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TAX SHELTERS: REAL ESTATE

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REAL ESTATE

General

The real estate industry is a capital intensive industry. The acquisition or construction of apartment buildings, shopping centers, commercial office buildings, hotels and motels, etc., generally require the commitment of large amounts of capital over a relatively long period of time. To provide this capital, a number of investment vehicles have been utilized which allow investors to pool their financial resources. This pooling of investment is commonly referred to as "real estate syndication" and may be set up in any one of a number of legal forms, such as a joint venture, a partnership, a real estate investment trust, or a corporation. These various legal forms differ with respect to the investor's right of control and participation in management, rights of survivorship, personal liability, tax treatment, etc. This pamphlet describes those forms of real estate investment which tend to be used most frequently to produce a "tax shelter" and analyzes the various elements which taken together make up a real estate tax shelter.

A real estate investment decision generally involves an evaluation of the potential risks and the overall rate of return, including the potential cash flow, the potential for appreciation, and the potential tax benefits. The various provisions that provide tax benefits for real estate include the deduction for accelerated depreciation, the deduction for interest and taxes during the construction period, the deduction for prepaid interest, the rules of partnership taxation (including the determination of a partner's basis, especially the treatment of nonrecourse loans, and the allocation of income and losses among the partners), and capital gain treatment upon the sale of the property.

In general, a real estate tax shelter is an investment in which a significant portion of the investor's return is derived from the realization of tax savings on other income as well as the receipt of tax-free cash flow from the investment itself. The shelters encourage investments by higher income taxpayers since the tax savings on a tax shelter investment increases as the individual investor's tax bracket increases, which is a result of our progressive tax rate system. For example, tax savings on other income generated by a deduction of $10,000 is $7,000 in the case of a taxpayer in the 70 percent bracket, $6,000 in the case of a taxpayer in the 60 percent bracket, $5,000 in the case of a taxpayer in the 50 percent bracket, etc.

The savings in tax are principally achieved by allowing current deductions for costs which many feel are attributable to later years. For example, during the construction period the interest paid on the construction loan and the real estate taxes are immediately deducted even though there is no income from the property. Later, after the building is completed, deductions for accelerated depreciation are permitted which, for a period of years, are generally greater than the net rental income before depreciation. These deductions combine to generate losses which can be used to offset income from other sources, such as salary and dividends. In effect, the taxpayer is allowed to defer or postpone the payment of tax on current income, either by offsetting current income with loss deductions attributable to real estate or by receiving a tax-free cash flow from the real estate project, or both. This deferral is the equivalent of an interest-free loan from the government, the economic benefits of which can be very significant.[1]

The entity most commonly used to create real estate tax shelters and produce the maximum tax benefits for an individual investor is the limited partnership. Typically, a real estate venture is syndicated as a limited partnership with the builder-entrepreneur as the general partner and the investors as limited partners. Unlike a corporation, the partnership itself is not subject to tax, but serves as a conduit through which the tax consequences of a particular project are passed to the individual partners. Thus, to the extent that the partnership incurs losses during a particular taxable year, these losses are allocated to and become the individual losses of the various partners.

A partner, including a limited partner, can deduct these losses only to the extent of the basis in his partnership interest. However, a limited partner's basis includes his share of those liabilities of the partnership for which no partner is personally liable ("nonrecourse liability"). This rule relating to nonrecourse debt is extremely important in real estate since such debt financing (leverage) increases the tax benefits to the limited partners and permits them to deduct losses which exceed the amount they have at risk.

In addition, this form of business ownership has several other advantages. For example, one of the important characteristics of real estate syndication is the extent to which mortgage financing can be obtained to acquire property. It is often possible for a syndication to arrange financing for as much as 90 percent of the purchase price. The remaining 10 percent (or equity) of the purchase price can be raised by selling small shares or units in a partnership to numerous investors who become limited partners. Through the use of nonrecourse borrowing by the partnership, the risk of loss to the individual limited partners is minimized, since the limited partners are passive investors and their liability for the debts or claims against the partnership does not include any nonrecourse debt of the partnership.

Present Law

In the case of a real estate tax shelter, two types of accelerated deductions are principally utilized to generate losses: the deduction for accelerated depreciation and the deduction for construction period

[1] An example which illustrates the benefits from a real estate tax shelter is contained in the Appendix.

interest and taxes. In certain cases, prepaid interest may also be utilized, but the availability of a deduction for certain prepaid interest is not peculiar to the real estate tax shelter.

