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Recommended Citation

C. W. Ritter, & Emil M. Sunley Jr., *Real Estate and Tax Reform: an Analysis and Evaluation of the Real Estate Provisions of the Tax Reform Act of 1969*, 30 Md. L. Rev. 5 (1970)

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Maryland Law Review

VOLUME XXX

WINTER, 1970

NUMBER 1

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REAL ESTATE AND TAX REFORM: AN ANALYSIS AND EVALUATION OF THE REAL ESTATE PROVISIONS OF THE TAX REFORM ACT OF 1969

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On January 17, 1969, in one of the last official acts of the outgoing administration, Secretary of the Treasury Joseph Barr warned Congress of a taxpayer revolt and outlined the now-famous cases of 155 "taxpayers" who made over \$200,000 and twenty-one "taxpayers" who made over \$1 million in 1967 and paid no Federal income taxes.¹ Eleven months later, President Nixon signed the Tax Reform Act of 1969 into law.²

This paper focuses on the real estate provisions of the Tax Reform Act of 1969³ with particular emphasis on the impact of these tax changes on investment in housing. The 1969 Act contained reforms in the real estate provisions designed to raise in excess of \$900 million

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The opinions expressed herein are the authors' and do not necessarily represent the position of the Treasury Department.

1. JOINT ECONOMIC COMMITTEE, THE 1969 ECONOMIC REPORT OF THE PRESIDENT, 91st Cong., 1st Sess. 5-6 (1970). It is interesting to note that these high income "taxpayers" who paid no taxes were not real estate investors. The statistics cited by Secretary Barr concerned "taxpayers" with adjusted gross income of over \$200,000. Since real estate depreciation is deducted from gross income in determining adjusted gross income, real estate investors were not included in the select group cited by Secretary Barr.

2. Act of Dec. 30, 1969, Public L. No. 91-172, 83 Stat. 651.

3. The portions of the Act dealing directly with real estate are sections 521 (adjustment to depreciation and recapture under Code §§ 167 and 1250), 910 (tax-free sale of federally assisted low and moderate income housing under new § 1039 and amended § 1250(d)(8)), and 913 (investments by public housing authorities in cooperative apartments under Code § 216(b).) Throughout this paper, the amended provisions of the law will be referred to by their new sections in the Internal Revenue Code.

per year in revenue when fully implemented⁴ and introduced a systematic bias in favor of investment in housing.

I. THE STRUCTURE OF REAL ESTATE TAXATION

A fundamental problem of income taxation is the proper matching of income and expenses. Clearly the cost of acquiring, constructing, reconstructing or rehabilitating a building is a cost of producing the income from that structure which will be derived over a number of years. A mismatching of income and expenses would occur if these capital costs were written off in the year in which they are incurred. The purpose of the allowance for depreciation is to provide a deduction for the exhaustion, wear and tear and obsolescence of property used in a trade or business or held for the production of income.⁵ The annual depreciation allowance is computed by spreading the cost of the building over its estimated useful life.

Since it is not possible to measure the using up of a building which is associated with the production of income in each taxable year,⁶ the Internal Revenue Code provides several methods for computing the allowable depreciation deduction. Prior to 1946, the capital costs were amortized mainly under the straight-line method which permits the taxpayer to spread the cost of the building evenly over the useful life. Thus, if a building costs \$1 million, has an estimated useful life of forty years, and has no salvage value, then each year the taxpayer deducts one-fortieth of his cost or \$25,000.

Prior to 1954, the declining balance method of depreciation at 1.5 times the straight-line rate was also permitted administratively but seldom used. Under this method the taxpayer is able to compute his depreciation deduction on the basis of 1.5 times the normal straight-line rate applied not to the original basis but rather to the adjusted basis. This method of depreciation is generally known as 150 percent declining balance depreciation.

In 1954, the administrative practice was codified and expanded in section 167(b) of the Internal Revenue Code. Congress permitted depreciation on new investments in capital equipment and structures to be computed under either the double declining balance method⁷ or

4. JOINT COMMITTEE ON INTERNAL REVENUE TAXATION, REVENUE ESTIMATES RELATING TO THE HOUSE, SENATE, AND CONFERENCE VERSIONS OF H.R. 13270: TAX REFORM ACT OF 1969, 91st Cong., 1st Sess. 9 (1969).

5. INT. REV. CODE of 1954, § 167(a).

6. Paul Taubman and Robert H. Rasche attempted to measure the true economic depreciation of office buildings. P. Taubman & H. Rasche, *Economic and Tax Depreciation of Office Buildings*, 22 NAT'L TAX J. 334-46 (1969). They concluded that even under straight-line depreciation, too much depreciation is allowed in the early years. *Id.* at 342.

7. INT. REV. CODE of 1954, § 167(b)(2). This method is similar to 150% declining balance except that twice the straight-line rate is applied to the adjusted basis.

the sum of the years-digits method,⁸ both of which permit a larger portion of costs to be recovered in the earlier years of an investment. Owners of capital assets acquired from an original owner were permitted to use the 150 percent declining balance method of depreciation that previously had been allowed administratively.⁹ Since the Internal Revenue Service was already allowing 150 percent declining balance depreciation on all investments (whether old or new), Congress apparently intended to create a preference for investment in new construction instead of old.

The availability of accelerated methods of depreciation, in combination with extremely high marginal tax rates¹⁰ and favorable tax treatment of long-term capital gains,¹¹ stimulated the creation of the now well-known real estate tax shelter. While there are a number of variations, the basic approach is to form a syndicate of investors who put up a relatively small amount of equity (between ten and twenty percent of the total cost of a project), with the remainder financed through a long-term mortgage. The deduction of depreciation and interest payments on the mortgage loan during the early years creates "tax losses" which can then be applied against income from other sources. After a certain period of time, when the annual depreciation deductions and interest payments have been reduced, and the investment begins to throw off positive taxable income, the building is sold with the gain taxed at the favorable capital gains rates. A major advantage of real estate investment is that the generous depreciation deductions during the years of operation shield income which otherwise would be taxed as ordinary income at rates up to seventy percent (seventy-seven percent with the surcharge). The gain at the time of sale, which may be largely attributable to prior depreciation deductions, is then taxed at the preferential capital gains rates. The taxpayer in effect converts ordinary income into capital gains.

In 1962, Congress imposed a recapture rule with respect to depreciable personal property, under which gain on sale of such property is treated as ordinary income to the extent of all depreciation deductions attributable to periods after December 31, 1961.¹² At that time, the Treasury had recommended the same rule with respect to

8. *Id.* at § 167(b)(3). Under this method the rate of depreciation for any year is a fraction of which the numerator is the remaining useful life at the beginning of the year and the denominator is the sum of the digits representing the useful life. For example, if the useful life is four years, the numerator for the first year would be four and the denominator ten (one + two + three + four).

9. *Id.* at § 167(c); Treas. Reg. § 1.167(b)-0(b) (1956).

10. The maximum marginal tax rate during 1969 was seventy percent (seventy-seven percent with the ten percent surcharge). INT. REV. CODE OF 1954, §§ 1, 51.

11. Prior to 1970, gain was taxed either at one-half the rate applied to other income, or a maximum of twenty-five percent. *Id.* at §§ 1201, 1202.

12. *Id.* at § 1245.

depreciable real property.¹³ In testimony before the Senate Finance Committee the Treasury modified its position with respect to real property and recommended that the amount of depreciation subject to recapture should be phased out at the rate of one percent per month for each month that the property was held for more than seventy-two months.¹⁴

Congress rejected recapture for real estate in 1962, and then enacted a milder version in 1964.¹⁵ Under this milder version, gain on the sale or exchange of depreciable real estate, where such disposition takes place within ten years after its acquisition, is ordinary income to the extent of a declining percentage of the excess of the post-1963 depreciation over straight-line depreciation. The recapture percentage is phased out at the rate of one percentage point for each full month the property is held over twenty months. Consequently, if the property is held for over ten years, no portion of the excess of accelerated over straight-line depreciation is recaptured as ordinary income.¹⁶

II. CHANGES IN THE TAX TREATMENT OF REAL ESTATE

The real estate tax shelter is an outgrowth of the accelerated depreciation deductions permitted in 1954, and typifies the tax preference

13. HOUSE COMM. ON WAYS AND MEANS, PRESIDENT'S 1961 TAX RECOMMENDATIONS, 87th Cong., 1st Sess. 44-45 (1961).

14. SENATE COMM. ON FINANCE, REVENUE ACT OF 1962, 87th Cong., 1st Sess. 88-89 (1962). The justification for this suggested phase-out was that otherwise the recaptured portion of the sale price might include some of the appreciation in the underlying non-depreciable real estate. See H.R. REP. NO. 1447, 87th Cong., 2d Sess. 67 (1962). We have never understood this reasoning. Present § 1250 recapture rules apply only in the case of "section 1250" property — defined as property subject to the allowance for depreciation. See § 1250(c). Section 1250 therefore necessitates an allocation of sale price between land and improvements before any recapture rules are applied. Moreover, since a purchaser will generally want to allocate as much of the sale price as possible to depreciable assets, and the seller subject to recapture will want to allocate as much of the sale price as possible to the land, there is a certain amount of assurance that the allocation is a fair one.

15. INT. REV. CODE OF 1954, § 1250.

16. Administrative response to the 1962 and 1964 actions raises interesting questions about the relationship between depreciation rates and guidelines lives. After Congress agreed to stiff recapture rules for depreciable personal property in 1962 in § 1245, the Treasury proceeded with a substantial revision of the guidelines lives for purposes of depreciation. The useful lives of personal property were shortened, but (except for farm buildings) the useful lives of depreciable real estate were unchanged. Rev. Proc. 62-21, 1962-2 CUM. BULL. 418. The Treasury's failure to shorten guidelines lives for depreciable real estate was a reaction to Congress' failure to include real estate in the § 1245 recapture rules. See HOUSE COMM. ON WAYS AND MEANS, & SENATE COMM. ON FINANCE, TAX REFORM STUDIES AND PROPOSALS U.S. TREASURY DEPARTMENT, 91st Cong., 1st Sess. 447 (1969) [hereinafter cited as 1968 TREASURY TAX REFORM STUDIES].

The assumption underlying both decisions to shorten lives for personal property, and to continue longer lives for real estate, is that there is a trade-off between shorter lives and recapture. And since accelerated depreciation methods have the same

or tax loophole created largely by accident.¹⁷ The focus of the 1954 liberalization was the proper allowable depreciation for machinery and equipment, but there was little or no analysis of the possible impact of the liberalized depreciation methods on investment in real estate. The 1964 recapture rule was the first step in limiting the real estate tax abuse, not by denying the depreciation deductions which give rise to the abuse, but rather by limiting the possible conversion of ordinary income into capital gains.¹⁸

The aim of the Tax Reform Act of 1969 was to further limit the real estate abuses which have developed as a result of the 1954 liberalization of depreciation. At the same time, both Congress and the Executive branch recognized the need to balance the objectives of tax reform and the nation's housing needs. According to the Department of Housing and Urban Development, some twenty million Americans currently live in substandard housing. In the Housing Act of 1968, Congress declared as a matter of national policy that the nation construct twenty-six million additional housing units by 1976, of which six million were to be subsidized homes for low and moderate income

impact as shorter lives the same assumption would apply: tougher recapture rules would permit a liberalization of depreciation methods.

