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THE STAGES OF RENTAL HOUSING OWNERSHIP: ACCELERATED DEPRECIATION AND THE RAPID TURNOVER SYNDROME

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ABSTRACT

This paper argues that accelerated depreciation or cost recovery causes frequent turnover of rental housing ownership as tax advantages disappear after seven to ten years. The practice of balloon mortgages in which most of the principal is due at the end of ten years contributes to the trend. Three stages of ownership, each with distinctive landlord types, emerge in this setting. The triggers causing a decline to the next stage are discussed. The rapid turnover also brings lack of long-term commitment to maintenance, increased debt service with each sale and co-op or condo conversion as traditional buyers leave the rental housing market.

INTRODUCTION

Planners from other countries visiting the United States often cite two unique features of American housing: the vast amount of single unit sprawl and the rapid abandonment of rental housing. The reasons for sprawl are evident, while the reasons for the relatively short-lived stock of multiple unit housing are not.

The frontier spirit of building anew, rather than rehabilitating the old, has been institutionalized in our tax structure and mortgage procedures. On the frontier, people moved from one side of the mountain to the other when the latrines filled up. The luxury of open space and ample supplies allowed this to happen without raising concern. But our abandoned rental stock cannot be replaced so easily. Moderate-and low-income renters, in particular, are being squeezed out of the market.

It can be argued that the accelerated depreciation allowance creates a market dynamic in which there is frequent turnover in ownership of large residential buildings. Richard Slitor (1968) coined the term "the rapid turnover syndrome" to describe this effect. Whether the building appreciates or depreciates in value, there is a generous tax write-off for the first five-to-ten years of ownership.

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Many of the large corporate owners of real estate seek to sell when this tax advantage disappears. Often buildings are traded simply so new owners can start with a new depreciable basis. Long-term ownership is rare for such complexes, with resultant instability for building maintenance and for tenants.

Other factors have complicated or reinforced this rapid turnover syndrome. The practice of giving ten-year mortgages to the owners of large residential complexes forces a refinancing, usually at higher interest rates, just when the tax advantage is disappearing. The increase in fuel prices has erased the profit margin for many owners.

Traditional buyers for these buildings, finding financing difficult, have recently discovered alternative investment opportunities. With the traditional buyers off the market, owners have turned to co-opping of buildings. Many cities with large rental stocks have experienced periods of extensive conversion to co-ops or condos. In New York City, the State Attorney General approved the conversion plans for 98,000 apartment units in 1982 and 1983. It amounted to 5.5 percent of the total rental stock.

History of Depreciation Allowance

Depreciation allowances are based on the assumption that property depreciates in value over time. Through a depreciation allowance, a company may create a non-taxable fund to allow for replacement of machines after their useful life is over. With real estate, the depreciation allowance is given even if the market value rises. In addition, accelerated depreciation schedules are allowed for real estate.

Prior to 1954, most real estate was depreciated on a straight line or a 150 percent basis. Under the straight line method, if a building was considered to have a 20-year life span, half of its value was subtracted from the taxable income of the corporation over a ten-year period. Under the 150 percent formula, 42 percent of its value could be deducted in the first seven years. The useful life was defined rather arbitrarily. After 1954, a 200 percent formula (double declining balance) could be used by the first owners of residential real estate, with less liberal, but still generous, formulas for subsequent owners. The 200 percent formula allowed 52 percent of the cost to be depreciated over the first seven years.

The major headline of an issue of the *Wall Street Journal* (Penn, 1961) read "Profits in Losses: Real Estate Investors Turn Depreciation Tax Write-Offs into Gains." The article refers to companies that "are able to write down the value of the properties they own so heavily and so rapidly that they can show a bookkeeping loss yet at the same time generate a large cash flow - that is, operating income plus depreciation."

The article notes that the tax law encouraged owners to "sell the property after, say, six or seven years when the property nears the point of showing a taxable profit." Since the fastest depreciation could be used on new property, it was to the advantage of the investor to build rather than to purchase older buildings.

The loss to the Treasury prompted President John Kennedy (1963) to cite the article just quoted as he requested legislation that would recapture some of the profit earned through the depreciation allowance. In 1964, Congress did legislate that any accelerated depreciation over the straight line depreciation would be taxed as ordinary income at the sale of the building rather than as less-taxed capital gains.

This recapture is easily avoided. Various means are used to avoid the recapture: the percentages of sale price attributed to buildings and to land (which is non-depreciable) are allocated to the benefit of the seller. The seller can receive his or her proportionate interest in unrealized receivables or in installments or deferred payments. Either the capital gains tax or the income tax can be deferred virtually forever by real estate exchanges.

