



## Real Estate

# MONITOR

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### Housing: Affordability of Home Ownership

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As the old adage goes, every cloud has a silver lining, and if we can find a silver lining in how home prices have fared over the past few years it would be housing affordability. According to a recent article, *Housing Affordability – A Good Omen (we hope!)*, by Lawrence Yun in the September 2010 issue of the National Association of Realtor's newsletter, *real estate insights*, housing affordability could reach an all time high in the second half of 2010.

#### NAR's Housing Affordability Index

According to the National Association of Realtor's website ([www.relator.org](http://www.relator.org)), the housing affordability index is designed to measure whether or not a typical family (one earning the median family income as reported by the U.S. Census Bureau) could qualify for a mortgage loan on a typical home (defined as the national median-priced, existing single family home as calculated by NAR), assuming a 20 percent down payment is made.

To interpret the indices, a value of 100 means that a family with the median income has exactly enough income to qualify for a mortgage on a median-priced home. An index above 100 signifies that family earning the median income has more than enough income to qualify for a mortgage loan on a median priced home. For example, a composite housing affordability index of 120.0 means a family earning the median family income has 120 percent of the income necessary to qualify for a conventional loan. The average affordability index over the past 40 years was 118, reaching an all-time high of 184 in early 2009.

According to the article, the principal reason for the expected record housing affordability index reading is the rock bottom mortgage

rates of 4.4 percent on a 30-year fixed rate loan. In addition, modest gains in the average wage rate, rose three percent in 2009 and is up 1.2 percent this year-to-date in spite of the high unemployment rate.

#### U.S. Homeownership Rates

However, even as the home affordability index continues to rise, the U.S. Census Bureau reports that U.S. homeownership rates have continued their downward trend through the second quarter of 2010 and remained at 66.9 percent in the third quarter. U.S. homeownership rates have not been at this low a level since the fourth quarter of 1999. There are a number of contributing factors to the depressed homeownership rates, such as high unemployment, increased foreclosures, weak demand, and more stringent mortgage underwriting standards making qualifying for a loan difficult. U.S. homeownership rates hit a peak of 69.1 percent in the first quarter of 2005 at a time when the housing affordability index was 132.3.

#### Homebuyer Confidence

"A compelling argument can be made about the best affordability conditions, but it will be for naught if consumers lack confidence," says Lawrence Yun in his article. Facing a weak economic recovery with persistently high unemployment, nine percent as of October 2010, potential homebuyers are staying out of the market as some lack confidence in the recovery and others may feel there is additional downward housing price movement to come. Staying out of the market will only help to prove them right, as the lack of demand will result in an increase in inventory, and, consequently, further downward pressure on housing prices (and possibly an increase in the housing affordability index).

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The article published by the National Association of Realtors can be accessed at: <http://www.realtor.org/research/reinsights/archives>.

The press release issued by the U.S. Census Bureau can be accessed at: <http://www.census.gov/hhes/www/housing/hvs/qtr310/files/q310press.pdf>.

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## Real Estate

# MONITOR

### Deductions: Passive Losses

With the year reaching its end, real estate professionals should review the special rules that entitle them to deduct losses from rental real estate activities at once rather than carrying them forward to future years. In general, all rental real estate activities are passive, so that losses incurred by non-professionals can only be deducted against passive income. Passive losses exceeding passive income for the year must be carried over to future years.

#### Exception for Real Estate Professionals

For real estate professionals, rental real estate losses are currently deductible if (1) during the year if more than 50 percent of their personal services are performed in real properties businesses, and (2) more than 750 hours are spent in real property businesses.

For both tests, a taxpayer must "materially" participate in the real property businesses. If a joint return is filed, one spouse must meet both tests. Services performed as an employee are ignored unless the employee owns more than five percent of the employer-firm. A closely-held C corporation that is generally subject for the passive loss rules will satisfy these tests if more than 50 percent of its gross receipts are derived from real property businesses in which the corporation materially participates. Real property businesses are those involving real property development, re-development, construction, acquisition, conversion, rental operations, management, leasing and brokerage (but not lending).