Clearly, the effect of the 1962 trade-off was to tend to a maintenance of the long-run status quo, since combining shorter useful lives with tough recapture rules tends to cancel out. In this respect, the 1969 Act represents the first true reform in real estate taxation. Except in the case of the rehabilitation incentive, the rules are tightened at both ends — reduction of allowable depreciation methods, and stiffening the rules on recapture.

17. Dan Throop Smith, formerly Special Assistant to the Secretary of the Treasury in charge of Tax Policy, has indicated that the prime focus of the 1954 liberalization was equipment. See D. SMITH, *FEDERAL TAX REFORM 157* (1961); 1968 *TREASURY TAX REFORM STUDIES*, *supra* note 16, at 446.

18. We do not mean to suggest that recapture is necessarily the ideal solution to the problems of depreciation. For example, if a taxpayer builds a \$1 million structure with a fifty year useful life, he could claim depreciation deductions of \$240,000 on the straight-line basis over the first twelve years; and \$400,000 utilizing 200% declining balance depreciation. Let us further assume that he sells the building for \$900,000. Since this exceeds the adjusted basis (or unrecovered cost) by \$300,000 he has gain to that extent.

If the \$300,000 is viewed as "profit" attributable to general market conditions in the sense that securities generally increase in value, then the gain should be treated as long-term capital gain. On the other hand, if one takes the view that the \$300,000 represents an error in the original depreciation estimates, then the taxpayer has had \$300,000 of ordinary income deductions that he shouldn't have had. The question then becomes how to treat that excess.

Conceptually, the most logical approach would be to recompute the taxpayer's income for every year in which he claimed a depreciation deduction on that property, and then assess the additional tax thus generated with interest. That, in effect, would return the taxpayer to the status quo, as though the depreciation deduction had been properly computed in the first place. While such a "throwback" concept is not unknown in the tax laws, it is clearly impractical in this context to suggest that taxpayers might have to keep their books open for the entire life of a building, not to mention problems with the statute of limitations.

A second alternative is to add the amount of depreciation to the taxpayer's ordinary income in the year of sale, with the tax computed on the basis of the average

families.¹⁹ However, the continuation of high interest rates and a contracted money supply, required in the fight against inflation, in-veighs most heavily against housing. In the first half of 1969 alone, seasonally adjusted annual housing starts dropped by over thirty percent from 1.9 million to 1.2 million.²⁰ Vacancy rates in many large cities were as low as one percent. Through December 1969, the effective interest yield on FHA new home mortgages had increased over a six-year period from less than 5.5 percent to nearly 8.5 percent — an increase of over fifty percent.²¹ Over the same six-year period the consumer price index for shelter has increased by nearly thirty percent. In short, real estate tax reforms could not ignore the housing crisis.

A. Changes in Depreciation

1. Investments in New Structures

The real estate provisions of the Tax Reform Act of 1969 were designed to substantially reduce the opportunities to avoid taxes as a result of accelerated depreciation.²² Investors in new commercial and industrial construction (but not new housing construction) are limited to depreciation deductions which cannot exceed the deductions which would have been allowed if the deductions had been computed under the 150 percent declining balance method of depreciation;²³ and owners of used structures (other than housing with a useful life of twenty or more years) are limited to the straight-line method of depreciation.²⁴

tax rate paid over some base period — say, the past three years. This alternative is available in a limited form under the averaging provisions of the Code, which have been somewhat liberalized under the 1969 reform act and would mitigate the problem of abnormally high taxes in the year of sale. See INT. REV. CODE of 1954, §§ 1301-05.

The third alternative — adopted by the Congress in §§ 1245 and 1250 of the Code — is to treat a portion of the depreciation as ordinary income ("recapture") taxable in the same way as any other component of income. Under this approach, however, the taxpayer is permitted to defer a substantial amount of taxes until the year of sale — he receives an interest-free loan equal to the taxes saved during the holding period.

The benefit of excess depreciation, even with full recapture, can be shown as a function of the taxpayer's discount rate. In our example, let us assume that the full amount of \$300,000 is "recaptured" after the sale on the twelfth year, and subjected to tax at an effective rate of fifty percent. The additional \$150,000 in taxes is then a rough measure of the taxes saved during the intervening years.

19. 42 U.S.C. § 1441(a) (1964).

20. COUNCIL OF ECONOMIC ADVISORS, ECONOMIC INDICATORS, 91st Cong., 2d Sess. 20 (1970).

21. *Id.* at 33.

22. SENATE COMM. ON FINANCE, TAX REFORM ACT OF 1969, S. REP. No. 552, 91st Cong., 1st Sess. 212-13 (1969) [hereinafter cited as SENATE REP.].

23. INT. REV. CODE of 1954, § 167(j) (1).

24. *Id.* at § 167(j) (4).

In order to encourage greater investment in housing, the bill provides for retention of the 200 percent declining balance and the sum of the years-digits depreciation for owners of new housing.²⁵ In addition, owners of used housing with a useful life of twenty or more years are permitted to use 125 percent declining balance depreciation.²⁶

The House Ways and Means Committee made the basic decision to create a preference for housing by cutting back on the allowable depreciation permitted on new commercial and industrial structures while retaining double declining balance and sum of the years-digits methods of depreciation for new housing.²⁷ In its testimony before the Senate Finance Committee, the Treasury Department supported the House provisions regarding depreciation on new structures.²⁸ Since these provisions were not changed by either the Senate Finance Committee²⁹ or by Senate floor amendments, the depreciation of new structures was not an issue in the Conference Committee.

The Senate Finance Committee concluded that the most accelerated methods of tax depreciation constituted an undue incentive for commercial and industrial construction.³⁰ By cutting back on the depreciation permitted on new industrial and commercial buildings, the bill limits the potential use of the real estate tax shelter. By continuing to permit the most accelerated methods of tax depreciation for new housing, the bill continues the tax incentives needed to meet the housing goals.

25. *Id.* at § 167(j) (2).

26. *Id.* at § 167(j) (5).

It should also be noted that under the reform act, investors in industrial and commercial properties, who are entitled to use 150% declining balance depreciation, and investors in used housing with a useful life of over twenty years who are entitled to use 125% declining balance depreciation, will no longer be allowed to change to the straight-line method of depreciation without securing the consent of the Commissioner of the Internal Revenue Service. The right to switch to straight-line is contained in § 167(e) of the Code, which permits the change from a method of depreciation "described in subsection (b) (2)." Now, however, § (b) (2) is limited to new housing investments and investments made before the effective date of the Act. INT. REV. CODE of 1954, § 167(j) (2), (3). However, this would not appear to be a serious problem in view of Rev. Proc. 67-40, 1967-2 CUM. BULL. 67-4, under which the Commissioner is deemed to have consented to a change in depreciation methods if the taxpayer complies with certain formal procedures. Cf. Schwab & Nicol, *Depreciation: An Optimum Switching Rule*, THE ACCOUNTING REV. 292-96 (1969).

27. HOUSE COMM. ON WAYS AND MEANS, TAX REFORM ACT OF 1969, H.R. REP. No. 413, 91st Cong., 1st Sess. 166 (1969) [hereinafter cited as HOUSE REP.].

28. *Hearings on H.R. 13270 Before the Senate Comm. on Finance*, 91st Cong., 1st Sess., pt. 1, at 614-15 (1969) [hereinafter cited as SENATE HEARINGS].

29. SENATE REP., *supra* note 22, at 213.

30. *Id.* at 212-13.

2. Used Structures

The Douglas³¹ and Kaiser³² Commissions, and the 1968 Treasury studies,³³ argued the adverse effects of the allowance of accelerated depreciation with respect to properties acquired by second and third owners.³⁴ Permitting subsequent owners to utilize fast depreciation methods encouraged the flow of money into existing structures rather than into new structures.

The House bill called for the elimination of accelerated depreciation methods in respect to all used property — both housing and commercial. The Treasury Department supported this position and contended that no useful purpose was served by continuing incentives for the turnover of existing properties.³⁵ Furthermore, in the case of older housing, the bill already provided special incentives for rehabilitation.³⁶ The Senate Finance Committee accepted the House bill on this point, noting that the reason for limiting the depreciation on used structures was to “eliminate the repeated sale and resale of property for the purpose of tax minimization.”³⁷

As finally enacted, however, the bill continues to provide limited depreciation advantages for used housing. As a compromise to a Senate floor amendment³⁸ the Conferees permitted 125 percent declining balance depreciation to continue in respect to used housing with a useful life of twenty or more years.³⁹

31. NATIONAL COMM'N ON URBAN PROBLEMS, BUILDING THE AMERICAN CITY, H.R. Doc. No. 34, 91st Cong., 1st Sess. 403-04 (1968) [hereinafter cited as DOUGLAS COMM'N REP.].

32. THE PRESIDENT'S COMM. ON URBAN HOUSING, A DECENT HOME 99-100 (1969) [hereinafter cited as KAISER COMM'N REP.].

33. 1968 TREASURY TAX REFORM STUDIES, *supra* note 16, at 439-43 *passim*.

34. *Contra*, Blum & Dunham, *Income Tax Law and Slums; Some Further Reflections*, 60 COLUM. L. REV. 446, 451 (1960).

35. See remarks of Edwin S. Cohen, Assistant Secretary of the Treasury for Tax Policy, before The Section of Taxation, American Bar Association Annual Meeting, in Dallas, Texas, Aug. 9, 1969.

36. INT. REV. CODE OF 1954, § 167(k).

37. SENATE REP., *supra* note 22, at 213.

38. Senator Tower proposed Amendment No. 407, which would have allowed 150% declining balance depreciation if the life of the property exceeds thirty years, 125% if the life is between twenty and thirty years and straight-line depreciation if the life is less than twenty years. See 115 CONG. REC. S16343-51 (daily ed. Dec. 10, 1969) *passim*.

39. INT. REV. CODE OF 1954, § 167(j)(5). As passed by the Senate, 125% declining balance depreciation would have been allowed any building with a “remaining useful life” of between twenty and thirty years. 115 CONG. REC. S16343-44 (daily ed. Dec. 10, 1969). The word “remaining” was stricken from the final version of the bill, indicating that the useful life is that established by the taxpayer, rather than the original useful life reduced by the total holding period at the time of sale.

3. Comparison of the Various Depreciation Methods

The significance of the changes in allowable depreciation methods is illustrated by Table 1 which gives the annual depreciation allowance under the five basic methods of depreciation for the first ten years of ownership, assuming a forty year useful life and a \$1,000 building investment.