In 1969 and in 1972, changes were enacted making it more difficult to apply accelerated depreciation to older housing. The second and subsequent owners of rental housing had to declare a useful life of at least 20 years and could use only a 125 percent depreciation formula. The very rapid depreciation for new buildings was not affected because of the concern to stimulate new building. According to Atlas and Drier (1980), this discouragement of normal turnover of apartment buildings and the attractiveness of conversion are two factors bringing on "condomania."

The 1969 Tax Reform Act introduced a provision authorizing a five-year accelerated depreciation for rehabilitation expenditures for low-income rentals. It provided an incentive for owners to invest in rehabilitation, but the recapture at the end of five years could be avoided by investing specified percentages of profits into another rehabilitation. Hawley (1978) found landlords got an "incredible bonanza" from the tax benefits and the increase in rents which accompany such rehabilitation. However, they also had the incentive to sell after the five-year depreciation bonanza.

Part of President Ronald Reagan's first tax package involved a change in the concept from accelerated depreciation to "Accelerated Cost Recovery System". This is a more honest name for the tax allowance. Real property may be depreciated in 15 years. In addition, the formula for most real property allows 43 percent of the cost to be recovered in the first five years. The 1984 Tax Code revisions extended the cost recovery period for real property to 18 years, exempting low-income residential properties which remained at 15 years. The 1981 revisions did include tax credits for improvements on older housing (which were reduced in 1984) and equal depreciation formulas for old and new housing. This reduces the bias against older housing. While the recapture laws have been tightened on commercial properties, other preferences once reserved to residential properties now apply to all real estate (Hite and Krasniewski, 1982). Whether there has been a shift of capital in or out of residential properties as a result of these changes is not yet clear.

Rental Property Investments and Periods of Ownership

The Tax Reform Act of 1976 limited the allowable depreciation in most non-real estate investments to the amount actually invested. But exemptions were made for real estate. The investor in real estate may deduct from taxable income more than his or her cash investment. A person who invests \$100,000 of his or her own money in a building and takes a \$900,000 mortgage can claim depreciation on a million dollars. In five years, he/she might deduct \$460,000. Professional athletes often seek such shelters in order to keep their sports income from being taxed.

There are two incentives for ownership of income-producing properties. A profit can be made if rents exceed operating costs. Sometimes it is advantageous for an investor to own even with negative operating margins if a building is appreciating rapidly in market value or if the investment is used to shelter other taxable income for the owner. Martin (1977) describes the mechanism:

Tax-sheltered income exists when depreciation charges and mortgage interest payments exceed mortgage amortization payments. When tax shelter begins to decline more rapidly than mortgage amortization, one of the major advantages of income property investment begins to disappear. ...Tax-sheltered income generally will disappear after seven to twelve years. A sophisticated investor will sell the property when the tax shelter is gone (p.47).

Actual studies of turnover rates for ownership of buildings shows that the selling of rental properties occurs every five to thirteen years on the average. Sternlieb (1969) cites three studies giving data for the 1900-1955 period. Grebler (1955) traces 4.5 changes per property in 958 parcels on the Lower East Side of New York City between 1900-1949. Rapkin (1959) finds an average of 1.46 conveyances per property for 1,619 parcels on New York's West Side for the 17 year period between 1938-1955. Sporn (1960) finds an average of 2.3 conveyances in 123 slum properties in Milwaukee between 1929-1958. The average turnover rates for these three studies are 11.1 years, 11.6 years and 13 years respectively. Sternlieb (1969) notes a wide dispersion in the frequency distribution of conveyances in these studies. The velocity of turnover was much greater in the larger than in the smaller ones. The large buildings are more likely to have corporate owners than the one-to-four unit buildings. Downie (1974) investigates people using slum area rental buildings as tax shelters in the Washington, D.C. area. In a typical case, the owner of a large three-building complex, Clifton Terrace, sold the property after five years of taking the maximum allowable depreciation.

Refinancing is another factor associated with rapid turnover. The ten-year "balloon mortgage" has been widely used for rental housing since the early '70s. Most, if not all, of the principal is still owed when the mortgage comes due. In the early years, all of

the mortgage payment is designated interest (front-loaded) to allow for greater tax deductions. But when refinancing is necessary, owners face 14-to-18 percent interest instead of the 7-to-9 percent interest that was probably paid ten years earlier. Sternlieb and Hughes (1981) find that a landlord has to increase rents by 20 percent to cover an increment of 4 percent in interest rates. This is for a typical case in which the mortgage is five times the rent roll. Often the easiest way to refinance is to sell the property. Buyers may not be plentiful if rent control laws or the inability of tenants to pay make it difficult to pass along costs in order to get financing.