#### Proving Material Participation

The IRS has seven tests for determining "material participation." The following is a brief statement of each test, with an indication of the type of records that should

be kept by the tax-payer:

**1. The 500-hour test.** An individual materially participates in an activity by spending more than 500 hours on it during the year. Since this requires 10 hours per week on average, an individual is not likely to meet the test unless the activity is his primary source of income. A diary, contemporaneous daily time reports, logs or similar documents showing the exact hours of participation should be kept.

#### 2. The substantially participation test.

An individual materially participates in an activity if the involvement represents substantially all the involvement as compared to anyone else. This test is intended for persons who run sideline or seasonal businesses. Because a comparative test is involved, the taxpayer must maintain records covering all those involved in the activity, including owners, employees, and independent contractors.

**3. More-than-100-hours test.** Material participation exists when (a) an individual spends more than 100 hours in the activity during the year and (b) the participation is at least as much as the participation of any individual. This is a variation of the preceding test, and the same documentation rules apply.

#### 4. Significant participation activities test.

This test applies to an individual involved in several activities. If the individual (a) participates for more than 100 hours in each of the activities and (b) the total participation in all the activities is more than 500 hours, the individual will have materially participated in all of them. Detailed time records should be maintained, since failure to establish participation in any one activity may result in all being treated as passive activities.

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## Deductions: Passive Losses

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**5. The 5-out-of-10-years test.** The test applies primarily to persons who have retired from an active real estate trade or business but still maintain an ownership interest. The rule seeks to prevent a person from treating retirement income as passive income that can be sheltered by passive losses. Also, the rule says that if the person had materially participated in the activity in any five out of the 10 previous tax years, current income will be active income and not be passive loss.

**6. Personal service activity test.** This test has the same purpose as the five-out-of-10-years test, but applies to persons who have retired from a personal service activity, such as architecture, accounting, law, engineering, or any other business in which capital is not a material income producing factor. If the person materially participated in it for any three taxable years, whether or not consecutive, preceding the current year, then the person's current income or loss from the activity is active and not passive.

**7. Facts and circumstances test.** An individual can establish material participation by showing facts and circumstances that he or she participated on a "regular, continuous and substantial basis," at a minimum of more than 100 hours. This means that daily time records must be maintained. In addition, management services cannot be included in the needed 100 hours, unless the person spent more time in managerial activities than any other person.

**Observation:** Material participation for a limited partner's interest can be achieved only under tests 1, 5, or 6. This is because an interest as a limited partner in a partnership is treated as a passive activity without regard to material participation in the statute, except for the tests indicated above.

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### Mortgage Loans: New Rules

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It is widely accepted that the recent real estate collapse was primarily due to lenders reducing, or disregarding the standards relating to home mortgage qualifications. Exacerbating these issues was having these same lending institutions bailed out, closed, and reopened under another name. As a result of this collapse, President Obama signed into law on July 21, 2010, the Dodd–Frank Wall Street Reform and Consumer Protection Act (the “Act”). The stated aim of the legislation is “to promote the financial stability of the United States by improving accountability and transparency in the financial system, to end “too big to fail,” to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes.” While the Act will affect all financial markets, it will directly impact the real estate market due to clauses relating to mortgage loans, asset backed securities and appraisals.

#### Mortgage Loans

The purpose of Title XVI–Mortgage Reform and Anti-Predatory Lending Act is to “assure that consumers are offered and receive residential mortgage loans on terms that reasonably reflect their ability to repay the loans and that are understandable and not unfair, deceptive or abusive.” The Act sets forth that all mortgage originators be qualified, registered, and licensed as a mortgage originator in accordance with applicable State or Federal law, including the Secure and Fair Enforcement for Mortgage Licensing Act of 2008. Furthermore, for all residential mortgage loans, no mortgage originator may receive compensation that varies based on the term of the loan, other than the principal amount. Finally, the mortgage originator must verify the consumer’s ability to pay. A violation of this, or if the mortgage loan has unfair,

deceptive, or abusive terms, can be raised as a defense in a foreclosure hearing, without regard to a statute of limitations.

#### Asset-Backed Securities

A provision in the legislation requires the Securities and Exchange Commission (“SEC”) and the banking agencies by April of next year to jointly prescribe regulations to prohibit a securitizer (defined as an issuer of an asset-backed security) from directly or indirectly hedging or otherwise transferring the credit risk the securitizer is required to retain with respect to an asset, require a securitizer to retain not less than five percent of the credit risk for any asset that is not a qualified residential mortgage, while requiring something less than five percent of the credit risk for securitizers selling asset backed products involving qualified residential mortgages that meet certain underwriting standards.