Table 1¹
ANNUAL DEPRECIATION ALLOWANCE UNDER FIVE BASIC
DEPRECIATION METHODS²

<i>Year</i>	<i>Straight-line</i>	<i>125 Percent Declining Balance</i>	<i>150 Percent Declining Balance</i>	<i>200 Percent Declining Balance</i>
1	\$ 25.00	\$ 31.25	\$ 37.50	\$ 50.00
2	25.00	30.27	36.09	47.50
3	25.00	29.33	34.74	45.13
4	25.00	28.41	33.44	42.87
5	25.00	27.52	32.18	40.73
6	25.00	26.66	30.98	38.69
7	25.00	25.83	29.82	36.75
8	25.00	25.02	28.70	34.92
9	25.00	24.24	27.62	33.17
10	25.00	23.48	26.58	31.51
Total	\$250.00	\$272.01	\$317.65	\$401.27

¹ Adapted from Richard E. Sliator, *The Federal Income Tax in Relation to Housing*, prepared for the consideration of the National Commission on Urban Problems, Research Report No. 5 (Washington, D.C.: U.S. Government Printing Office, 1968), p. 134.

² Assuming a 40-year useful life and \$1,000 building investment.

Limiting new owners of commercial and industrial structures to 150 percent declining balance depreciation will reduce the depreciation deductions during the first ten years from \$401.27, if 200 percent declining balance depreciation previously was used, to \$317.65. This represents a 20.8 percent decrease in allowable depreciation deductions during the first ten years. Owners of used properties limited to the straight-line method of depreciation will have their allowable depreciation during the first ten years reduced from \$317.65 to \$250.00: a reduction of 21.4 percent. Owners of used housing with a useful life of twenty or more years, who are limited to 125 percent declining balance depreciation, will have their allowable depreciation decreased from \$317.65 to \$272.01: a 14.4 percent reduction.

Another, and a somewhat better, way of looking at the significance of the changes in the allowable depreciation method is to compare the present value of the tax shield afforded by the depreciation deductions.

This recognizes that for an investor a dollar deducted this year is worth more to him than a dollar deducted next year. If it is assumed that investors discount dollars at a ten percent discount rate, then the present value of ten years of depreciation of a \$1,000 structure, depreciated on a forty year life by the sum of the years-digits method of depreciation is \$368.55.⁴⁰ If 200 percent declining balance depreciation is used, the present value of the depreciation deductions is \$338.22. The corresponding present values for 150 percent declining balance, 125 percent declining balance and straight-line depreciation are \$284.96, \$259.65 and \$244.48,⁴¹ respectively. The switch from 200 percent to 150 percent declining balance depreciation reduces the present value of the depreciation deductions by \$53.26 or 15.7 percent. The limitation of owners of used properties to straight-line depreciation reduces the present value of the depreciation deductions by 14.2 percent. If the owners of used property are limited to 125 percent declining balance, the reduction in present value is 8.9 percent. These figures represent the percentage reduction of tax shelter afforded by real estate tax investments.

4. The Eighty Percent Rule

The Tax Reform Act creates an important distinction between housing and other structures with respect to allowable depreciation methods. It was therefore necessary to develop a rule for distinguishing housing from other structures. The bill provides that the 200 percent declining balance and sum of the years-digits methods are allowable on new housing only if eighty percent or more of the income from the property is derived from the rental of dwelling units.⁴² A dwelling unit is defined as a house or an apartment used to provide living accommodations in a building or structure, but does not include a unit in a hotel or other establishment more than one-half the units in which are used on a transient basis.⁴³

One of the interesting features of the special rule for housing is that it permits a taxpayer to compute his depreciation deduction in different ways from year to year, depending on the source of income

40. If D_i is the depreciation deduction in the i^{th} year, r is the discount rate and n is the useful life, then the present value is equal to $\sum_{t=1}^n d_i/(1-r)^t$. For simplified expressions for computing the present values, see Sunley, *The Present Value of Depreciation Allowances*, 9 QUARTERLY REV. OF ECONOMICS AND BUSINESS 77-79 (Winter 1969).

41. These computations for declining balance depreciation assume an optimal switch to straight-line depreciation as permitted under § 167(e)(1), INT. REV. CODE of 1954.

42. INT. REV. CODE of 1954, § 167(j)(2)(B).

43. *Id.* at § 167(k)(3)(C).

derived from the property. The bill makes this explicit by specifying that a change in the method of computing depreciation attributable solely to the application of the eighty percent rule will not be considered a change in a method of accounting.⁴⁴

For example, if a \$1 million structure is erected with a forty year useful life, the allowable deduction each year under 200 percent declining balance depreciation would be five percent of the adjusted basis of the property. The allowable deduction under 150 percent declining balance depreciation would be 3.75 percent of the adjusted basis of the property. Thus if the structure meets the eighty percent test during the first year of operation, the allowable deduction would be \$50,000 (five percent of \$1 million); if not, the deduction would be \$37,500 (3.75 percent of \$1 million). If the structure meets the eighty percent test for the first year, then the adjusted basis of the property at the beginning of the second year would be \$950,000. At the end of the second year, the allowable depreciation would be either five percent of \$950,000 if the eighty percent test is met or 3.75 percent of \$950,000 if the eighty percent test does not apply.

The eighty percent rule also applies to used structures with a useful life of twenty or more years.⁴⁵ Thus, used structures might some years be depreciated under the 125 percent declining balance method and other years be limited to straight-line depreciation.

B. Changes in Recapture

Of the many provisions of the Tax Reform Act of 1969 relating to real estate, the recapture provisions generated some of the greatest controversy. As noted above, Congress had enacted a limited recapture rule for real estate in 1964 which provided for the recapture as ordinary income of a percentage of the excess of accelerated over straight-line depreciation.⁴⁶ The recapture percentage phased out at one percentage point per month after the property had been held for twenty months.

1. Rules Applied to Sales of Depreciable Real Estate

There were two possible approaches to tightening recapture. Under the first approach real estate, like personal property, would be subject to full recapture to the extent of any prior depreciation. Under the second approach the phase-out of recapture would be eliminated but real estate would continue to be subjected to recapture of prior depreciation only to the extent that it exceeded the depreciation allowable under the straight-line method.

44. *Id.* at § 167(j) (2) (C).

45. *Id.* at § 167(j) (5).

46. See text accompanying note 15 *supra*.

The Ways and Means Committee accepted the second approach and eliminated the phase-out provisions from the recapture rules altogether, although still permitting the straight-line portion to escape ordinary income treatment.⁴⁷ Little consideration seems to have been given to the possibility of including the straight-line element in the portion of the gain subject to recapture.

In order to provide a further stimulus to housing, in line with the preferences created in respect to depreciation, the Senate Finance Committee reinstated the phase-out provisions for sales of housing, except that the phase-out was to begin after ten years instead of twenty months.⁴⁸ Then, following a floor amendment to permit phase-out beginning after five years for housing and ten years for non-housing investments, the Conference Committee agreed to allow a phase-out for housing beginning after one hundred months, and unlimited recapture of excess depreciation with respect to non-housing investments.⁴⁹ Thus, as finally enacted, the bill permits an investor in housing to achieve full capital gains treatment if he holds the property for sixteen years and eight months, as opposed to ten years under the pre-1970 law.⁵⁰

2. Comparison of the Various Recapture Rules

In order to give some further perspective on these various recapture proposals, Tables 2-4 present the amount of capital gain which would be subject to recapture as ordinary income under the various proposed changes in the recapture rules. These tables assume an original depreciable basis of \$1 million and holding periods of from one to twenty years.

47. HOUSE REP., *supra* note 27, at 167.

48. SENATE REP., *supra* note 22, at 214.

49. INT. REV. CODE of 1954, § 1250(a)(1)(C).

50. Even the critics of the House bill were willing to accept an extension of the holding period from twenty to sixty months before a phase-out would begin. This, it was asserted, would be sufficient to control the abuses. See testimony by the National Association of Real Estate Boards, SENATE HEARINGS, *supra* note 28, at 3930. However, the extension to sixty months would be less than the recommendations made seven years ago, and would still only apply to the excess depreciation over the straight-line allowance.

Table 2

GAIN SUBJECT TO RECAPTURE UNDER ALTERNATIVE RECAPTURE RULES¹
 200 PERCENT DECLINING BALANCE⁸
 (thousands of dollars)

Holding Period (Years)	RECAPTURE RULE			Excess Over Straight- Line ⁵	Full Re- capture ⁶
	Excess over Phase-out of 1% 20 Months ²	Excess over Straight Line with 60 Months ³	Excess over Phase-out of 1% per month after 100 Months ⁴		
1 ⁷	\$ 50	\$ 50	\$ 50	\$ 50	\$ 50
2	46	48	48	48	98
3	57	68	68	68	143
4	62	86	86	86	186
5	61	101	101	101	226
6	55	101	115	115	265
7	46	97	127	127	302
8	33	88	137	137	337
9	17	75	133	145	370
10	0	60	121	151	401
11	0	44	106	156	431
12	0	26	90	160	460
13	0	6	71	162	487
14	0	0	52	162	512
15	0	0	32	162	537
16	0	0	13	160	560
17	0	0	0	157	582
18	0	0	0	153	603
19	0	0	0	148	623
20	0	0	0	142	642

¹ The sales price of the building is assumed to be \$1,000,000, which is also the original basis of the building.

² Recapture rule prior to the Tax Reform Act of 1969 for all real estate improvements. The rule remains applicable to publicly-assisted housing.

³ The recapture rule proposed by the National Association of Real Estate Boards and by the Realty Committee on Taxation in testimony before the Senate Finance Committee. This recapture rule was adopted for housing on the Senate floor.

⁴ The recapture rule accepted by the Conference Committee for all housing except publicly assisted housing.

⁵ The recapture rule contained in the House bill.

⁶ Section 1245 recapture.

⁷ There is full recapture of prior depreciation deductions in the case of properties not held more than one year. See INT. REV. CODE of 1954, § 1250(b).

⁸ The declining balance depreciation assumes an optimal switch to straight-line depreciation.

Table 3

GAIN SUBJECT TO RECAPTURE UNDER ALTERNATIVE RECAPTURE RULES¹
 150 PERCENT DECLINING BALANCE DEPRECIATION⁸
 (thousands of dollars)

Holding Period (Years)	RECAPTURE RULE			Excess Over Straight- Line ⁵	Full Re- capture ⁶
	Excess over Straight Line with Phase-out of 1% per month after				
	20 Months ²	60 Months ³	100 Months ⁴		
1 ⁷	\$ 38	\$ 38	\$ 38	\$ 38	\$ 38
2	23	24	24	24	74
3	28	33	33	33	108
4	30	42	42	42	142
5	29	49	49	49	174
6	26	48	55	55	205
7	22	46	60	60	235
8	15	40	63	63	263
9	8	34	61	66	291
10	0	27	54	68	318
11	0	19	46	68	343
12	0	11	38	68	368
13	0	3	29	67	392
14	0	0	20	64	414
15	0	0	12	62	437
16	0	0	5	59	459
17	0	0	0	57	482
18	0	0	0	54	504
19	0	0	0	52	527
20	0	0	0	50	550

¹ The sales price of the building is assumed to be \$1,000,000, which is also the original basis of the building.