Two aspects of physical costs and requirements have been further disincentives for ownership of rental housing, particularly of older buildings. Many older buildings are at the point of needing new roofs, heating systems, piping or other major rehabilitation. It is often difficult for the landlord to refinance the mortgage without facing additional capital costs. Heating oil has gone up 800 percent or more in the last ten years, putting a squeeze on operating margins.

STAGES OF OWNERSHIP IN RENTAL HOUSING

Sociologists, economists and geographers have been involved in the development of change models, in which the triggers, the agents and the conditions for change are specified. In the classic Burgess Concentric Zone land use model (Burgess, 1925), the triggers of the invasion-succession process and the conditions for the outward expansion of the city are identified. In the Hoover and Vernon model of the stages of neighborhood transition (Hoover and Vernon, 1962), the demographic, economic and social factors that hasten or retard neighborhood transitions are identified. Downs' (1982) model of the stages of neighborhood change similarly explains both neighborhood decline and revitalization.

A similar kind of model will be offered here illustrating the three stages of ownership in rental housing. As in the Hoover-Vernon (1962) model, a building may remain for long periods or forever in one of the first two stages. But if the history of abandoned housing is checked, it most likely will have gone through all three stages. The model applies to corporate-owned, non-subsidized housing. This model would not apply to one-to-four unit buildings because most are owner-occupied. Even though many 5-to-50 units buildings have non-professional owners, and even some 50-unit-plus buildings have similar ownership, these buildings are affected by the market trends set by the corporate owners. Some buildings that are privately-owned at one stage may be corporately-owned at another stage as they get drawn into the dynamics of the change process. Sternlieb and Hughes (1981) report that in 1978, the U.S. had 2.5 million rental units in buildings containing 50-or-more units and 9.8 million rental units in 5-to-49 unit buildings.

Stage I. The Investor-Developer Stage

Large financial institutions, especially insurance companies, and large companies involved in development and management of buildings

dominate at this stage. The tenants are usually upper- or middle-class residents. The buildings are well maintained and have extras like security guards and, if possible, gardens. An example of a complex having two Stage I owners is the Fresh Meadows complex in Queens, New York. This 3,300 unit complex was developed by the New York Life Insurance Company. Its second owner is Helmsley-Spear, a large firm involved in the ownership and management of realty.

Sometimes the Stage I owners band together in real estate associations. Lawson (1980) studies the different types of real estate associations in New York. One is a group named Associated Builders and Owners. It has only 80 members owning 2,000 to 10,000 apartments each. It focuses its lobbying efforts in Washington on issues of tax treatment and subsidies. There is overlapping membership between this group and the powerful 350-member Real Estate Board of New York that focuses on local issues affecting commercial and residential real estate and the Association for a Better New York, which promotes the interests of New York. Although there is no hard and fast dividing line, the members of these three groups cited by Lawson (1980) are mostly Stage I owners.

There are telltale signs that a building is about to get a Stage II owner. Two of the principal signs are changes in tenants and changes in the surrounding neighborhood environment. If many tenants are getting old at once or if there is a change in the class or ethnic composition of the tenants, there is a high probability of a change to Stage II ownership. Since most buildings are on the market roughly every five-to-ten years, the switch to Stage II ownership is likely the next time the owner's period of accelerated depreciation or cost recovery ends. If the building is in a neighborhood where a change is predicted on the basis of the Burgess, Hoover-Vernon or Downs models, there is a high probability that the corporate-owned rental buildings in that neighborhood will pass into the next stage.

Stage II. The Real Estate Management Stage

Medium-sized companies, which borrow most of their capital, dominate at this stage. Their profits are made through a combination of operating profits (margin between rents and expenses) and tax advantages. They try to preserve the capital value of the building so they can sell it when their tax advantage disappears. However, many of the extras of Stage I disappear. In Stage II, many of the medium-sized buildings may be owned by non-professional real estate people, often craftsmen who live in the area or local businesspeople. Sternlieb (1969) examines over 300 parcels in Newark. The professional owners were most significant in the "worst" and "best" of the subsets, which roughly correspond to Stage I and Stage III of this model. The non-professional owners are more prevalent in the middle stage.

