089154
B-171630
1-24-75
089154

COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

RELEASED

B-171630

JAN 24 1975

The Honorable Les Aspin
House of Representatives

Dear Mr. Aspin:

By your September 4, 1974, letter you requested that we do a complete audit of the Shorehaven housing project in Racine, Wisconsin--a Department of Housing and Urban Development (HUD) section 236 project. You asked that we determine whether a rent increase effective August 1, 1974, was necessary to insure the project's survival. You stated that HUD had advised you that the increase was essential for the project's survival and was needed because of the general inflationary trend and a large underestimation of real estate taxes and electrical expenses. You also stated that the owners said that they operated at a loss of $40,000 during 1973 and projected similar losses for 1974 unless there was a rent increase.

We worked at HUD's Milwaukee area office, the Shorehaven project, and the accounting firm which maintains the project records. Our review included discussions with HUD officials, Racine city officials, and the managing agent and an examination of HUD files and project accounting records.

Our review showed that the rent increase was necessary to meet increased operating costs. Even with the rent increase, it appears there will be an operating loss in 1974 because of increases primarily in utility costs and real estate taxes.

The law covering section 236 projects permits owners to receive a 6-percent return on their investment. The Shorehaven project owners did not receive a 6-percent return in 1973. In that year the project incurred an operating loss.

Whether the project would survive without the rent increase is difficult to determine mainly because owners receive certain tax benefits from losses on section 236 projects. We have no way of determining how long the present owners would continue to operate the Shorehaven project at a loss.

~~906270~~
089154

RED-75-323

In addition to the above question, you also asked these specific questions.

1. What were the actual costs and income for operating the project in 1973?

2. Why were the original estimates on taxes and electricity so inaccurate? Who made these estimates?

3. What is the projected 1974 operation cost? How much revenue would have been generated at the pre-rent-increase rate? How much at the new rent rate?

4. In what way could the management have cut its operating costs to reduce their loss?

5. How much money has been acquired through tenant security deposits that was applied toward the maintenance cost? Was this money considered when figuring the 1973 loss?

BACKGROUND

Section 236, which was added to the National Housing Act (12 U.S.C. 1715z-1) by section 201 of the Housing and Urban Development Act of 1968, authorized a program under which housing units would be provided to low- and moderate-income families. Under section 236 HUD is authorized to insure privately financed mortgage loans for constructing or rehabilitating multifamily housing projects and to pay, on behalf of the mortgagors, the mortgage insurance premiums and the interest on the mortgage loans over 1 percent. Because HUD makes these payments--called interest reduction payments--a basic monthly rent for each housing unit is established at a lower rate than would apply if the project received no Federal assistance.

Section 236 provides that a tenant pay either the basic rent or 25 percent of his monthly income, whichever is greater, and that a tenant's rent payment not exceed the rent which would apply without Federal assistance. Mortgagors must turn over to HUD rent payments exceeding the basic rent charges to help HUD provide future program assistance.

Incentives to invest in federally subsidized multifamily housing have been provided through tax shelters that may reduce Federal income tax liabilities. Some of the tax shelters include accelerated depreciation, 5-year writeoffs of rehabilitation costs, deferments of taxable gains when they are reinvested in other subsidized housing, and allowance of fair market values rather than depreciated costs as deductible items when housing is donated to qualified charitable organizations.

The owner of a newly constructed section 236 project is permitted to depreciate the construction cost at an accelerated rate, using either the double-declining balance or the sum-of-the-year-digits method of depreciation. This depreciation expense, combined with other facility operating costs, often results in a loss from operations which can be offset against income from other sources and which thereby can reduce tax liabilities. The advantage of accelerated depreciation diminishes rapidly after the project operates for about 10 years.

SHOREHAVEN HOUSING PROJECT

The Shorehaven housing project, located in Racine, Wisconsin, consists of 120 three-bedroom townhouse-type apartments. Construction began in February 1972 and was completed in May 1973; however, some of the units were occupied by February 1973.

The original sponsors submitted a feasibility application to HUD in June 1970. Before receiving HUD's firm commitment the original sponsors sold the proposed project site. The new sponsors, including the general contractor, submitted an application for a firm commitment in August 1971 which was approved in October 1971. Before construction was completed, the sponsors sold their interest to a group of investors consisting of four general and eight limited partners.

HUD approved the initial basic rent rate for the Shorehaven project at $148 a month. On January 22, 1974, after operating approximately 1 year, the project owners, because of increased operating costs, requested HUD to authorize a rent increase to $194 a month. HUD evaluated the request and authorized an increase to $184.67 a month which became effective on August 1, 1974.

Information and our comments relating to each of the five questions raised in your letter follow.

1. <u>What were the actual costs and income for operating the project in 1973?</u>

The schedule below shows the income and operating expenses for the Shorehaven project for calendar year 1973.

Income		
Apartment rentals	$118,200	
Interest	3,254	
Furniture rentals	200	
Late charges	55	
Total income		$121,709
Expenses		
Renting expense:		
Advertising	5,080	
Commission	6,445	
Credit reports	1,639	
Auto expense	304	13,468
Administrative expense:		
Management fee	8,708	
Managers' salaries	5,803	
Auditing expense	2,275	
Managers' apartments	1,753	
Legal expenses	1,093	
Office expense	1,069	
Telephone and telegraph	822	
Miscellaneous	490	22,013
Operating expense:		
Electricity	33,223	
Water	2,784	
Garbage and rubbish removal	1,520	
Janitor's	709	
Exterminating	194	
Electrical supplies	47	
Apartment cleaning	15	
Keys and locks	1	38,493
Maintenance expense		4,780
Taxes and insurance:		
Real estate taxes	70,460	
Insurance	1,175	
Payroll taxes	736	72,371
Total operating expenses		151,125
Net loss from operations		29,416

Financial expenses	$ 85,716
Net loss before depreciation	115,132
Depreciation	193,708
Net loss	$308,840

The 6-percent equity dividend, which the owners were entitled, was not paid during 1973. This dividend would have amounted to $13,927.

