



Rehabilitate to Rent

Focusing Resources to Revive the Housing Market

By David Abromowitz and John Griffith

October 2011

Introduction

A growing chorus of policymakers and economists around the country support converting vacant foreclosed homes into affordable rental units, a process we call “rehab-to-rent.” Simply put, with an estimated 1 million or more homes for sale and in foreclosure than we have owner-occupant buyers for today, our country needs more buyers interested in becoming landlords so we can remove for-sale signs from these properties and speed a broader housing market recovery.

Some policy experts, including former Obama budget director Peter Orszag, argue that substantial new tax benefits are needed to entice private investors to make such purchases on a larger scale. Orszag suggests an immediate tax write-off of 100 percent of the cost of the house to investors who buy vacant houses and rent them out, a type of “fast depreciation.” He estimates the subsidy would cost the government \$10 billion annually to spur investors to purchase and rent an extra 250,000 homes a year.

Without a doubt, ramping up the pace of rehab-to-rent would benefit the economy. Getting these so-called real estate-owned, or REO properties—usually vacant houses now owned by lenders who foreclosed upon the former owners—off the glutted for-sale market would help the broader economy. And in specific local housing markets where too many of these REO properties blight neighborhoods, attracting any potential REO buyers would be very worthwhile.

But do potential investors really need more tax incentives? That’s doubtful. An untargeted and inefficient approach that relies on tax credits would unduly reward those that are likely to get in the game anyway while leaving out other groups, such as nonprofit organizations, with an important role to play but who face real barriers to participation.

Lack of tax incentives is not the major barrier to rehab-to-rent

The federal government's recent request for public feedback on the disposition of the 250,000 REO properties owned by the Federal Housing Administration and the two government-controlled mortgage finance giants, Fannie Mae, and Freddie Mac, produced roughly 4,000 responses, many from private groups already engaged in similar rental programs—and many more from investor groups forming funds to jump into the rehab-to-rent market.

Consider Amherst Securities Group, an Austin-based broker-dealer that specializes in residential mortgage-backed securities. The firm recently launched a program to purchase distressed single-family properties and convert them to rental units, according to Senior Managing Director Laurie Goodman. “This is a good business opportunity for interested investors to rent the distressed homes as the rental market strengthens,” Goodman said in testimony to the Senate Subcommittee on Housing, Transportation, and Community Development last month. As Goodman noted, National Association of Realtors data from July 2011 shows that 18 percent of existing home sales were to investors paying cash, most of whom were likely concentrating on distressed properties.

Another company, Renu Management LLC, an Indianapolis-based firm that specializes in the acquisition and management of rental properties, recently completed a study assessing the feasibility of purchasing, rehabilitating, and renting REO properties on a large scale. “We found viability in this as a commercial offering to institutional investors,” said principal Tom Eggleston at a Center for American Progress event last month. The returns to investors for single-family rentals were comparable to those that investors in apartment properties usually target with upfront investment in renovating the houses usually repaid within a five-year period, Eggleston said.

“We simply need to change our thinking and allow the capital that’s on the sidelines to transfer significant single-family ownership so they can achieve the same returns as multifamily now generates,” Eggleston said.

Given this already strong and growing interest in rehab-to-rent, untargeted bonus tax incentives are not what is needed. Indeed, investors already enjoy significant tax incentives. When homes are bought and rented out, owners get a tax deduction for depreciation of roughly 4 percent per year of the purchase price. Rental investors therefore already get a larger write-off than the approximately 2.5 percent per year depreciation deducted from owning an office building or a shopping center.

If these investors rent out the properties for more than a year, and sell for a profit, their “capital gains” are taxed at only 15 percent (and 25 percent on a portion of recaptured depreciation) under the Bush-era tax rates in effect until the end of 2012. And the organizers of investment groups being formed to buy up foreclosed homes also may be

planning to take advantage of the so-called “carried interest” tax advantage. Carried interest tax treatment means that when entrepreneurs profit from putting these deals together, they pay only low capital gains rates instead of the 35 percent ordinary income rate that Americans in higher tax brackets pay on service income that they earn.

On top of this, certain existing tax code incentives that were intended to funnel private investment into home ownership are at the heart of exacerbating the oversupply of foreclosed homes sitting on the market. Vast amounts of investment in subprime and alternative mortgages flowed through entities called real estate mortgage investment conduits, or REMICS, which enjoy a special tax break. REMICs would normally pay a business-level income tax (in addition to the tax investors would pay on the income they receive from the REMIC), but the tax code gives REMICs a special exemption, adding to billions in foregone government revenue each year. The exemption is mostly intended to attract private investment into the home mortgage market.