In New York, there is an association of realtors called the Community Housing Improvement Program. Lawson (1980) finds that the members were mostly from small companies owning pre-1947 buildings. The buildings are outside the luxury apartment areas of

the center city. The members "tend to move in different social circles" than the members of the Real Estate Board of New York and the other two organizations cited earlier under the Stage I owners. The 2,500 members own an average of 160 units each and rally around the anti-rent control banner. The members are good examples of Stage II owners.

The same signs of advancing age of tenants, change of class of tenants and neighborhood change that were indicators of a change from Stage I to Stage II are also the same indicators of the switch from Stage II to Stage III ownership. Additional signs are the need for major rehabilitation of the buildings and nearby deteriorating units.

Stage III. The Quick Profit Stage

The landlord, at this stage, wants the quickest possible profit. The tax advantage may or may not be used. If it is, it is only for the first few years of very rapid depreciation. At this stage, the owner will maximize rent collections and minimize maintenance, a process called "milking". Buildings are frequently traded by these speculators, who band together more informally than owners of the other two stages. Sternlieb (1969) calls these landlords "slum specialists", noting they are typically involved in other areas of real estate. The end of the line for the building may be abandonment after a period of non-payment of taxes, or arson, if the owner can get a return from insurance.

IMPLICATIONS OF THE RAPID TURNOVER

1. MAINTENANCE: Short-term owners have less incentive to continue good maintenance, knowing they will not be responsible for the property in a few years.

2. INCREASED DEBT SERVICE WITH EACH TURNOVER: In 1971, it was estimated that 50 cents for every rent dollar went into debt service, mainly for interest payment (Hawley, 1978). Because interest rates have doubled since then and since the mortgage rate usually increases with each turnover, the percent of rents going into debt service has undoubtedly increased. An example of the impact was cited earlier, showing an increment of four percent in the interest rate at refinancing would require a 20 percent increase in rent in a typical building when the mortgage is five times the rent roll. (Sternlieb and Hughes, 1981). Where rents are regulated, increases on account of debt service usually are not permitted. But in a period of very high interest rates, neither the landlord nor tenant can get satisfactory terms whether there is regulation or not.

The situation is complicated by the practice of many real estate owners of "leveraging up" or "exchanging up". Bernstein (1981) quotes a self-made millionaire, "Exchanging has often helped me defer taxes and get bigger properties in the process". Bernstein (1981) notes this real estate owner "clearly understands the basic rule of tax avoidance in exchanging - trade up". A building purchased for \$1,000,000 and resold for \$1,100,000 yields 100 percent profit for someone who invested only \$100,000 of his or her own money. Now

\$200,000 is available to leverage on a new building.

3. NON-PROFESSIONAL OWNERS FORCED OUT: These smaller owners often do not or cannot take advantage of tax depreciation. They might have older, less costly mortgages or no mortgages at all. Many reach a point where they have negative operating margins and cannot stay in the market with firms that depend more on tax depreciation for gain. They lack the legal staff and the connections to large financial interests necessary for getting deeply involved in tax shelters. The fuel price increase and higher financing costs cut into profitable operating margins for many of them.

4. CO-OP CONVERSION: Until the mid '70s, the real estate market for large rental buildings operated rather predictably, as described in the three stages above. Co-op conversion has altered the scenario. Co-op conversion can happen at any stage, whenever a building is on the market. It does not occur just when a building is about to pass from one ownership stage to the next. It can happen at any of the frequent times that a building is for sale. There are now companies which buy for the sole purpose of converting.

Co-op conversion may be the occasion for needed improvements on buildings and can bring added assessments to cities that are suffering from a declining tax base. The filtering-down process in the value of the building is usually stalled or reversed. Many tenants welcome the co-oping. But there are socially undesirable effects. Tenants are often divided. Some cannot afford the purchase. It means fewer apartments available for people who typically rent: young adults, older people and moderate-and low-income people. In some cases, tenants are evicted or forced out of their apartments, putting new responsibilities on lawmakers and enforcement personnel to define legal eviction and illegal tactics. Massive co-op conversion in a neighborhood can quickly change the character of even very stable neighborhoods, even to the extent of forcing local stores out of business because they are not catering to the needs of a new class of people.

There may be another effect of co-op conversions in a few years. Many people taking out loans to buy co-ops are front-loading the interest, so that all of their repayments for the initial years are declared interest and, thus, deductible from taxes. The interest rates for these loans reached 19 or 20 percent before demand slowed down. What will happen when most of the repayment is for principal is not clear. In many cases, this will happen after eight or ten years of occupancy. The people may move or they may refinance the co-op to start another period of front-loaded interest. In an era of tight credit, legislators might consider whether this a prudent use of credit and make laws to regulate or prevent abuses if necessary.