The banking agencies and the SEC will specify items such as the permissible forms and minimum duration of risk retention and the fact that the securitizer is not required to retain any part of the credit risk for an asset-backed security if all the assets that collateralize the asset-backed security are qualified residential mortgages. The Act also establishes underwriting standards for each asset class that specifies the terms, conditions, and characteristics of a loan within the asset class that indicate a low credit risk with respect to the loan. Lastly, the SEC will establish rules and regulations for registration statements and filings by issuers of asset backed securities as well as for disclosures of information regarding the assets backing each class or tranche of a security.

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## Mortgage Loans: New Rules

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The goal of this section of the Act is to require securitizers to think twice about taking unnecessary risks. What better way to do so than to keep these parties “on the hook” for their required percentage of the asset? Attorneys and other commentators are divided on whether investors will be encouraged to purchase more asset-backed securities if they know the seller is also interested in the outcome. On the other hand, issuers and underwriters may be required to engage in fewer deals because their investment assets are tied up in the retained portion of the security.

### Appraisals

The Act requires the Federal Reserve Board to implement section 129 E of the act. This imposes new requirements to insure appraisal independence with respect to consumer transactions secured by a principal dwelling. The provisions of the proposed rule are briefly described below. The Federal Reserve said the rules are designed so that appraisers make judgments “without influence or pressure from those with interests in the transaction.” The rule also calls for appraisers to receive “the customary and reasonable payments for their services.”

### Significant Provisions

The rule prohibits coercion or other similar actions intended to cause an appraiser to base an appraisal on factors other than the appraiser’s independent judgment.

The rule bars appraisers and management companies hired by lenders from having financial or other interests in the properties or the credit transaction.

The rule bars creditors from extending credit based on appraisals if it is known beforehand of violations such as appraisal coercion or conflicts of interest unless the creditor determine the property values on not to materially misstated.

The rule requires creditors or settlement service providers having information about appraiser misconduct to file reports with state licensing authorities.

### Extent of Rule

The rule applies to appraisals for any consumer credit transaction secured by the consumer’s principal dwelling. The Federal Reserve said the scope of the final rule as presently stated is broader than the 2008 appraisal independence rules that apply to closed-end loans but not to home equity lines of credit. The final rule will come into effect on April 1, 2011.

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# MONITOR

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## Housing: Residential Ground Leases

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Housing affordability remains a major concern for home builders and home buyers. One approach to cutting home prices already has a long history: the residential ground lease. By giving the builder a share of the anticipated future appreciation of the property, ground leasing can achieve the same results as a program such as the shared appreciation mortgage (SAM) but with few complexities.

### How it Works

As with a commercial ground lease, a home builder can retain title to the underlying land while selling only the building to a home buyer. Since land can represent 20% or more of the total cost, this substantially reduces the price of the home and the buyer's down payment. Also, if the ground rent is less than the after-tax debt service on the financing the buyer would otherwise need, carrying costs also are reduced.

Ground rent usually is set as a percentage of the value of the land. The builder normally will value the land to equal to its cost to him. This permits the builder to realize a normal profit on the sale of the building. However, in order to make the deal more attractive to the buyer, the builder can allocate a value to the land that is less than his cost in order to keep the initial rental as low as possible. Typically, ground rent will represent anywhere from eight percent to 10 percent of the value of the land. Since the ground lease normally is for long-term, the builder will want to include an escalation formula. This can take several forms.

### Periodic Escalation

From the builder's point of view, the best approach is to have the rent adjust each year in accordance with the consumer price index

or some other index. Alternatively, the land can be reappraised every five or 10 years with the rent equal to a specified percentage of the land value. However, this could impose a serious burden on the home buyer, particularly if inflation accelerates in the next few years.

### Fixed Rental for Initial Term

A second approach is to set a fixed ground rent for a number of years, after which the rent will increase in accordance with an outside index. The potential problem for the home buyer is that the ground rent could double or triple at the end of the fixed-rate term, unless increases are to be based on the initial value of the land.