In addition to generating tax losses, these deductions may not subsequently be subject to recapture, thus resulting in the conversion of ordinary income into capital gain.[2]

Depreciation

Before 1946 depreciable real estate buildings generally were depreciated under the straight line method for income tax purposes (that is, a depreciation deduction of an equal pro rata amount over the useful life of the property). In 1946 administrative practices began to permit the depreciation of real estate on the 150 percent declining balance method, which had previously been available only for tangible personal property such as machinery and equipment. Under the 1954 code real property could be depreciated in the same manner as tangible personal property, so that when a building was first placed in service the double declining balance method or the sum of the years-digits method could be used by the first owner.[3] A later owner was permitted to use the 150 percent declining balance method.[4]

The Tax Reform Act of 1969 limited the extent to which accelerated depreciation would be allowed with respect to real property. Under this Act, the use of accelerated methods of depreciation depends upon the class of property involved. A description of these classes of property and the methods available for each class is provided below following a brief analysis of the depreciation methods generally.

It is important to note that depreciation is allowable with respect to the entire cost basis in the depreciable portion of the property and not merely with respect to the taxpayer's equity. Thus, if an apartment building is purchased at a cost of $120,000 ($20,000 for the land and $100,000 for the building) depreciation may be taken on the entire $100,000 cost of the apartment building even if the entire property is purchased for $20,000 cash subject to $100,000 mortgage. The total depreciation taken within the first 4 or 5 years is likely to exceed the owner's entire net equity. (See table below.)

The following summarizes the first year, first 5-year, and first 10-year depreciation deduction as a percentage of a building's cost with 25- and 40-year lives and under the four major alternative depreciation formulas:

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[2] Although the depreciation recapture rules are designed to prevent conversion by taxing certain gain from sales as ordinary income rather than capital gain, they do not fully recapture accelerated depreciation in all cases.

[3] The code also permits the use by the first owner of "any other consistent method productive of an annual allowance which, when added to all allowances for the period commencing with the taxpayer's use of the property and including the taxable year, does not, during the first two-thirds of the useful life of the property, exceed the total of such allowances which would have been used had such allowances been computed under the [double declining balance] methods * * *."

[4] The second owner may be able to approximate, at 1½ times declining balance, the depreciation deductions available to the first owner, since the second owner often can depreciate over a shorter useful life than the first owner. The other benefits described below (depreciation calculated upon total basis, little recapture, and generally capital gains at disposition) are available to second and subsequent owners as well as to the first owner.

[In percent]

	Straight line[5]		200-percent declining balance[6]		Sum-of-the-years digits[7]		150-percent declining balance[8]	
	25-year life	40-year life	25-year life	40-year life	25-year life	40-year life	25-year life	40-year life
Year 1	4	2.5	8.0	5.0	7.7	4.9	6.0	3.75
1st 5-year total	20	12.5	34.1	22.6	35.4	23.2	26.6	17.40
1st 10-year total	40	25.0	56.6	40.1	63.1	43.3	46.1	31.80

The use of these different methods depends, as a result of the Tax Reform Act of 1969, upon whether the property is residential rental property, non-residential property, or low income residential property. In addition, in the case of residential and non-residential property, the allowable method also depends upon whether the property is new or used.

In general, residential rental property includes single and multiple family housing, apartments, and similar structures which are used to provide living accommodations on a rental basis. A building or other structure will qualify as residential rental property if 80 percent or more of the gross rental income from the building or structure is rental income from dwelling units. Hotels, motels, inns, or other similar establishments are not treated as dwelling units if more than one-half of the units are used on a transient basis.

With respect to *new* residential property (the original use of which commences with the taxpayer), both the 200 percent declining balance method and the sum of the years digits method are allowed. (The sum of the years digits method is not allowed for any other class of real property.) Residential property which is *used* property can be depreciated at a 125 percent declining balance rate if it has a remaining life of 20 years when acquired. If *used* residential property has a remaining life of less than 20 years, only straight line depreciation is permitted.[9]

The second class of property is non-residential rental property which includes buildings or other structures that are not used to provide living accommodations, such as commercial office buildings, industrial buildings, shopping centers, etc.

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[5] The straight-line method of depreciation results in an equal annual expense charge for depreciation over an asset's useful life. For purposes of computation, the straight-line rate is determined by a fraction, the numerator of which is one and the denominator of which is the estimated useful life of the asset.

[6] The 200-percent declining balance method of depreciation, more commonly referred to as double-declining balance, allows a rate equal to twice the straight-line rate. In either case, the declining balance rate is applied to the unrecovered cost, i.e., cost less accumulated depreciation for prior taxable years. Since the depreciation base is reduced to reflect prior depreciation, the amount claimed as depreciation is greater in earlier years and declines in each succeeding year of an asset's useful life.