² Recapture rule prior to the Tax Reform Act of 1969 for all real estate improvements. The rule remains applicable to publicly-assisted housing.

³ The recapture rule proposed by the National Association of Real Estate Boards and by the Realty Committee on Taxation in testimony before the Senate Finance Committee. This recapture rule was adopted for housing on the Senate floor.

⁴ The recapture rule accepted by the Conference Committee for all housing except publicly assisted housing.

⁵ The recapture rule contained in the House bill.

⁶ Section 1245 recapture.

⁷ There is full recapture of prior depreciation deductions in the case of properties not held more than one year. See INT. REV. CODE of 1954, § 1250 (b).

⁸ The declining balance depreciation assumes an optimal switch to straight-line depreciation.

Table 4

GAIN SUBJECT TO RECAPTURE UNDER ALTERNATIVE RECAPTURE RULES¹
 125 PERCENT DECLINING BALANCE DEPRECIATION⁸
 (thousands of dollars)

Holding Period (Years)	RECAPTURE RULE			Excess Over Straight- Line ⁵	Full Re- capture ⁶
	— Excess over Straight Line with — Phase-out of 1% per month after				
	20 Months ²	60 Months ³	100 Months ⁴		
1 ⁷	\$ 31	\$ 31	\$ 31	\$ 31	\$ 31
2	12	12	12	12	62
3	13	16	16	16	91
4	14	19	19	19	119
5	13	22	22	22	147
6	11	20	23	23	173
7	9	18	24	24	199
8	6	15	24	24	224
9	3	12	22	24	249
10	0	9	18	23	273
11	0	6	15	22	297
12	0	3	12	21	321
13	0	1	9	20	345
14	0	0	6	20	370
15	0	0	4	19	394
16	0	0	1	18	418
17	0	0	0	17	442
18	0	0	0	17	467
19	0	0	0	16	491
20	0	0	0	15	515

¹ The sales price of the building is assumed to be \$1,000,000, which is also the original basis of the building.

² Recapture rule prior to the Tax Reform Act of 1969 for all real estate improvements. The rule remains applicable to publicly-assisted housing.

³ The recapture rule proposed by the National Association of Real Estate Boards and by the Realty Committee on Taxation in testimony before the Senate Finance Committee. This recapture rule was adopted for housing on the Senate floor.

⁴ The recapture rule accepted by the Conference Committee for all housing except publicly assisted housing.

⁵ The recapture rule contained in the House bill.

⁶ Section 1245 recapture.

⁷ There is full recapture of prior depreciation deductions in the case of properties not held more than one year. See INT. REV. CODE of 1954, § 1250(b).

⁸ The declining balance depreciation assumes an optimal switch to straight-line depreciation.

Consider an investor who uses 200 percent declining balance depreciation over a holding period of ten years. Table 2 indicates that this investor would have no gain subject to recapture as ordinary income under the pre-1970 law, a gain of \$121,000 subject to recapture under the new rule applicable to housing and a gain of \$151,000 subject to recapture under the new rule applicable to non-housing. This should be contrasted to the gain of \$401,000 which would be subject to recapture if the rules applicable under section 1245 were made applicable to all structures.

Tables 3 and 4 indicate the impact of the various recapture rules on the investor taking 150 percent and 125 percent declining balance depreciation.⁵¹ Since only prior depreciation in excess of straight-line depreciation is subject to recapture, the tightening of the recapture rule will have a lesser effect on these investors since they will have taken less depreciation.

It can be concluded that the changes in the recapture rules contained in the Tax Reform Act of 1969 do make a significant contribution to limiting the possibilities of converting ordinary income into capital gains through taking rapid depreciation deductions and later selling for capital gains. At the same time, significant possibilities for converting ordinary income into capital gains still remain. Structures will continue to receive a more favorable tax treatment than equipment with respect to recapture of prior straight-line depreciation. In addition, the Tax Reform Act of 1969 carves out a more favorable recapture rule for housing than for non-housing. This increases the attractiveness of investing in housing relative to commercial buildings and should help to stimulate needed housing construction although the extension of the recapture holding period from twenty months to one hundred months will have some opposite effect.

3. Transitional Rules for Computing Recapture

Under the bill, the new recapture rules are to apply only to the depreciation claimed with respect to property disposed of after December 31, 1969.⁵² The taxpayer who disposes of property with both pre-1970 and post-1969 depreciation must compute the recapture by a two-step procedure. First, the taxpayer computes the additional depreciation attributable to the period after December 31, 1969. The new recapture rules are applied either to this post-1969 additional depreciation or to the gain on the sale of the property, whichever is less. Second, if the gain on sale exceeds the post-1969 additional depreciation, the gain is reduced by the post-1969 amount regardless of how much of that additional depreciation was treated as ordinary

51. These computations assume an optimal switch to straight-line depreciation.

52. INT. REV. CODE of 1954, § 1250(a)(1).

income. The pre-1970 recapture rules are then applied to either the pre-1970 additional depreciation or the reduced gain, whichever is less. Of course, any additional depreciation attributable to the period before December 31, 1963 is not subject to recapture.⁵³ The significant point for the investor is that the continued exclusion of straight-line depreciation from the recapture rules still permits substantial conversions of ordinary income to capital gain.⁵⁴

4. Application of Recapture Rules to Sales of Housing

One question that will have to be answered by the regulations under the new recapture rules relates to the application of these rules to housing. Since the same structure may qualify as housing in one year but fail to qualify as such in a subsequent year if more than twenty percent of its income is from other than dwelling units, which set of recapture rules are to be applied when the structure is disposed of? Section 1250(a)(1)(C)(iii) permits the phase-out of recapture with respect to "residential rental property," but does not specify whether that determination is to be made for the year of sale, for the entire life of the property or whether the special rules would apply only with respect to additional depreciation claimed in years when the property in fact qualified as residential rental housing.

The simplest rule would be to allow the phase-out of recapture if the structure qualified as housing in the year of sale.⁵⁵ However, this rule creates the possibility that some investors might convert some portion of their property into residential rental property in the year of sale solely in order to take advantage of the special phase-out provisions. It might also cause unintended hardship in the case of an owner of a building which has qualified as housing for many years, but which has not met the eighty percent of income test during the year of sale. In this instance the owner would receive no benefit from the phase-out provision even though the building has in fact been used as housing for most of its life.

The retention of the one hundred month phase-out rule in computing recapture on sale was intended to create an investment preference for housing. This requires that the investor be assured that if his structure is used for housing recapture on the eventual sale will be

53. *Id.* at § 1250(a).

54. This point is frequently overlooked. For example, Leon Keyserling, former Chairman of the Council of Economic Advisors, testified before the Senate Finance Committee that under the House recapture rules, ". . . only the postponement of ordinary income, *never its conversion into capital gain*, will be possible under the new law," SENATE HEARINGS, *supra* note 28, at 3996 (emphasis added).

55. See remarks of William A. Kelley, Jr., Chairman, Comm. on Real Estate Tax Problems, before the Section on Taxation of the American Bar Association, in San Francisco, California, Jan. 31, 1970.

computed with a phase-out. This could be accomplished by a rule applying the phase-out to that portion of the total additional depreciation attributable to years in which the property qualified as housing in the hands of the taxpayer. Additional depreciation attributable to years when the property did not meet the eighty percent test might then be subject to full recapture under the general revision of recapture rules.

5. Recapture and Existing Structures

One feature of the recapture rules that has generated some criticism is their applicability to all excess depreciation after the effective date. Even though the bill exempts post-effective date sales pursuant to binding contracts, the tougher rules will still affect the investor who purchased a building with the expectation that after a certain number of years he would be able to dispose of it with gain computed at long-term capital gains rates and no recapture.

The rule in the present bill follows the rule in the 1964 recapture provisions. A person who bought property before 1964 and claimed excess deductions was not protected from the impact of recapture with respect to his post-1963 excess depreciation, even though the extent of recapture was phased-out after twenty months of holding. Moreover, a taxpayer has no vested interest in the continued existence of a tax law on which he may have relied in making his investments.

Since the general recapture rules contain no phase-out for the sale of commercial buildings, it may be argued that the analogy is inaccurate — that the investor in pre-1963 property was not completely locked in — and could still avoid recapture if he held long enough. One reply to this point is that even under the reform provisions the amount of depreciation subject to recapture dwindles as the holding period is extended.

C. Evaluation of the Depreciation and Recapture Reforms

Much of the public discussion relating to tax reform is characterized by misunderstanding and exaggeration. This is particularly true with respect to real estate, where the tax laws are only one of a number of factors affecting an investor's profit. In the midst of rising labor and material costs, soaring interest rates and a contracting money supply, the industry's concern over increased taxation was entirely understandable. At the same time, the abuses generated by real estate tax shelters and the plight of the housing industry indicated the need for reform. In order to evaluate these competing claims, it is necessary to develop a model of a typical real estate investment, designed to quantify the possible economic consequences of changes in the tax treatment of real estate.

1. Analytic Model of a Real Estate Investment

The first step in developing the model is to specify a typical or standard real estate investment. This specification of the standard case requires assumptions concerning such factors as the original equity, mortgage interest rate, mortgage term, depreciable life, net rental income, marginal tax rate of the investor, depreciation method and holding period. The standard case then serves as a benchmark against which to compare changes in both tax and non-tax variables. For example, if the standard case assumes a forty year depreciable life for tax purposes, the depreciable life could be altered to thirty-two years and the results compared with the standard case.

The computer model calculates the cash flow from the investment during each of the operating years and from the sale of the investment at the end of the holding period.⁵⁶

For example, a shorter useful life, by increasing the depreciation deduction during the early years, would decrease the income tax and thus increase the cash flow. On the other hand, the shorter depreciable life would also decrease the cash flow from the sale of the property by decreasing the adjusted basis of the property and increasing the capital gain and the associated capital gains and recapture taxes. Thus, a shorter depreciable life implies a greater cash flow during the early operating years and a smaller cash flow from the sale at the end of the holding period. How do these two opposite changes in the cash flows affect the profitability of the real estate investment?

The computer model measures the results of the possible changes in the tax and non-tax variables in two ways: rate of return after tax on original equity and present discounted value. The rate of return *after* tax on original equity, generally referred to as the rate of return, is that interest rate which allows comparison with alternative investments, like bonds, when the return earned can be reinvested each year and the original investment is returned intact at the end of the term.

The present discounted value method of comparing alternative investments is similar to the rate of return method. Under this method the cash flow from each year is discounted back to the time of the original investment at some assumed rate of interest generally referred to as the opportunity cost of capital. The total present value is then compared with the cost of the original investment and with the present value of alternative investments. The interest rate chosen for discounting the cash flow ideally is the rate of return the investor could earn on alternative investments. Selection of the rate obtainable on alternative investments, can, of course, only be approximate.

56. The cash flow during the years of operation is the net rent (gross rent less operating costs) less mortgage payments and less taxes. If the property generates negative taxable income (tax losses), then the benefit of shielding other income from taxes increases the cash flow. The cash flow from the sale is the sales price less unpaid mortgage and less the capital gains and recapture taxes.