### Graduated Rental Payment

The most attractive approach for home buyer is a graduated rental beginning at a very low level (similar to a graduated payment mortgage) in order to keep initial carrying costs as low as possible.

### Lease Term and Purchase Option

The term of a ground lease should always be at least as long as the expected life of the building and often as much as 99 years with renewal options. This assures the homeowner that the house can be sold at fair market value without the need to buy out the ground lease. The buyer always is given the option to purchase the land, which usually is exercisable at any time and is assignable to a subsequent owner of the house. The option price initially will be equal to the cost allocated to the land by the builder. However, the option price is likely to increase annually by an amount that reflects the projected appreciation in the value of the land (if any). In this respect the ground lease resembles a shared appreciation

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## Housing: Residential Ground Leases

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mortgage (SAM).

### Leasehold Financing

A major concern for the purchaser of a home on leased land is whether a leasehold mortgage can be obtained. The bank or other lender is not likely to provide the loan unless the land is subordinated to the mortgage (so that the lender has some protection as in the case of a straight fee mortgage). In some cases, however, the lender may be willing to make a leasehold mortgage as long as the ground lease and the option to purchase are assignable in the event of a foreclosure on the building.

### Ground Lease as Investments

A builder using the ground lease technique will end up holding a portfolio of building plots subject to leases. The builder has two alternatives at this point. One is to continue to hold the land, earning rental income that likely represents a below-market return on his investment. (However, he can anticipate future purchases by home buyers and appreciated prices.) The other alternative for the builder is to sell a portfolio of building plots to a third-party investor at a discount in order to realize immediate cash. The investor might be a local syndicate that sees this type of holding as a secure and relatively high return investment.

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## Securities: No Liability Under Securities Exchange Act

A pension fund brought a 10b-5 class action against reinsurers for securities fraud but a federal district court ruled that the reinsurer was not required to disclose its sub-prime risks in greater detail than it did and that the statement by an executive officer regarding the risk of its sub-prime related activities was not false or misleading.

In addition, allegations that the reinsurer misstated the value of its credit default swap (CDS) arrangements by failing to mark them to market value, did not provide sufficient particularity to state a 10b-5 claim. *Plumbers' Union Local No. 12 Pension Fund v. Swiss Reinsurance Co.*, 2010 WL 3860397 (S.D. N.Y. 2010).

### Background

A reinsurer who identified sub-prime risks in the portion of its balance sheet dealing with invested assets, and disclosed that sub-prime risks were elsewhere in its balance sheet other than in invested assets, and that these included credit default swap (CDS) activity, was not required to disclose these risks in greater detail. There is no obligation under the Securities Exchange Act for an issuer to identify specifically every type of asset or liability in possesses, so long as its disclosures are broad enough to cover all instruments that are relevant to the value of the issuer's securities.

A statement by an executive officer of a reinsurer that its sub-prime related activities had significantly less risk than it was exposed to through its investments in sub-prime bond, was not false or misleading to support a 10b-5 claim for securities fraud. Statements by a reinsurer that it took a cautious stance regarding various risks, that it could manage volatility and that it engaged in active

management of financial market risk, did not give rise to a claim for securities fraud. Such statements were no more than puffery and were too general to cause a reasonable investor to rely on them. The court also ruled that an allegation that a reinsurer repeatedly misstated the value of its credit default swaps (CDS) by failing to mark them to market value, did not provide sufficient particularity to state a 10b-5 claim in a class action brought by a pension fund against the reinsurer and two of its senior executives for securities fraud. When plaintiffs contend the defendants had access to contrary facts that they did not disclose as would give rise to a claim of securities fraud, they must specifically identify the reports or statements containing this information.

### Credit Default Swaps

A credit default swap is a contract under which a purchaser makes a series of payments to the CDS seller in exchange for credit protection in the event that a particular credit instrument covered by the CDS experiences a defined event such as a default or credit rating downgrade. The occurrence of such an event triggers a payment by the CDS seller to the purchaser of the CDS. The CDS functions as a form of insurance because the buyer of the CDS makes periodic payments and in return receives a sum of money if one of the events specified in the contract occurs. When Swiss Re disclosed severe CDS losses, its shares dropped sharply, while analysts expressed surprise about Swiss Re's involvement in the sub-prime CDS business.

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