[7] The sum of the years' digits method of depreciation is computed using a fraction the numerator of which is the years' digits in inverse order and the denominator of which is the sum of the number of years. For example, if an asset has an estimated useful life of 10 years, the denominator is the sum of one plus 2 plus 3, etc., plus 10, or 55. The numerator would be 10 in the first year, 9 in the second year, etc. Thus, in the first year, the fraction would be 10/55, in the second year 9/55, etc. As in the case of the declining balance method, the annual depreciation is greater in earlier years and declines in each succeeding year of an asset's useful life.

[8] The 150-percent declining balance method of depreciation allows a rate equal to 1.5 times the straight-line rate.

[9] Other accelerated methods may be used for residential property if the depreciation allowance under these methods during the first two-thirds of the useful life does not exceed the depreciation allowance under the applicable declining balance.

In the case of new non-residential property, depreciation under the declining balance method is limited to a rate which does not exceed 150 percent of the rate determined under the straight-line method.[10]

In addition to the rules relating to the two classes of property mentioned above, special amortization rules are provided for expenditures to rehabilitate low income rental housing (sec. 167(h) of the code). Low income rental housing includes buildings or other structures that are used to provide living accommodations for families and individuals of low or moderate income. An individual or family is considered to be of low or moderate income only if their adjusted income does not exceed 90 percent of the income limits described by the Secretary of HUD for occupants of projects financed with certain mortgages insured by the Federal Government. The level of eligible income varies according to geographical area.[11]

In the case of low or moderate income property, taxpayers can elect to compute depreciation on certain rehabilitation expenditures under a straight-line method over a period of 60 months if the additions or improvements have a useful life for 5 years or more. To qualify for this special treatment, the aggregate rehabilitation expenditures as to any housing unit may not exceed $15,000 and the sum of the rehabilitation expenditures for 2 consecutive taxable years (including the taxable year) must exceed $3,000 per rental unit.

Interest and Taxes During Construction Period

Under present law, amounts paid for interest and taxes attributable to the construction of real property are allowable as current deductions except to the extent the taxpayer elects to capitalize these items as carrying charges.[12] If an election is made to capitalize these items, the amount capitalized will be amortized over the useful life of the building. The deduction for taxes (sec. 164) includes sales and real estate taxes paid or accrued on real or personal property during the construction period. The deduction for interest during the construction period includes amounts designated as "points" or loan processing fees so long as these fees are paid by the borrower prior to the receipt of the loan funds and are not paid for specific services.[13] (Generally, construction period interest is not presently treated as investment interest for purposes of the limitation on investment interest (sec. 163(d)) or treated as a tax preference for purposes of the minimum tax in computing the preference for excess investment interest for purposes of the minimum tax or tax preferences.)

Recapture of Accelerated Depreciation

Under present law, net gains on the sale of real property used in a trade or business (with certain exceptions) are taxed as capital gains, and losses are generally treated as ordinary losses. However, gain on the sale of buildings is generally "recaptured" and taxed as

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[10] Other accelerated methods may be also used for new non-residential property if the depreciation allowance under these methods during the first two-thirds of the useful life does not exceed the depreciation allowable under the applicable declining balance method. No accelerated depreciation is allowable with respect to *used* non-residential real property.

[11] The level of eligible income for a family of four is $15,400 in Washington, D.C., $13,700 in Chicago, and $11,900 in Los Angeles.

[12] Interest paid or accrued during the construction period is deductible under the provisions dealing with the deductibility of interest in general (sec. 163).

[13] See Rev. Rul. 68-643 (C.B. 1968-2, 76), Rev. Rul. 69-188 (C.B. 1969-1, 54) and Rev. Rul. 69-582 (C.B. 1969-2, 29).

ordinary income rather than capital gain to the extent that the gains represent accelerated depreciation taken in excess of the amount that would be allowed under the straight-line method of depreciation.

The provisions relating to depreciation recapture were first enacted in 1962 to prevent deductions for accelerated depreciation from converting ordinary income into capital gain. In general the 1962 provision (sec. 1245 of the code) provided that gain on a sale of most tangible personal property would be taxed as ordinary income to the extent of all depreciation taken on the property after December 31, 1962. In 1964, the recapture rules were extended to real property (buildings) to provide in general that gain on sale would be taxed as ordinary income to the extent of the depreciation (in most cases only the accelerated depreciation) taken on that property after December 31, 1963. This provision (sec. 1250 of the code), however, had a gradual phase-out of the recapture rules. If the property had not been held for more than 12 months, all of the depreciation was recaptured. However, if the property had been held over 12 months, only the excess depreciation over straight-line was recaptured and the amount recapture was reduced after an initial 20-month holding period at the rate of one percent per month. Thus, after 120 months (10 years) there was no recapture of any depreciation.

