,142,265	1,073,050	1,069,215
Constant \$	1,780,330	891,758	888,571
	1980	1980	1980
Actual \$	2,219,795	1,039,011	1,180,784
Constant \$	1,669,433	781,405	888,028
	1981	1981	1981
Actual \$	2,403,510	922,955	1,480,555
Constant \$	1,594,165	612,164	982,001
	1982	1982	1982
Actual \$	2,647,836	1,007,395	1,640,441
Constant \$	1,651,495	628,327	1,023,167
Slope, Actual \$	0.08721	0.03308	0.13918
Y first year	1,804,856	884,031	920,825
Y last year	2,591,877	1,030,241	1,561,637
Slope, Constant \$	- 0.02636	- 0.05530	0.00008
Y first year	1,845,494	881,066	964,428
Y last year	1,602,290	637,468	964,822

FIGURE
The Brittany
4500 So. Four Mile Run Dr.
Arlington, Virginia





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