5. ABANDONMENT, TAX FORECLOSURE OR ARSON: Planners from outside the United States often remark about the rather quick abandonment of older building stock in this country. It has been argued here that tax treatment creates this rapid turnover syndrome which, in turn, causes effects that can lead to abandonment. It is impossible to assign the portion of the blame or to tell how different the situation would be without such depreciation laws. But the levels

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of abandonment, tax foreclosure or arson demand a serious re-consideration of our policies. As a result of tax foreclosure, New York City has become landlord to 120,000 people. The City has the responsibility for 10,000 buildings, 4,000 of them occupied, which are in generally advanced stages of disrepair.

IS CHANGE POSSIBLE?

There are many refinements that can be suggested, but the will to reform probably depends more on the comprehensive view that one has regarding the influence of these tax benefits. Accelerated depreciation can be likened to taking a narcotic. In the beginning, the narcotic produces a "high" which can be likened to the effect of new capital being invested, usually in building construction. But the more the narcotic is taken, the lesser the "high" and the greater the dependence on the drug in order to function. A sudden stoppage of drug supplies results in severe withdrawal symptoms for the addict. Suddenly stopping the depreciation allowance could throw the residential housing market into chaos.

President Reagan's tax reform proposals for 1986 contain revolutionary changes in depreciation rules. They most certainly will discourage rental housing investment in the short run. The long-term effects are not clear. All real estate would depreciate over a 28-year period using a formula that provides for only a slight acceleration. Depreciation would only be taken on the amount of money "at risk", thus disallowing the depreciation on the full value of the property beyond the actual investment. The increase of value in real estate would no longer be subject to the capital gains tax, but to the higher ordinary rates. Turnover of ownership would be slowed, but new investment in rental properties would be deterred.

Some tax preference alterations can be made to attract capital to older housing or to discourage rapid turnover without scaring away investment. One means is the investment tax credit for improvement to older housing. The 1981 Economic Tax Recovery Act gave such a credit for housing more than 30 years old, but the 1984 Act reduced these credits. The Reagan Administration, which was praised by landlords and tenants for starting this credit, has proposed its elimination in 1986. The tax credit, which is taken directly from the bottom line of taxes due, has the advantage of not favoring investors in the highest tax bracket, as an operating expense deduction would.

A second kind of tax preference that does not deter new investment is the application of advantageous cost recovery rates for improvements on low-income housing and on older housing. Since 1969, a five-year straight line depreciation or recovery period has been allowed for improvements to low-income housing. Recently, many non-profit groups have used this shelter to sell syndication shares to gather capital for these improvements. An informal study in May, 1984 found plans for the renovation of two thousand units of low-income housing in New York City which depended on these syndications (Association of Neighborhood and Housing Development, 1984). The administration has advocated the repeal of this five-year amortization.

A lower tax rate on profit margins for owners of low and moderate rental buildings is another step which could be taken without changing corporate tax rates by making only a percentage of these profits subject to tax. A similar lowering of tax rates might be applied to residential properties which have been owned for an extended period of time. This would begin to reverse the pattern in which the most lucrative tax benefits are given to those who own properties for short periods of time. The loss of tax revenue from this could be offset by lessened cost recovery allowances.

If the Congress elects a more rapid depreciation than President Reagan has proposed, one means of discouraging rapid turnover would be a tightening of recapture provisions. Local government, too, has a means of slowing the turnover rate by capital gains taxation. Washington, D.C. has a local capital gains tax based on the duration a property is held. Since public facilities or services contribute to the capital appreciation of real property, there is a justification in tax theory for such a law. Restrictions on the front-loading of interest on the loans of co-op buyers would create a more equitable balance in tax benefits given to various sectors of the housing market and would slow conversions of rental housing.

It is beyond the scope of this paper to examine government subsidies to the rental housing market. But in order to evaluate the impact of the Reagan tax proposals, they have to be weighed along with his proposed moratoriums or eliminations of the rental rehab grants, the rental housing development grants, the vouchers providing subsidies to renters and the tax-free mortgage revenue bonds. Can the patient (rental housing) withstand the cumulative impact of these medicines? A selective use of these remedies could lead to the long-term health of the patient. But the wrong combination could also lead to the death of the private rental housing market.

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