But REMIC investors are only supposed to keep this tax break if they are making loans, not if they are piling up and sitting on foreclosed houses. Commentators such as former Assistant Treasury Secretary Michael Barr (before he joined Treasury, while he was a senior fellow at the Center for American Progress) and others have long noted that the rules REMICs operate under contribute to the glut in the market and the lack of loan modifications and principal reductions that would avoid further foreclosures. New special tax breaks for private investors in foreclosed homes may turn out to have similar unintended negative consequences in the future.

Some tailored government action to help overcome these market frictions may be necessary to accelerate the pace of rehab-to-rent, but an across the board tax subsidy is the wrong approach.

A better approach for rehab-to-rent

Instead, the federal government should dedicate resources to reducing the specific barriers to participation in rehab-to-rent. The public’s interest would be better served by a targeted subsidy to give mission-driven nonprofit groups a prominent seat at the bidding table. These groups almost always have access to less capital than for-profit investors, which could impede their ability to buy REO properties in bulk. But these entities tend to have close community ties and a vested interest in neighborhood stabilization, which means they’re more likely to keep the rents affordable and retain a long-term stake in the property.

That’s a goal worthy of investing public dollars.

Rather than a lack of tax incentives, experience shows there to be a number of other potential barriers to the rehab-to-rent model. Prime among them is that managing single-family homes that are scattered at a distance from one another is troublesome. Renting out 200 scattered houses of different ages, locations, and styles is far less efficient than running one 200-unit apartment building. And many investors are finding it hard to hire quality on-the-ground managers who could handle such scattered-site single-family rentals.

The acquisition process also can be difficult and costly. Foreclosed houses in any given city are rarely owned by a single seller. A dozen different loan servicers, with different decision-making systems, might own the hypothetical 200 homes an investment group is trying to buy.

Real public benefits result not just from getting homes off the market faster. As we move into a decade or more of rising demand for rental housing, with limited new apartments being built, most economists are forecasting sharply higher rents for average working households.

Many of these same vacant homes are in communities hardest hit by foreclosures, among them Atlanta, Phoenix, and Las Vegas. These communities need long-term revitalization, not just the quick benefit of getting a fire hazard renovated and occupied. Moreover, the private investor groups being formed today appear least likely to buy up homes in the most challenged communities, as their profit models depend upon home prices rebounding over the next five years.

As an alternative, since the passage of the Neighborhood Stabilization Program in 2008, a growing number of community-based organizations, or government-sponsored organizations, have successfully handled the acquisition and rehabilitation of foreclosed homes in their communities. The National Community Stabilization Trust, a nationwide nonprofit organization, uses Neighborhood Stabilization Program funds to help hundreds of local governments and nonprofits purchase vacant REO properties and transform them into affordable homeownership or rental assets.

The pace of this activity would certainly be accelerated by directing the same \$10 billion (as the proposed tax breaks would) toward expanding the capacity and capital of these groups. Most nonprofit mission-driven organizations lack the necessary capital to outbid all-cash, for-profit investors, but with a source to level the playing field that would change substantially.

Some may have a concern that nonprofit groups and local government efforts alone could not grow to a large enough scale to make a meaningful dent in the huge foreclosure inventory. To overcome this, however, funding could be used to help such groups in this effort to partner with for-profit companies experienced in larger-scale real estate

development and management. The community-based organizations might best direct the effort and ensure that rentals and later resales are affordable, while engaging for-profit companies that can renovate homes or manage rentals in larger numbers at once. But the essential public benefit for the long term should not be lost.

Conclusion

To be sure, it is also possible to craft this as a tax incentive. Why not offer fast depreciation, but only if investors partner with a community-based organization that will rent the home out at affordable rents for a minimum of 20 years or longer? Our country has 25 years of experience with the housing tax credit for more traditional apartment buildings, and could adapt that model in a simpler format for rehab-to-rent.

Those advocating for an investor-based tax incentive are right that market forces alone are not converting vacant homes to quality shelter fast enough, and they are right to link the health of the overall economy to tackling the housing glut. But a public investment of such magnitude is better targeted to do more good for the long term if channeled in a way that builds up responsible stewards and a pool of much needed quality housing for working families.

David M. Abromowitz is a senior fellow at the Center for American Progress, focusing on housing policy and related federal and state programs and issues. John Griffith is a Research Associate with the Economic Policy team at the Center.