The $40,000 loss for 1973 mentioned in your letter was computed by HUD on the basis of the $29,416 loss from operations plus 2-months debt repayment of $12,025. The first mortgage payment was due in November 1973. The $85,716 financial expenses shown above includes such items as interest on letters of credit, construction loan fee, and certain first year organizational expenses.

Our test of expense items for 1973 did not disclose any improper or inaccurate recording of expenses except for the overstatement of management fee as mentioned on page 7.

2. <u>Why were the original estimates on taxes and electricity so inaccurate? Who made these estimates?</u>

The sponsor's application for firm commitment submitted on August 26, 1971, contained an estimate of $67,000 for annual real estate taxes. In evaluating the application, HUD lowered the sponsor's estimate to $57,000. HUD officials could not explain why they reduced the sponsor's estimate.

We determined that if HUD used the Racine real estate tax rate in effect for 1970, the tax estimate for the project would have been $70,000. We noted that the actual taxes for 1973 were $70,460. We conclude that HUD had no apparent basis for lowering the sponsor's tax estimate and by doing so, HUD arbitrarily understated the project's estimated operating costs.

The sponsor's application for firm commitment also indicated that a gas hot-water-type heating system would be installed in the project. The application included an operating costs estimate of $66,000 but there was no breakdown showing what elements made up the total. After the submission of this application, but before HUD reviewed the application, the sponsor requested a change to an electric heating system. The sponsor did not submit a revised application to HUD for this change.

HUD's approval of the project was based on the use of an electric heating system. HUD estimated that the annual project operating costs would be $60,000 or $500 a unit, of which $184 was for electricity. Before HUD's approval of the project, the Wisconsin Electric Power Co. estimated in August 1971 that the annual electric costs would be approximately $305 a unit. HUD officials were unable to tell us how they developed their $184 estimate or why they did not use the Wisconsin Electric Power Co.'s estimate.

If HUD used the higher estimates on taxes and electricity in determining the initial operating costs of the project, the project would have required a basic rental rate of about $169.

3. What is the projected 1974 operation cost? How much revenue would have been generated at the pre-rent-increase rate? How much at the new rent rate?

The following amount of rental income would have been generated in 1974 under the various situations, assuming a 5-percent vacancy factor existed.

a.	Pre-rent-increase rate	$202,000
b.	New rent rate (effective since August 1, 1974. Only those tenants with leases terminating between that date and December 31, 1974, and new tenants will pay at the new rent rate during 1974.)	216,000
c.	New rent rate (in effect for an entire year, assumes all tenants pay new rent rate)	253,000

The following schedule shows the estimated amount of profit or loss for 1974 based on the owners' and HUD's projected expenses. For comparative purposes, we used the actual expenses incurred for the first 9 months and projected the expenses for the remaining 3 months. The estimated income is based on the new rent rate effective August 1, 1974, and projected through December 1974.

	Owners' estimate	HUD estimate	GAO estimate
Income	$216,000	$216,000	$216,000
Less:			
Operating expense	105,600	96,425	111,029
Real estate taxes	73,000	70,500	86,376
Net profit from operations	37,400	49,075	18,595
Less:			
Debt repayment	64,000	64,000	63,383
Reserve for replacements	8,697	8,697	8,697
6-percent return to owners	13,950	13,950	13,927
Net loss before depreciation	49,247	37,572	67,412
Less:			
Depreciation	173,949	173,949	173,949
Net loss	$223,196	$211,521	$241,361

4. In what way could the management have cut their operating costs to reduce their loss?

Our review disclosed almost no areas in which management could have reasonably reduced operating costs. Real estate taxes and utilities amounted to about 70 percent of operating costs for 1973. To reduce taxes the Shorehaven owners appealed the 1973 assessment but were denied a reduction by the city of Racine. The fact that utilities are included in the rent provides no incentive for tenants to conserve. The owners investigated the possibility of installing individual meters for each apartment, but this was rejected because of an estimated cost of $50,000.

In reviewing the remaining expense items for 1973, we found that the management fee was overstated approximately $1,400. It appeared that the overstatement was caused by a computational error made by the management agent in billing the project for its services. A HUD official said that they would review this item and if they found it to be overstated, the money would be returned to the project. We concluded from our review and discussion with HUD officials, that the remaining expense items seem reasonable and in line with other section 236 projects.

5. <u>How much money has been acquired through tenant security deposits that was applied toward the maintenance cost? Was this money considered when figuring the 1973 loss?</u>

In 1973, $2,477 of tenant security deposits was applied as income to the project rather than being returned to the tenants. According to the sponsor's accountants, these funds were to cover apartment repairs or rent owed for tenants moving out. The accounting records maintained by the project did not identify those funds required for repairs, so we were unable to determine the amount of security deposits applied to maintenance work. An official of the accounting firm stated that the managing agent would begin to maintain records for tenant security deposits to permit the identification of amounts spent for maintenance items.

- - - -

As requested by your office, we did not give HUD an opportunity to formally review and comment on the matters discussed in this report. However, we have discussed these matters with officials of HUD's Milwaukee area office.

We plan to make no further distribution of this report unless you agree or publicly announce its contents.

Sincerely yours,

Elmer B. Staats

Comptroller General
of the United States