The standard case can be described as follows: The investor puts up his original equity on January 1, 1970. During 1970 an apartment or office building costing \$100,000 (\$10,000 for the land and \$90,000 for the building) is constructed. At the end of the one year construction period, the investor is able to deduct for federal income tax purposes certain carrying charges, including interest on the construction loan, insurance, and property taxes totaling 6.2 percent of the original cost, or \$6,200. Since there is no income from the project during the construction period, the investor realizes a tax loss on the investment, which shields other income from tax. At the beginning of 1971 the building is fully rented. During the years of operation the building yields an annual net rent (gross rent less operating costs) before income taxes and debt service of 9.5 percent of the original cost, or \$9,500. At the end of the holding period it is assumed that the building is sold for \$100,000. The financing terms are ten percent original equity, twenty-five year mortgage term and an eight percent mortgage interest rate. The depreciable life of the building is forty years. The investor is able to offset all real estate "losses" against other income.⁵⁷

The computer model calculated the rates of return assuming a sale of the property at the end of each year up to a forty years holding period. The model also assumed three different marginal tax rates — thirty, fifty and seventy percent, and assumed three different depreciation methods — straight-line, 150 percent declining balance and 200 percent declining balance.

It is not the purpose of this article to discuss in great detail the results obtained with the help of the computer model of real estate investments.⁵⁸ Rather it is intended to present some selective results

57. All of the assumptions of the standard case can be questioned. The particular assumptions listed above were derived through consultation with people knowledgeable about real estate, both inside and outside of government. A major advantage of having a computer model for analyzing the effect of proposed changes on the rate of return due to changes in the tax treatment of real estate is that it forces the analyst to specify his underlying assumptions. It is thus possible for other analysts to alter the various underlying assumptions and to determine the sensitivity of the results to these assumptions.

58. The following example is given only to illustrate the method the computer used in arriving at the results which were used in the Treasury Department.

The rate of return on equity capital after tax and after financing is that value of "i" which satisfies the following equation:

$$E = \frac{M}{(1+i)} + \sum_{t=2}^n \frac{CF_t}{(1+i)^t} + \frac{CF_s}{(1+i)^n}$$

where, E = Initial equity investment
 M = Tax shelter benefit during the construction period
 CF_t = Cash flow from operation during the tth year
 CF_s = Cash flow from the sale
 i = Rate of return
 n = Holding period (including the one year for construction)

The equation involves three terms. The first term is the present value of the tax shelter benefit from deducting the carrying charges during the assumed one-year construction period. The second term is the present value of the annual cash flow from the investment. The annual cash flow is equal to the net rental income (gross

which should indicate the economic significance of the various tax changes which were proposed and adopted. But before presenting even these selective results, one important caveat must be given. The most important underlying assumption of the computer model is a *ceteris paribus* one requiring that all other things remain equal. For example, it is assumed that a tightening of the recapture rule will not affect the net rent from the investment. It must be recognized, however, that changes in tax provisions will interact with the net rent through the supply side of the real estate market. A decrease in the tax preferences permitted the real estate industry decreases the attractiveness of investing in real estate. This leads to a decrease in the supply of buildings (or a decrease in the rate of increase in the supply of buildings) which would *increase* the net rent of existing buildings in later years. Thus, the *ceteris paribus* assumption overstates the changes in the rates of return and the changes in the present discounted value.

In addition, the model implicitly assumes that there are no tax or financial changes affecting the attractiveness of investments which compete with real estate for the limited supply of savings generated by the economy. To the extent that repeal of the investment credit decreases the demand for equipment and eases pressure on interest rates, the profitability of real estate investment should increase. To the extent that the attractiveness of investing in commercial and industrial structures is decreased relative to that of housing, scarce investment funds should flow into housing.

2. Changes in the Rates of Return

Table 5 presents rates of return for typical real estate investments assuming different depreciation methods, marginal tax rates, recapture rules and as a benchmark, a change in the interest rate. As stated, the Treasury computer model calculated rates of return for holding periods from one to forty years. The data for a ten year period was selected for presentation here because they best show the effect of the 1969 changes in depreciation and recapture rules. Under the old law, after a ten year holding period, no recapture of depreciation was treated

rent minus operating expenses), minus the debt service payments and minus income taxes, which in turn crucially depend on the allowable depreciation. The third term is the present value of the cash flow from the sale of the building at the end of "n" years. The cash flow is equal to the sales price, minus the unpaid mortgage balance and minus the capital gains and recapture taxes paid. For example, Table 5 *infra* indicates that the fifty percent taxpayer using 200 percent declining balance depreciation would earn a rate of return on equity of 20.9 percent under the assumptions of the standard case. See n.4 of Table 5 *infra* for the assumptions of the standard case. In particular, the investor's tax benefit during the construction period would be \$3,100. During the first through the tenth year of operation, the cash flows would be \$2,014, \$1,860, \$1,707, \$1,555, \$1,403, \$1,251, \$1,098, \$943, \$785 and \$624. The cash flow from the sale would be \$17,878. The computer first calculates the cash flows given the assumptions of the model and then searches for that "i" which will equate the right hand side of the above equation to the assumed original equity of \$10,000.

as ordinary income. For no other holding period will the effect of changes in recapture rules be greater. Thus, although the absolute rate of return is different under different assumptions, Table 5 allows certain inferences as to the extent of changes in the relative rates of return.

Table 5

THE RATE OF RETURN FROM REAL ESTATE INVESTMENTS
AFTER TAXES

The Standard Case and Selected Changes in the Standard Case	DEPRECIATION METHOD AND MARGINAL TAX RATE					
	200 DB ¹		150 DB ²		SL ³	
	50%	70%	50%	70%	50%	70%
Standard Case ⁴	20.9	25.4	18.2	20.9	16.0	17.1
Recapture rule						
Phase-out after: ⁵						
60 months	20.5	24.8	18.0	20.5	16.0	17.1
100 months	20.1	24.1	17.8	20.2	16.0	17.1
Full recapture of excess over straight-line	19.9	23.8	17.7	20.0	16.0	17.1
Full recapture ⁶	17.9	20.2	15.7	15.9	13.9	12.8
Interest rate						
9 percent	18.0	24.0	15.3	19.4	13.1	15.6

¹ 200 percent declining balance depreciation.

² 150 percent declining balance depreciation.

³ Straight-line depreciation.

⁴ The standard case assumes:

Holding period = ten years (after
one year construction period)
Depreciable life = forty years
Interest rate = eight percent
Mortgage term = twenty-five years
Building value = \$90,000

Land value = \$10,000
Sales price = \$100,000
Net rent = \$9,500 per year
Construction carrying charges = \$6,200
Original equity = ten percent

Recapture of the excess of accelerated over straight-line depreciation with a phase-out of one percent per month after twenty months. The holding period does not include the one year construction period. For a ten year holding period there is no recapture.

⁵ Recapture of the excess of accelerated over straight-line depreciation with a phase-out of one percent per month after the stated number of months.

⁶ The recapture rule of § 1245, INT. REV. CODE OF 1954.

Though it is difficult to generalize from just these few selected cases, a number of inferences can be drawn. First, the change in depreciation method from 200 percent declining balance to 150 percent declining balance or from 150 percent declining balance to straight-line is relatively more important than the changes in the recapture rules. For example, an investor in the fifty percent marginal tax rate using 200 percent declining balance depreciation would find his rate of return decreased from 20.9 percent to 18.2 percent if he is limited to 150 percent declining balance depreciation, but his rate of return

would be decreased to only 20.1 percent under the new recapture rule applicable to housing.

Second, the various recapture rules have only minimal effect on the rate of return, *except for the rule requiring full recapture of all prior depreciation*.⁵⁹ Since Congress never seriously considered going to full recapture on real estate, this suggests that the debate over the applicable phase-out periods was largely unnecessary.

Third, as would be expected, the effects of changes in depreciation method and recapture are more significant for the investor in the seventy percent marginal tax bracket than for an investor in a fifty percent bracket. This is true for two reasons. First, the accelerated depreciation deductions generate negative taxable income in the early years. These tax losses are worth more to the investor the higher his marginal tax bracket. Second, upon sale, an investor with a marginal tax rate above fifty percent is able to take advantage of the alternative capital gains rate.⁶⁰

Fourth, Table 5 shows that the investor in the seventy percent marginal tax bracket makes a better rate of return than the investor in the fifty percent tax bracket. This is just the opposite of what one would expect in a progressive tax system where investors with higher tax rates should have lower after-tax rates of return than investors with lower tax rates. Even in the case of municipal bonds, after tax rates of return are equal for high bracket and low bracket investors. It is this upside-down-world characteristic of real estate investment which leads some observers to describe the tax treatment of real estate investment as a negative income tax for the wealthy.

Fifth, the relative importance of the various tax changes on the rate of return from investing in real estate can be put in some perspective by examining the effect of a one percentage point increase in the interest rate. For an investor in the fifty percent marginal tax bracket, the one percentage point increase in the interest rate leads to a larger decrease in the rate of return than does limiting depreciation to 150 percent declining balance or tightening recapture.⁶¹ The table also indicates that as interest rates increase, so does the relative advantage of the seventy percent taxpayer as compared with the fifty percent taxpayer.

59. INT. REV. CODE of 1954, § 1245. The impact of full recapture may be overstated if properties typically are sold at a price below their original basis since the standard case assumed that the properties would be sold at their original cost.

60. The model assumes the twenty-five percent maximum capital gains rate under the pre-1970 rules. The alternative rate was modified in the Reform Act. See note 96 *infra* and accompanying text.

61. For an investor in the seventy percent marginal tax bracket, the percentage point increase in the mortgage interest rate is actually less significant than limiting depreciation to 150 percent declining balance or the tightening of recapture, because he receives a larger tax benefit from the deductibility of interest than the fifty percent taxpayer.

3. Changes in Present Discounted Values

Table 6 shows the present discounted values of the same investment situation presented in Table 5. The present discounted values can be interpreted as follows: How much would an investor be willing to pay for a real estate project costing \$100,000 (\$10,000 land and \$90,000 building) given that the income from the building will be treated in certain ways for tax purposes and that he must make ten percent after taxes on his original equity? In short, we assume that the investor bids up the price on the building until his after-tax rate of return is just ten percent. Under less favorable tax treatment the investor would not bid the price up quite as far.

Table 6

THE PRESENT DISCOUNTED VALUE FROM REAL ESTATE INVESTMENTS
DISCOUNT RATE OF TEN PERCENT

<i>The Standard Case and Selected Changes in the Standard Case</i>	— DEPRECIATION METHOD AND MARGINAL TAX RATE —					
	— 200 DB ¹ —		— 150 DB ² —		— SL ³ —	
	50%	70%	50%	70%	50%	70%
Standard Case ⁴ _____	\$107,145	\$109,109	\$105,648	\$106,767	\$104,341	\$104,739
Recapture rule						
Phase-out after: ⁵						
60 months_____	106,700	108,309	105,450	106,410	104,341	104,739
100 months_____	106,256	107,509	105,251	106,052	104,341	104,739
Full recapture of excess over straight-line ____	106,034	107,110	105,152	105,873	104,341	104,739
Full recapture ⁶ _____	104,198	107,955	103,316	105,614	102,506	101,434
Interest rate						
9 percent_____	104,984	107,955	103,488	105,614	102,181	103,585

¹ 200 percent declining balance depreciation.