In the Tax Reform Act of 1969, the recapture rules were further modified as to post-1969 depreciation on real property. Under the Act, in the case of residential real property and property with respect to which the rapid depreciation for rehabilitation expenditures has been allowed, post-1969 depreciation in excess of straight-line is fully recaptured at ordinary income rates if the property has been held for more than 12 months [14] but less than 100 months (8 years and 4 months). For each month the property is held over 100 months, there is a one percent per month reduction in the amount of post-1969 depreciation that is recaptured. Thus, there will be no recapture of any depreciation if the property is held for 200 months (16 years and 8 months).

In the case of non-residential real property, all post- 1969 depreciation in excess of straight-line depreciation is recaptured (to the extent there is gain) regardless of the length of time the property is held.

In addition, in the case of certain Federal, State, and locally assisted housing projects constructed, reconstructed, or acquired before January 1, 1976, such as the FHA 221(d) (3) and the FHA 236 programs, the pre-1969 recapture rules on real property are retained.[15] However, if the property is constructed, reconstructed, or acquired after December 31, 1975, the regular post-1969 rules previously discussed above with respect to residential property will apply (i.e., a one percent reduction per month after 100 months).

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[14] There was no change in the rule providing for recapture of all depreciation (including straight-line) if the property is not held for more than 12 months.

[15] That is, with respect to these projects, accelerated depreciation will be fully recaptured at ordinary income rates only if the property has been held for not more than 20 months. (If the property is sold within 12 months, all of the depreciation is recaptured.) For each month the property is held over 20 months, there is a 1 percent per month reduction in the amount of accelerated depreciation recaptured. Thus, there will be no recapture if the property is held for a period of 100 months (8 years and 4 months).

Leverage

The amount of loss a partner may deduct is limited to the amount of his adjusted basis in his interest in the partnership (sec. 704(d)), which is reduced by the amount of any deductible losses (sec. 705).

Generally, the partner's basis in his partnership interest is the amount of his cash and other contributions to the partnership (sec. 722). If a partner assumes liability for part of the partnership debt, this also increases his basis. However, under the regulations, where the partnership incurs a debt and none of the partners have personal liability (a "nonrecourse" loan), then all of the partners are treated as though they shared the liability in proportion to their profits interest in the partnership (Regs. § 1.752–1(e)). For example, if a partner invested $10,000 in a partnership, in return for a 10-percent profits interest, and the partnership borrowed $100,000 in the form of a nonrecourse loan, the partner's basis in the partnership would be $20,000 ($10,000 of contributions to the partnership, plus 10 percent of the $100,000 nonrecourse loan).

Expenses of Syndication

Until recently, in the case of a real estate partnership, as in the case of tax shelters generally, it has been the common practice for limited partners to deduct the payments made to the general partner for services in connection with the syndication and organization of the limited partnership. However, in Rev. Rul. 75–214 (I.R.B. 1975–23, 9), the Service ruled that such payments to general partners constitute capital expenditures which are not currently deductible. Nevertheless, because of the past practices of taxpayers deducting these payments, it might be appropriate further clarify the law in this area.

Rev. Proc. 74–17

Under present law, if the purpose of a transaction is tax avoidance, the transaction may be set aside for Federal tax purposes, with the result that the taxpayer will not receive the deductions resulting from the transaction to which he would otherwise be entitled *Court Holding Co.* v. *Commissioner*, 324 U.S. 331 (1945). As a result, the Service generally will not issue a ruling letter with respect to any transaction where there is a serious question as to whether or not the principal purpose of the transaction is tax avoidance.

In Rev. Proc. 74–17, 1974–1 C.B. 438 (TIR–1290, issued May 3, 1974), the IRS set forth certain guidelines which it will apply in determining whether the formation of a limited partnership is for the principal purpose of reducing Federal taxes.

If the requirements of Rev. Proc. 74–17 are not satisfied, no ruling letter will be issued. However, the taxpayer is still free to argue (with an Internal Revenue agent, or before a court) that he is entitled to the deductions claimed in connection with the partnership.

The IRS guidelines contained in Rev. Proc. 74–17 are as follows:

(1) **All of the general partners, in the aggregate, must have at least a** one percent interest in each material item of partnership income, gain, loss, deduction or credit.

(2) The aggregate deduction of the limited partners during the first two years of the partnership's operations cannot exceed the amount of the equity investment in the partnership.

(3) No creditor who makes a nonrecourse loan to the partnership may acquire, as a result of making the loan, any direct or indirect interest in the profits, capital, or property of the limited partnership, other than as a secured creditor.