² 150 percent declining balance depreciation.

³ Straight-line depreciation.

⁴ The standard case assumes:

Holding period = ten years (after
one year construction period)
Depreciable life = forty years
Interest rate = eight percent
Mortgage term = twenty-five years
Building value = \$90,000

Land value = \$10,000
Sales price = \$100,000
Net rent = \$9,500 per year
Construction carrying charges = \$6,200
Original equity = ten percent

Recapture of the excess of accelerated over straight-line depreciation with a phase-out of one percent per month after twenty months. The holding period does not include the one year construction period. For a ten year holding period there is no recapture.

⁵ Recapture of the excess of accelerated over straight-line depreciation with a phase-out of one percent per month after the stated number of months.

⁶ The recapture rule of § 1245, INT. REV. CODE of 1954.

The results presented in Table 6 are interpreted much the same as those in Table 5. The changes in tax depreciation are of greater importance than the changes in the recapture rules. The tax changes affect the seventy percent taxpayer more than the fifty percent taxpayer. The tax changes are about equivalent to a one percentage point change in the mortgage interest rate.

4. Equivalent Investment Tax Credits

From Table 6 we can determine investment tax credits which would be equivalent to the various changes in the depreciation method and the recapture rules. These equivalent investment tax credits are presented in Tables 7 and 8. As pointed out above, under less favorable tax treatment the investor would not be willing to pay as much for a particular investment. However, there must be some investment credit which when combined with the particular tightening of the tax treatment of real estate under consideration would leave the investor as well off as under the prior law. The investor is then indifferent between having, for example, more liberal depreciation with no investment credit and less liberal depreciation with an investment credit.

Table 7

INVESTMENT TAX CREDIT (IN %) EQUIVALENT TO CHANGES IN DEPRECIATION METHOD ASSUMING NO CHANGE IN THE INVESTOR'S MARGINAL TAX RATE¹

<i>Depreciation Change</i>	<i>MARGINAL TAX RATE</i>	
	<i>50%</i>	<i>70%</i>
From 200 DB ² to 150 DB ³ _____	1.8	2.9
From 150 DB to SL ⁴ _____	1.6	2.5
From 200 DB to SL_____	3.4	5.3

¹ An investment credit is equivalent if it would leave the investor as well off as in the situation with no change in the depreciation method. It is assumed that the investment credit is taken at the end of the construction period based on the \$90,000 cost of the constructed building.

² 200 percent declining balance depreciation.

³ 150 percent declining balance depreciation.

⁴ Straight-line depreciation.

Table 8

INVESTMENT TAX CREDIT (IN %) EQUIVALENT TO CHANGES IN THE RECAPTURE RULE ASSUMING NO CHANGE IN THE INVESTOR'S MARGINAL TAX RATE OR DEPRECIATION METHOD¹

Recapture Rule	DEPRECIATION METHOD AND MARGINAL TAX RATE					
	200 DB ²		150 DB ³		SL ⁴	
	50%	70%	50%	70%	50%	70%
Phase-out after: ⁵						
60 months_____	0.5	1.0	0.2	0.4	0.0	0.0
100 months_____	1.1	2.0	0.5	0.9	0.0	0.0
120 months_____	1.4	2.4	0.6	1.1	0.0	0.0
Full recapture ⁶ _____	3.6	6.5	2.9	5.1	2.2	4.0

¹ An investment tax credit is equivalent if it would leave the investor as well off as in the situation with no change in the recapture rules. It is assumed that the investment credit is taken at the end of the construction period based on the \$90,000 cost of the constructed building.

² 200 percent declining balance depreciation.

³ 150 percent declining balance depreciation.

⁴ Straight-line depreciation.

⁵ Recapture of the excess of accelerated over straight-line depreciation with a phase-out of one percent per month after the stated number of months.

⁶ The recapture rule of § 1245, INT. REV. CODE of 1954.

Table 7 indicates the investment tax credits which are equivalent to the changes in depreciation method. Table 8 indicates the equivalent credits for the changes in the recapture rules. The important conclusion to be drawn from these tables is that *the economic impact of the major tax changes affecting real estate, especially the change in recapture, would appear to be considerably less than the impact of the removal of the seven percent investment credit on the attractiveness of investing in new equipment.*⁶² The Tax Reform Act of 1969 should greatly increase the relative attractiveness of investment in housing because new housing investment will continue to enjoy 200 percent declining balance and sum of the years-digits depreciation and will be subject to a change in recapture which is equivalent at most to the removal of approximately a two percent investment credit.

62. An indication of the relative impact of the tax changes can be found in the Treasury estimates of revenue effect. Elimination of the investment tax credit is estimated to have a \$3.5 billion effect, while the real estate depreciation and recapture changes a \$1.3 billion effect. Since the investment tax credit change affects each year only new purchases of equipment — something less than \$100 billion — while the real estate tax reforms affect new and existing depreciable real estate — far in excess of \$100 billion — it is obvious that the percentage effect is much smaller in real estate.

5. Effect of Changes in the Depreciation of Used Structures

Up to this point nothing has been said explicitly about the effect of limiting the depreciation of second or subsequent owners on the attractiveness of real estate investments for new owners. A second owner of an office building, realizing that he will be able to take only straight-line depreciation and not 150 percent declining balance depreciation as formerly, will be willing to pay less for the used building than before the changes in the tax law. In short, the changes in the tax law affecting subsequent owners will be capitalized into the sale price of the used buildings.

The effect of limiting subsequent owners to straight-line depreciation can be roughly determined from Table 6.⁶³ An investor in the fifty percent marginal tax bracket would be willing to pay \$105,648 if he were allowed 150 percent declining balance depreciation and \$104,341 if he were allowed straight-line depreciation. This represents a 1.2 percent decrease in the price a subsequent buyer would be willing to pay for the property. For an investor in the seventy percent marginal tax bracket the reduction in price would be from \$106,767 to \$104,739 or 1.9 percent. What impact will this have on potential new owners of commercial buildings? For a developer expecting a quick turnover, the effect will be no more than two percent of the total value of the property. For the investor looking to sale in ten years, a two percent decrease in price upon sale is about an 0.8 percent decrease in terms of today's dollars based on discounting at ten percent. Second, the government bears part of the burden of a reduced sales price. Since the sales price is somewhat lower, there will be less capital gains and recapture taxes collected as a result of the sale.

In conclusion, the effect of limiting the depreciation of subsequent owners will have minimal effect on the attractiveness of new investments in real estate.

6. Preference for Housing Investments

A stated goal of the Tax Reform Act is to create an investment preference for new housing. The combined effect of favorable depreciation and recapture rules on such investment can be measured from Table 5. A taxpayer in the fifty percent bracket who invests in new housing, taking advantage of the 200 percent declining balance depreciation and the favorable recapture rule, will earn a 20.1 percent annual return on a typical investment. In contrast, the rate of return from an investment in a commercial or industrial structure subject to

63. The figures presented in Table 6 assume a one year construction period. If the construction period is omitted and the cash flows are discounted back to the beginning of the first year of operation, the magnitude of the results is little affected. For purposes of discussing the effect of limiting subsequent owners to straight-line depreciation, the figures in Table 6 are quite adequate.

150 percent declining balance depreciation and full recapture of the excess of accelerated over straight-line depreciation, will be 17.7 percent. Thus, the rate of return from the new housing investment is fourteen percent greater than that from a new commercial or industrial structure. For the seventy percent bracket taxpayer, an investment in new housing yields a twenty percent higher rate of return. Actually the relative advantage to housing is even slightly greater because the effect of the new laws on the resale value of housing is slightly less than on the resale value of commercial property.

The differential in rates of return is even more pronounced between investments in new housing and used commercial structures. The rate of return on new housing is twenty-six percent greater for the fifty percent bracket taxpayer and forty-one percent greater for the taxpayer in the seventy percent bracket. Although investments in used housing can still be depreciated on the 125 percent declining balance method, the rate of return on new housing will be significantly greater than that on used housing.

III. SPECIAL INCENTIVES FOR LOW INCOME HOUSING

One of the most significant aspects of the real estate provisions of the Tax Reform Act of 1969 is the focus on housing for persons of low and moderate income. The House Ways and Means Committee adopted a special incentive for the rehabilitation of buildings for low cost rental housing. The Senate Finance Committee added two provisions to the bill specifically designed to encourage the construction of low income housing, each of which reflected recommendations by the Treasury. First, the Finance Committee provided for the retention of the favorable recapture rules for publicly assisted housing. Second, the Committee provided for a tax-free "rollover" in the case of sales of federally assisted housing.

A significant point in respect to the special incentives for low and moderate income housing is the imposition of termination dates. The retention of favorable recapture rules for publicly assisted housing and the fast write-off for rehabilitation expenses will apply only with respect to investments made through 1974.⁶⁴ This means that the burden will be on the recipients of the tax benefits to justify their continuation after the expiration date. As a result, these new tax incentives are somewhat more closely in line with the practices followed with appropriated subsidies.

A. The Rehabilitation Incentive

There are presently approximately 10,000,000 units of privately owned rental housing in the United States, exclusive of units in slum

64. INT. REV. CODE of 1954, §§ 1250(a)(1)(C)(ii), 167(k)(1).

areas and urban renewal areas. The Department of Housing and Urban Development estimates that each year some 150,000 of these units are lost through "slippage" into substandard status. These are units which, if rehabilitated, would fill the same need as the creation of 150,000 new housing units annually.

Both the Douglas and Kaiser Commission reports emphasized the tendency of existing tax incentives to encourage turnover in older properties to take advantage of repeated allowances of 150 percent declining balance depreciation — a trend which allegedly acted as a disincentive to proper maintenance and upkeep.⁶⁵ While somewhat limiting the depreciation allowed subsequent owners, and thus reducing the opportunities for tax avoidance by repeated turnovers of housing, the bill provides an important new incentive for the rehabilitation of buildings for occupancy by low income tenants.

Under new section 167(k), a taxpayer may elect to compute his depreciation deduction with respect to rehabilitation expenditures using a special five year useful life, and no salvage value. The normal recapture rules still apply with the five year write off being treated as accelerated depreciation.⁶⁶

The expenditures that may be depreciated over the special five year life must aggregate at least \$3,000 per dwelling unit, but not more than \$15,000 per dwelling unit may be written off under the special method.⁶⁷ These limits are designed to assure that the rehabilitation is a substantial one, not just a painting and general fix-up; and the ceiling is intended to deny the benefit beyond what is needed to do an adequate job for both lower and moderate income tenants. Both limits are based on the general experience of the FHA in respect to costs of rehabilitation.⁶⁸

The actual implementation of these limits will have to be resolved by regulations, particularly questions relating to the allocation of general expenses. While it is a simple matter to allocate the cost of a new floor, or a new kitchen, to the particular dwelling unit involved, it may be more difficult to allocate the cost of a new roof on a multi-family dwelling. Where the dwelling units in the structure are all roughly the same size, it would seem appropriate to allocate costs evenly to each unit. But if there is a substantial disparity in the sizes of the units, it may be necessary to allocate such costs on some other basis, such as respective square footage.