Problem

It is argued that with respect to accelerated depreciation on real property, the economic cost attributable to the exhaustion of the depreciable portion of the property will rarely equal the amount claimed as a deduction during the earlier years of its useful life. In fact, the property may appreciate in value rather than depreciate. Moreover, it is pointed out that accelerated depreciation will frequently exceed the amount required to service a mortgage against the property during the early life of the property (yielding a positive cash flow from the property). Many believe that this shows that lenders do not believe that the property depreciates at the accelerated rate presently allowed for tax deductions. Even when the property is acquired with a low down payment (and therefore there is a substantial amount paid to service the mortgage), there will often be a positive cash flow in the early years after acquisition.

The accelerated depreciation usually produces a deduction in excess of the actual decline in the usefulness of the property. As a result economically profitable real estate operations normally produce substantial artificial tax losses, thereby sheltering from income tax the economic profit of the operation and permitting avoidance of income tax by the taxpayer on other income, such as salary and dividends by also sheltering that income from taxes and providing a deferral of tax liability.

Because of the present tax situation, when an investment is solicited in a real estate venture, it has become common practice to promise a prospective investor substantial tax losses which can be used to decrease the tax on his income from other sources. There is, in effect, substantial dealing in "tax losses" produced by accelerated depreciation on real property.

Also, it is argued that the allowance of a deduction for construction period interest and taxes is contrary to the fundamental accounting principle of matching income and expenses. Generally, a current expense is deductible in full in the taxable year paid or incurred because it is necessary to produce income and is usually consumed in the process. However, some expenditures are made prior to the receipt of income attributable to the expenditures and, it is argued that under the matching concept, these expenditures should be treated as a future expense when the income "resulting" from the expenditure is received and the original investment is gradually consumed. Alternatively, it is argued that the allowance of a deduction for construction period interest should be deductible in the year paid, notwithstanding the fact that the building is in process and not yet placed in service, because the interest is a cost of financing and not a cost incurred to acquire the building; likewise, taxes paid during the construction period are period costs, not capital costs, because they do not add value to the underlying assets.

In the case of an individual who constructs a building and subsequently receives income in the form of rents from that building, it is argued that the accounting concept of matching income against expenses should require that the expenses incurred during the construction period be deducted against the rental income which is received over the life of the building, to the extent the expenses are attributable to a depreciable or wasting asset. The general construction costs of the building are treated this way, being capitalized and deducted as depreciation expenses. (Similarly, certain pre-opening or start-up expenses for a new trade or business are required to be capitalized for tax accounting purposes.) The interest and taxes paid during the construction period, however, are not capitalized under existing law except to the extent that the taxpayer may elect to treat these items as carrying charges chargeable to capital account.

The allowance of a deduction for construction period interest and taxes has contributed to the development of tax shelters in the real estate industry. Since the rental income from the building occurs substantially later than the time when the construction period interest and taxes are actually deducted, this results in losses which the investors are permitted to offset against their other income (salary and dividends) thereby sheltering that income from taxes and providing a substantial deferral of tax liability. As previously mentioned, this is essentially equivalent to an interest-free loan from the Federal Government, and can result in a substantial benefit, particularly in times of high interest rates.

In addition, when a building is sold, any realized gain may be eligible for capital gains treatment to the extent accelerated depreciation is not recaptured as ordinary income. However, there is no recapture with respect to the construction period interest and taxes. As a result the deductions for construction period interest and taxes that are taken against ordinary income enable the taxpayer to, in effect, convert ordinary income into capital gains.

It has been argued that real estate ventures which are formed primarily to obtain tax shelter benefits essentially represent a misuse of intended tax incentives of longstanding and major importance. In addition, many feel that tax shelters may cause serious distortions in real estate values and construction costs, result in investments being made in projects that are economically unsound, and interfere with the efficient allocation of the nation's resources. In some cases the tax avoidance which is made possible by use of the real estate shelter can reach substantial proportions, as is indicated by the examination of the real estate tax shelter returns.[16]

In case number 1, for example, the partnership commenced operations on December 28 and experienced $215,000 of losses ($197,000 of

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[16] Tax Shelter Investments: Analysis of 37 Individual Income Tax Returns, 24 Partnership and 3 Small Business Corporation Returns. Prepared for the use of the Ways and Means Committee, September 3, 1975.

depreciation) in 3 days of existance. One partner, with $448,000 of economic income, paid $1,200 of tax (primarily as a result of participating in 3 real estate shelters).

In case number 2, the partnership was leveraged in a ratio of about 65 to 1, and generated a loss of almost $4 for every dollar of actual investment. In that case, one partner paid tax of $30,000 on economic income of $252,000.