65. DOUGLAS, COMM'N REP., *supra* note 30, at 403-04; KAISER COMM'N REP., *supra* note 32, at 99-100.

66. INT. REV. CODE OF 1954, §§ 1250(a)(1)(C)(iv), 1250(b)(4).

67. *Id.* at § 167(k).

68. See KAISER COMM'N REP., *supra* note 32, at 101, indicating an average range of rehabilitation costs of from \$4,173 to \$13,636 in various regions of the nation.

1. The Low Income Requirement

The most important question to be resolved by the regulations is the test for determining whether the rehabilitated expenditures have been made for the benefit of persons of low income. Low income rental housing, the rehabilitation expenditures in respect to which may be depreciated over a five year useful life, is defined as follows:

The term "low-income rental housing" means any building the dwelling units in which are held for occupancy on a rental basis by families and individuals of low or moderate income, as determined by the Secretary or his delegate in a manner consistent with the policies of the Housing and Urban Development Act of 1968 pursuant to regulations prescribed under this subsection.⁶⁹

The term "lower income families" appears in the 1968 Housing Act in conjunction with the interest reduction payment programs of sections 235 and 236.⁷⁰ Under section 236, certain sponsors of multi-family housing projects can receive federally subsidized mortgages if the projects are made available to families and individuals of lower income. For purposes of that program, low income is defined as annual income not in excess of 135 percent of the income levels required to qualify for public housing in the area where the project is built. In Baltimore, for example, a family of four would qualify if its income was less than \$5,535.⁷¹

However, income levels used for purposes of section 236 of the Housing Act will not necessarily control in determining the eligibility of rehabilitated housing under the new section 167(k) write-off. The provision does not refer specifically to the section 235-36 definition. It requires only that the standard be determined in a manner "consistent with the policies" of the Act.

It can be argued that the benefits of section 167(k) should be funneled, to the extent possible, only to those persons who have the greatest need for housing, the low income families as defined for purposes of section 236 of the 1968 Housing Act. In principle, section 236 and the rehabilitation incentive are identical: both provide government subsidies to taxpayers who construct housing for persons of low income. In one context, Congress has determined that this phrase is limited to those whose income is within 135 percent of the local income level to qualify for public housing. A consistent administration of national housing programs suggests that the same standard be used for the rehabilitation incentive.

69. *Id.* INT. REV. CODE of 1954, § 167(k)(3)(B).

70. 12 U.S.C. § 1715z-1 (Supp. IV 1969).

71. *Id.* at § 1715z-1(i)(2); U.S. DEP'T OF HOUSING AND URBAN DEVELOPMENT, *FHA, REGULAR INCOME LIMITS FOR SECTIONS 235 AND 236 HOUSING* (1969).

If the target population is extended beyond the section 236 limits into middle income levels, there may be some indirect benefit to lower income families in that other housing would be freed for their use. However, the Senate Finance Committee noted that "the 'trickle down' supply effect for the lower income rental housing market is slow and uncertain,"⁷² presumably on the theory that capital is diverted from lower cost housing. One obvious possibility is that a more affluent family might occupy the rehabilitated unit rather than build their own house, with no overall increase in available housing. This suggests that if the rehabilitation incentive is extended to middle income levels the result will be a "horizontal" expansion of middle income housing and little net increase in the availability of housing to persons of lower income.

2. Administration of the Rehabilitation Incentive

Closely related to the question of the standard by which to identify families and individuals of low and moderate income is the method by which the Internal Revenue Service will make that determination. One approach is to require the taxpayer to secure a certificate from the Department of Housing and Urban Development, or a designated local agency, that the structure is being held for occupancy by low and moderate income persons. HUD could then issue certificates in accordance with the standards developed by the Treasury. This approach would make crystal clear the status of the incentive as an indirect subsidy, since HUD would presumably administer the payments in the same manner as it administers direct payments under its own programs.

The more fundamental question is whether, given a definition of the target population, the availability of rehabilitated housing to that group is to be determined by reference to the tenant's income or the rentals charged for the units. Under the FHA section 236 interest reduction program, sponsors of subsidized housing are required to secure information from tenants as to the tenant's annual income. A similar requirement for purposes of the rehabilitation incentive might be imposed, and the Internal Revenue Service would be able to audit the allowability of the incentive on the basis of the income tax returns and withholding reports of the individual tenants.

An alternative approach would be to limit the amount of rent charged for a dwelling unit to a fixed percentage of the maximum income levels under the section 236 assistance program. While this would not guarantee that the housing would in fact be occupied by low income families, it would indicate that the units could be afforded by such persons. And it may also be assumed that the investor will not expend substantial sums of money where he is in effect subject to

72. SENATE REP., *supra* note 22, at 212. *Contra*, testimony of Leon Keyserling, SENATE HEARINGS, *supra* note 28, at 3989.

rent control; thus presumably the dwelling units would not be attractive to persons who, because of higher income levels, could afford to pay more than the designated rental level.

3. Conversion of Rehabilitated Housing

During the initial five years, the availability of the fast depreciation deductions will make it economical to hold the property for rental by persons of low income. Thereafter, the taxpayer will presumably charge what the market will bear. The statute provides no express sanction against this practice, and Congress presumably assumed that the purpose of the provision would be met so long as the housing was held out to low income persons during the write off period.

If the rehabilitated structure ceases to qualify under section 167 (k) (3) as housing for the benefit of low income individuals, will the taxpayer lose the right to compute depreciation using the special five year useful life? While the statute does not specifically cover the point, the broad regulatory authority would seem to authorize such a rule. Certainly the policy of encouraging construction of low income housing would be ill served were the taxpayer permitted a full five year write off for token occupancy by low income persons.

If, in the subsequent year, the dwelling unit does qualify, the taxpayer might be permitted to elect to again use the five year useful life provision, claiming twenty percent of the remaining basis (reduced by the section 167 depreciation deduction computed for the year or years in which the election was not made). This rule, however, would permit a taxpayer to make the election only in years when his other income was sufficient to make the additional deduction worthwhile, and would create considerable administrative difficulties. To avoid this problem, the taxpayer could be allowed to make only one election with respect to a rehabilitated unit, which would remain in effect until such time as the structure ceased to qualify.⁷³ Thereafter, any remaining basis would be recovered through normal section 167 depreciation allowances, using the useful life determined independently of section 167 (k).

4. An Evaluation of the Rehabilitation Incentive

The Report of the Senate Finance Committee estimates that the rehabilitation incentive will cost the Treasury over \$400 million during its initial five year term and, if retained in the law after 1974,

73. Taxpayers will presumably be allowed to revoke an election, since the effect would be no different from a decision to switch from an accelerated method of depreciation under § 167 (b) or (j), pursuant to § 167 (e) (1) or Rev. Proc. 67-40, 1967-2 CUM. BULL. 674.

would result in annual revenue losses of some \$330 million per year.⁷⁴ Over a ten year period, the federal government could spend nearly \$2 billion in the effort to rehabilitate older housing, or an average of nearly \$200 million per year. By comparison, the President recommended a rehabilitation loan fund of \$84 million for fiscal 1970.⁷⁵ Thus, section 167(k) of the Code is a major instrument of government policy to preserve existing housing and to increase the housing available to persons of low and moderate income.

The rehabilitation provision has been strongly criticized. Professor Stanley S. Surrey, former Assistant Secretary of the Treasury for Tax Policy, has argued that such tax incentives generally involve waste, inefficiency and inequity.⁷⁶ And Professor Charles Davenport, in a statement submitted to the Senate Finance Committee,⁷⁷ focused on the inequitable effect of the rehabilitation incentive device. He pointed out that the five year write off is worth much more to the high bracket taxpayer than the low bracket taxpayer. The five year write-off of rehabilitation expenditures which would otherwise have had a twenty year life is equivalent to a nineteen percent investment credit for the seventy percent taxpayer, a five percent investment credit for the taxpayer in the twenty percent tax bracket, and is worth nothing to the potential investor with zero taxable income. In short, unrealistic capital recovery perverts the progressive tax system.

The criticism of the rehabilitation incentive is blunted by the requirement that the rehabilitated units be held for occupancy by families of low and moderate incomes. The greater subsidy to high bracket taxpayers may be a tolerable price for the substantial benefits to lower income families.

The rehabilitation provision was adopted by both the House and Senate with a minimum of debate, and the only substantive modification of the original Treasury proposal was the imposition of a five year termination date to permit Congress to re-examine the effectiveness of the provision in 1974. This evaluation will probably be directed to a determination of the increase in the amount of rehabilitation attributable to the incentive, and the extent to which additional housing is thereby made available to low income persons.

74. JOINT COMMITTEE ON INTERNAL REVENUE TAXATION, REVENUE ESTIMATES RELATING TO THE HOUSE, SENATE AND CONFERENCE VERSIONS OF H.R. 13270, TAX REFORM ACT OF 1969, 91st Cong., 1st Sess. (1969). Revenue losses attributable to tax incentives — unlike direct subsidies — are not subject to tax. Thus, the estimated revenue loss of \$330 million per year is equivalent to better than \$500 million of appropriated, taxable subsidies.

75. THE BUDGET OF THE UNITED STATES GOVERNMENT 312 (1969).

76. *Tax Incentives As A Device For Implementing Government Policy: A Comparison With Direct Government Expenditures*, 83 HARV. L. REV. 705, 721 (1970).

77. SENATE HEARINGS, *supra* note 28, pt. 5, at 4906-07.

B. Retention of Recapture Rules for Publicly Assisted Housing

In addition to retaining 200 percent declining balance depreciation and sum of the years-digits depreciation for all new housing, the Act retains the pre-1970 recapture rules with respect to certain publicly assisted housing projects constructed for the benefit of low and moderate income families.⁷⁸ Under this rule, the amount of gain which will be subject to recapture as ordinary income will be reduced by one percent per month after the property has been held for twenty months (as contrasted with the one hundred month rule generally applicable to housing). To qualify for this favorable treatment, the housing must be either financed by a mortgage insured under sections 221(d)(3) or 236 of the National Housing Act, or financed or assisted by direct loan or tax abatement under similar provisions of State or local laws. In addition, the taxpayer must, under such laws or regulations issued thereunder, be limited as to the rate of return on his investment and the rentals from the project.

The retention of the special recapture rules is not limited to federally assisted projects.⁷⁹ In the past few years, a number of State and local laws have been enacted with the same general purpose as section 236 — to encourage private investment in low and moderate income housing.⁸⁰ In the legislative process, the bill was amended to include such State and local programs whether they take the form of government guarantee of mortgages or some other type of public assistance.