In case number 5, one partner with economic income of $105,000 paid no tax and had $240,000 of net losses from real estate. Another partner with $262,000 of economic income also paid no tax, and had $463,000 of "losses" from real estate.

Others argue that the provisions of present law providing incentives are essential to attract investment in an industry already suffering from a shortage of capital. Without these incentives, they urge, the capital shortage problem will be severely aggravated.

However, it would appear that the goals of providing incentives to the real estate industry and at the same time curbing the present misuse of these tax incentives are not incompatible. The following section outlines the various proposals that have been advanced to accomplish both of these goals.

Alternative Approaches

There are a number of alternative approaches that the committee could consider to deal directly or indirectly with real estate tax shelter investments. If the committee believes that certain incentives are no longer desirable or that the tax benefits from the preferences are greater than they need be, the committee could revise the provisions directly; that is, the particular provisions could be eliminated or the preference cut back to some extent. For example, the committee could consider requiring interest and taxes during the construction period to be capitalized, further limiting the use of accelerated depreciation, and requiring complete recapture of depreciation. In addition, the committee could consider certain changes with respect to general partnership tax treatment (such as, not allowing deductions in excess of a partner's equity in the partnership or not allowing nonrecourse loans to increase a partner's basis).

On the other hand, if the committee believes that certain incentives should be continued for real estate but that the tax benefit involved should not be available to offset income unrelated to that particular activity, then the committee could consider limiting the tax write-offs to income from that particular activity. This would prevent the use of excess deductions to shelter other income.

This is the approach that the Administration adopted in its limitation on artificial loss (LAL) proposal made in the tax reform presentation to the committee on April 30, 1973, and essentially adopted by the committee (with certain modifications) in its 1974 tax reform bill, as described below.

A third approach to deal with real estate tax shelter investments could be considered if the committee decide against either of the first two approaches. If the committee believes that there is a desired objective for continuing the tax incentives and that revising the provision directly or applying a LAL approach would unduly restrict their purpose, then the committee could consider dealing indirectly with the preferences, such as by broadening the application of the minimum tax.

The following is a summary of the committee's decisions with respect to real estate in its 1974 tax reform bill, Mr. Ullman's proposals, and alternative proposals by other committee members.

Limitation on Artificial Losses

A. 1974 Committee Bill

To prevent taxpayers from sheltering unrelated income from taxation by deducting the accounting losses attributable to accelerated deductions for real estate activities, the 1974 committee bill provided for the deferral of the deductibility of accelerated deductions attributable to real property to the extent the deductions for a taxable year exceed the taxpayer's net related income from real property. The net related income would be equal to the gross income from real property less the "ordinary deductions" attributable to real property (deductions other than the accelerated deductions for that year). The accelerated deductions in excess of net related income would be suspended for use in a later year. The limitation would not apply to losses which represent true economic losses not attributable to accelerated deductions; thus these losses could continue to be deducted currently.

For purposes of applying the limitation on artificial losses in the case of real estate, the accelerated deductions to be taken into account would consist of the deductions for accelerated depreciation and construction period interest and real property taxes. Construction period interest and taxes that the taxpayer elects to treat as capital expenditures would not be considered to be accelerated deductions.

The limitation would apply to individuals (and estates and trusts) and to electing small business corporations (subchapter S corporations).

Deferred deductions.—The amount of the accelerated deductions attributable to real estate activities which is deferred would be reflected in a deferred deduction account. The deferred deductions would be allowed in subsequent taxable years against the taxpayer's net related income from real estate. The amount allowable with respect to the deferred deductions for a subsequent taxable year would be limited to the amount by which net related income exceeded the accelerated deductions for real property for that taxable year. The amount allowable could not, of course, exceed the balance of the deferred deduction account. Special rules would be provided to permit the allowance of deferred deductions when there is a disposition of the property giving rise to the deductions.

Under the 1974 committee decision, a separate deferred deduction account would be maintained for each class of property subject to the provisions, i.e., a real estate class, a farm class, etc. The real property "class" would include real property held for sale to customers in the ordinary course of a trade or business or held for the production of rents. The class would include both residential and commercial real property held for sale or rental; that is, all real estate would be consolidated for purposes of LAL.

Accelerated depreciation.—The depreciation to be treated as an accelerated deduction is that portion of the depreciation taken in excess of the amount that would be allowed under the straight-line method for computing depreciation.

Construction period interest and taxes.—The construction period interest to be treated as an accelerated deduction would be interest paid or accrued on indebtedness incurred to purchase or carry real property to the extent the interest is attributable to the construction period for the property. Thus, interest paid with respect to a purchase-money mortgage, or other indebtedness incurred to purchase or carry unimproved land, would not be considered to be an accelerated deduction to the extent the interest is not attributable to the construction period. Similarly, real property taxes would be considered to be accelerated deductions only to the extent attributable to the construction period of the property.

For purposes of this provision, the construction period would commence with the earlier of the date the construction, reconstruction, or erection begins, or the date that indebtedness for the construction, reconstruction. or erection is incurred. The construction period would end on the date that the building or other improvement is ready to be placed in service or is ready to be held for sale.

Exception for certain subsidized low and middle income housing.—No deduction attributable to certain low and middle income housing would be treated as an accelerated deduction for purposes of this provision. This exception would apply to property with respect to which a mortgage is insured under section 221(d)(3) or 236 of the National Housing Act. It would also apply to housing that is financed or assisted by direct loan or tax abatement under similar State or local provisions if the owner is limited as to the rate of return on investment and the rentals or occupancy charges. Further, the exception would apply to property with respect to which the dwelling units are held for occupancy by families or individuals eligible to receive subsidies under section 8 of the United States Housing Act of 1937 (or corresponding provisions of prior law) or under the provisions of similar State or local law.

Phase-in of LAL.—These provisions would not apply to residential real property if the construction period for the property began before January 1, 1978. In the case of commercial property, the provisions would not apply if the construction period for that property began before January 1, 1976. However, accelerated depreciation with respect to these properties during this period would be considered to be a tax preference for purposes of the minimum tax provisions.

With respect to construction period interest and taxes, transitional rules would be provided with respect to commercial starts after January 1, 1976, and residential starts after January 1, 1978. In the case of commercial property, only one-third of such interest and taxes would be subject to the limitation for taxable years beginning after December 31, 1975, and before January 1, 1977, and only two-thirds for taxable years beginning after December 31, 1976, and before January 1, 1978. In the case of residential property, only one-third of the construction interest and taxes would be subject to the limitation for taxable years beginning after December 31, 1977, and before January 1, 1979, and only two-thirds for taxable years beginning after December 31, 1978, and before January 1, 1980.

B. Mr. Ullman's Proposal

Mr. Ullman's proposal is very similar to the LAL approach tentatively adopted in the 1974 committee bill. However, instead of allowing all real estate to be consolidated and treated as one class for purposes of applying LAL, he would treat each property as a separate class. As a result, losses attributable to accelerated deductions from one property, such as an apartment building could not be used to offset income from another apartment building. The effect of this is to prevent the sheltering of income from one property by the artificial losses of another property. In addition, Mr. Ullman would apply LAL to all real estate, including low-income housing built under various Federal, State, and local government subsidy programs.

Further, Mr. Ullman would apply LAL generally to all real estate in 1976. In addition, he would propose transitional rules with respect to interest and taxes during the construction period, which differ somewhat from the 1974 committee bill. Under Mr. Ullman's proposal, in the case of construction period interest and taxes LAL would apply (1) to commercial property in 1976 without any phase-in; (2) to residential property generally beginning in 1977 and phased in over the years 1977 and 1978; and (3) to low-income housing built under various Federal, State and local government subsidy programs beginning in 1978 and phased in over the years 1978 through 1980.

C. Messrs. Vanik, Corman, Green, Gibbons, Karth, Vander Veen, Rangel, Stark, Jacobs, and Mikva, and Mrs. Keys

They would apply the rules in the same manner as Mr. Ullman; except that with respect to residential housing generally they would make LAL fully applicable in 1977.

D. Messrs. Waggonner, Helstoski and Conable

The proposal would apply LAL on a consolidated basis in the same manner as provided in the 1974 committee bill. In addition, the proposal of Mr. Waggonner and Mr. Conable would permit disallowed deductions to be capitalized and recovered through depreciation over some short period of time (e.g., 1/3 of the useful life of the property).

E. Mr. Vander Jagt

He would retain the exemption from LAL (as in the 1974 committee provision) for Federally and State-assisted housing for low- and moderate-income families. The effect of this proposal would be to continue the special tax benefits for subsidized low- and moderate-income housing.

Recapture of Depreciation on Real Property

1974 committee bill.—In the case of real estate, except as noted below, the committee bill provided for the complete recapture of all depreciation in excess of straight-line depreciation to the extent of any gain involved at the time of the sale of the property. (This rule already applies in the case of commercial property.) In the case of low-income housing assisted under Federal, State or local law, the depreciation in excess of straight-line which is to be recaptured would be reduced by one percentage point for each full month the property is held after the date on which the property was held 100 full months (20 full months if the property was acquired or construction began before January 1, 1978).

Mr. Ullman.—He would apply the general rule for recapture outlined above but with no special treatment in this respect for low-income housing assisted under Federal, State or local law.

Limiting the Depreciation to Equity in Rental Real Estate

Mr. Corman.—He would provide that in the case of a building which the taxpayer rents to others, the deduction for depreciation cannot exceed the taxpayer's equity in the building and the land (the depreciation deductions would be computed on the entire cost of the building, however, and not on the amount of the equity). This would not apply to a building if the primary use is by the taxpayer.

Capitalizing Construction Period Interest and Taxes

Messrs. Corman and Stark and Mrs. Keys.—The proposal would provide that interest and taxes attributable to the construction period in the case of real property may not be deducted, but instead are to be added to the cost of the building involved and recovered through depreciation allowances over the life of the building.

Restrictions on Depreciation for Real Property

Mr. Stark and Mrs. Keys.—The proposal would make the class life system (or ADR) inapplicable to real property. (Last year in H.R. 17488, which was reported out by the committee but on which no action was taken by the House, the committee repealed the provision requiring the application of the ADR system to real estate after 1973 (paragraph (1) of section 109(e) of the Revenue Act of 1971). Under this bill, in the case of real property placed in service before class lives have been prescribed for real property, a taxpayer who had elected the ADR system could also elect to determine the useful life of depreciable real property under Revenue Procedure 62-21 as in effect on December 31, 1970 (to the extent the provisions of that revenue procedure are applicable to real estate), or on the basis of the facts and circumstances of the particular case.)

The propcsal would also provide that accelerated depreciation allowable on any real property may not exceed 125 percent of the amount that would be deductible under the straight line method.

Appendix

The cash benefits flowing to investors may be illustrated by the following example:

Assume that a limited partnership is formed to purchase land and construct a building thereon. The partners make a total cash investment of $250,000. Land is purchased for $100,000 and a building is constructed for $800,000. During the first year of operation, the partnership incurs the following deductible expenses:

Construction loan interest [1]	$84,000
Loan commitment fee	12,000
Taxes [2]	3,280
Management and tax advisory fees	23,000
Total	122,280

[1] Assumes a 14 percent rate of interest and that one-half of the construction loan is owed for a full year and the remainder for six months.

[2] Assumes a tax rate of $4.10 per $100 and an assessment of 40 percent of fair market value.

In addition, the general partner is paid $20,000 for organizing the partnership. This payment is a nondeductible capital expenditure. The permanent mortgage is in the amount of $800,000 at 9¾ percent payable in equal monthly installments of principal and interest over 25 years.

The rental income is assumed to be equal to the sum of the operating expenses, the real estate taxes, the payments of principal and interest on the mortgage, and an annual distribution to the partners of $10,000 (4 percent of $250,000).

The basis in the building of $800,000 is depreciated, using the average lives of the building and components, over a 25-year useful life on a double-declining balance method of depreciation.

The following table illustrates the cumulative benefits which are available to the partners, assuming they are in the 60 percent bracket. The value of the deferral benefit is measured by assuming that the partners invest their tax savings and cash distributions in tax exempt bonds yielding 7 percent per annum tax-free interest. Under these circumstances, the total value of the cash flow and deferral benefits is $745,559.

CUMULATIVE TAX SAVING AND DEFERRAL BENEFITS

Year	Taxable income (loss)	Tax saving at 60 percent	Cash distributions	7-percent tax-free interest	Cumulative cash benefits
0	−$122,280	+$73,368			$73,368
1	−38,597	+23,158	$10,000	$5,136	111,662
2	−32,672	+19,603	10,000	7,816	149,082
3	−27,073	+16,244	10,000	10,435	185,762
4	−21,762	+13,057	10,000	13,003	222,823
5	−16,696	+10,018	10,000	15,527	257,369
6	−11,841	+7,104	10,000	18,015	292,489
7	−7,158	+4,295	10,000	20,474	327,259
8	−2,608	+1,565	10,000	22,908	361,732
9	1,837	−1,102	10,000	25,321	395,951
10	6,219	−3,731	10,000	27,716	429,936
11	10,565	−6,339	10,000	30,095	463,692
12	19,308	−8,951	10,000	32,458	497,200
13	19,307	−11,584	10,000	34,804	530,419
14	23,776	−14,265	10,000	37,129	563,283
15	28,356	−17,014	10,000	39,429	595,699
16	33,087	−19,852	10,000	41,698	627,545
17	38,009	−22,805	10,000	43,928	658,668
18	43,168	−25,901	10,000	46,106	688,874
19	48,608	−29,164	10,000	48,221	717,930
20	54,376	−32,626	10,000	50,255	745,559

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