The major argument advanced for the retention of the recapture rules in the case of projects developed under various federal, State and local housing programs is that these programs were designed to take advantage of the then existing tax preferences with respect to real estate investments. Any change in the recapture rules would tend to undermine the various housing programs and make it more difficult to achieve the national housing goals. The Senate Finance Committee accepted this argument, but limited the favorable recapture rules to projects constructed, reconstructed or acquired by the taxpayer before January 1, 1975. The Senate Finance Committee Report suggests that at that time Congress will have an opportunity to further evaluate

78. A further limitation on abuses is the provision recapturing the additional depreciation attributable to the short five year useful life. INT. REV. CODE OF 1954, § 1250(b)(4). In combination with the generally high mortgage balances that would remain unpaid in the event of a sale, it can be shown that the rate of return from an investment in low and moderate income rehabilitations will generally not exceed fifteen to twenty percent.

79. INT. REV. CODE OF 1954, § 1250(a)(1)(C)(ii).

80. At the present time, New York State, New York City and New Jersey have ongoing publicly assisted programs for the production of low and moderate income housing which are structured along the lines of the § 236 program. A number of other States are developing similar programs.

the effect of the incentive.⁸¹ The report of the House Ways and Means Committee suggests a broader concern over the use of the tax system to stimulate this type of investment.⁸²

It is not at all clear that the retention of the pre-1970 recapture rules was either necessary or significant in the effort to encourage additional investment in low and moderate income housing. As was indicated in the general discussion of depreciation and recapture, the effect of the changes in recapture rules is relatively small compared to changes in the depreciation method or interest rate, and the effect of not including publicly-assisted housing under the general one hundred month phase-out rule for housing is indeed slight. In view of the minimal level of the tax incentive and the major importance of other factors such as the level of direct subsidy, permissible rate of return and relative attractiveness of other investments, it may be difficult to isolate the effectiveness of the special phase-out rule in order to evaluate the recapture incentive before 1975.

C. *Tax-Free Sales of Federally Assisted Housing*

1. Application and Operation of Section 1039

Low and moderate income housing projects constructed with insured loans under section 236 of the 1968 Housing Act are subject to the control of HUD. Under the statute, the amount received by the owner upon sale cannot exceed an amount necessary to recover his original equity investment, pay the necessary capital gains and recapture taxes and retire the then-outstanding mortgage. This control is intended to permit the tenants of a multi-family project to purchase the project from the original owners at a price which does not give the owner a profit beyond that attributable to the rents which have been paid.⁸³

The Kaiser Commission recognized that one problem in the sale of these projects is the payment of taxes on the sale.⁸⁴ Since the sale price is set at a level that permits the investor's net receipts (after taxes and after retiring the mortgage) to equal the original investment, the taxes due increase the amount that tenant cooperatives have to pay, thereby increasing the debt service carried by the individual low and moderate income tenants.

In an attempt to alleviate this problem, the Act contains a special provision permitting the tax-free sale of, and reinvestment in, low and

81. SENATE REP., *supra* note 22, at 215; INT. REV. CODE of 1954, § 1250(a) (1) (C) (ii).

82. HOUSE REP., *supra* note 27, at 166: "The present tax treatment of real estate does not efficiently stimulate investment in low- and middle-income housing."

83. SENATE REP., *supra* note 22, at 292.

84. KAISER COMM'N REP., *supra* note 32, at 84; SENATE REP., *supra* note 20, at 292.

moderate income housing.⁸⁵ Under the new section 1039, no tax will be due on the sale of federally assisted section 221(d)(3) or 236 low income housing projects, to the extent that the proceeds of the sale are reinvested in another project, and the basis of the old project is carried over to the new. The provision is modeled on section 1033 of the Code permitting the tax-free reinvestment of amounts received from involuntary conversion of an asset.⁸⁶ In both instances, the underlying theory is that the taxpayer has not altered his general economic situation: he has simply transferred his investment from one low income housing project to another, and tax is due only with respect to the moneys that he actually removes from the "basket."

Section 1039 is limited to federally assisted housing projects.⁸⁷ As passed by the Senate Finance Committee, the provision would have applied only to federally assisted housing projects, but coverage was broadened on the floor of the Senate to include low income projects assisted by State and local governments,⁸⁸ and in principle there is no distinction. The Conference Committee, however, rejected the Senate's inclusion of state assisted projects, presumably for concern over the difficulty of monitoring the operations of a multitude of State programs.

The ironic result is that for purposes of measuring recapture on sale, both federal and State assisted low income housing projects are entitled to use the pre-reform rules for the next five years, but only the federally assisted projects can take advantage of the section 1039 rollover.

Housing projects qualifying for the special rollover provision include those financed under both the mortgage guarantee program of section 221(d)(3) and the interest reduction program of section 236 of the National Housing Act.⁸⁹ Section 221(d)(3) projects are included despite the phasing-out of the program⁹⁰ to make the favorable

85. INT. REV. CODE of 1954, § 1039.

86. *Id.* at § 1033(a)(3)(a).

87. The new § 1039 has been drafted very strictly. The provision specifies that investors in qualified § 236 housing projects must, under that law or its regulations, be limited as to the rate of return on their investment, and limited as to the rental or occupancy charges for dwelling units therein, even though § 236 already contains those rules.

88. *See* 115 CONG. REC. S15953-54 (daily ed. Dec. 6, 1969). The amendment was sponsored by Senator Javits and would have applied only to State and local assisted projects subject to the same limitations as federally assisted projects.

89. INT. REV. CODE of 1954, § 1039(b)(1)(A).

90. Projects financed by direct loans at below market interest rates under section 221(d)(3) are being converted to interest-subsidy projects under section 236 of the 1958 Housing Legislation, because of the reduced impact on the federal budget. Conversation with G. Richard Dunnells, esq., Special Assistant to the Under Secretary, Department of Housing and Urban Development, September 4, 1969.

treatment available to existing structures which were financed under that program.⁹¹

Since the general intent of section 1039 is to treat the original investment in low income housing as continuous, the holding period for purposes of section 1250 would have to be carried over to the new property, along with the basis of the old property. However, if the previous holding period was tacked on to the entire new investment, an opportunity would be created for unjustifiable tax avoidance where the investment in the second project was substantially greater than the proceeds from the disposition of the original investment: on the sale of the second, depreciated project, the taxpayer would be able to take advantage of the holding period accumulated during the earlier, smaller investment, and reduce the applicable percentage to be applied to the total amount of depreciation claimed with respect to both investments. To meet this problem the section 1250 recapture rules applicable to disposition of assisted projects acquired in a section 1039 rollover transaction⁹² require the division of the second and subsequent investments into elements representing the original and subsequent investment.

2. Evaluation of the Section 1039 Rollover

The effectiveness of section 1039 in encouraging low priced sales to tenants depends upon whether the tax advantages offered under section 1039 outweigh the disadvantages. The taxpayer making the section 1039 rollover secures the advantage of a longer holding period for purposes of recapture⁹³ and of deferral of gain, including the

91. While the statute is not explicit on the point, it seems clear that the rollover will be available both to limited dividend sponsors — where the rate of return is limited to six percent of the equity investment — and to non-profit cooperative sponsors whose charters must, under the Housing Act, provide that no net earnings or net profits from the assisted project inure to the benefit of anyone other than the low income tenants, in effect limiting the rate of return to zero. This view is supported by the specific provision of § 1039(b)(2) that permits sales only to such non-profit cooperatives: since the corresponding amendments to § 1250 contemplate the possibility of second and third sales of the same project by the initial purchaser under § 1039, the statute must also cover sales by such groups which act as the initial owner-sponsor. See INT. REV. CODE of 1954, § 1039(b); 12 U.S.C. § 1715z-1(b) (Supp. 1969). See also remarks of William A. Kelley, Jr., Chairman, Comm. on Real Estate Tax Problems, before the Section on Taxation of the American Bar Association, in San Francisco, California, Jan. 31, 1970.

92. INT. REV. CODE of 1954, § 1250(d)(8)(E).

93. *Id.* Since the holding period in respect to the initial investment in the assisted project is cumulative, the § 1039 election reduces the tax on sale that would have to be paid if the rollover to a new project were made without the election. For investments made after 1974, this feature becomes relatively more important, since the phase-out of recapture does not begin for such investments until the property has been held one hundred months. Under the post-1974 rules, all the additional depreciation would be recaptured on a sale after five years; but if the § 1039 election is made, the amount of gain subject to recapture will be reduced to zero after sixteen years and eight months.

possibility of ultimately passing property on at death with a stepped-up basis. Moreover, since the sale price under the election is lower, a tenant cooperative, or other qualified purchaser, would more likely be able to afford the project.

The primary disadvantage of a section 1039 election is the lower basis for depreciation on the second project. If the owner can sell the property for the maximum the law allows, including his capital gains and recapture taxes, he will probably not make a 1039 election: getting a greater depreciable basis in his new investment with the buyer of the old investment paying all the tax cost would be an advantageous bargain. When the project is sold at less than the maximum, however, the non-recognition election may be beneficial.

Since the sale price of a section 236 project is designed to retain the original investor's status quo, elimination of the tax on sale permits a lower sale price for the acquiring tenant cooperative and increases the possible market for such sales. If the section 1039 rollover were not available, the sale price of the first project would have to be large enough to cover not only the mortgage and original investment, but also the tax on sale. The increase in the sale price required is above what the tenant cooperative would have to pay to acquire the project with a section 1039 rollover election. This would increase the annual debt service proportionately. To the extent that the section 1039 election increases the marketability of his investment, the taxpayer will be encouraged to take advantage of it.

Finally, the rollover provision permits a taxpayer to take greater advantage of the provisions permitting a tax-free stepped-up basis at death.⁹⁴ Absent the rollover, an investor might be reluctant to sell and reinvest in a new project, with the accompanying tax cost, if he could instead hold the existing project until death. At that time, his heirs would take the project with a stepped-up basis and no capital gains tax. Moreover, while the rollover would not permit the investor to take additional depreciation deductions, he would probably be able to increase his interest deduction without increasing his total mortgage payments and he would be able to take advantage of a new round of construction cost deductions.

IV. OTHER TAX CHANGES AFFECTING REAL ESTATE

In addition to the provisions limiting allowable depreciation, tightening the recapture rules and granting special incentives for investment in low and moderate income housing, the Tax Reform Act of 1969 contains a number of other important provisions which will have an effect on the attractiveness of real estate investment. It is not possible to discuss each of these provisions in full detail, but it is necessary to give some indication of their importance.

94. *Id.* at § 1014.

A. Repeal of the Investment Credit

The repeal of the seven percent investment credit, with its estimated revenue impact of \$3 billion a year, removes a significant tax preference for investment in depreciable personal property.⁹⁵ It was shown in Table 7 that the reduction in allowable depreciation for commercial and industrial property was equivalent to the elimination of an investment credit of less than three percent. Thus, the combined effect of limiting allowable depreciation on industrial and commercial buildings and eliminating the seven percent investment credit for equipment is to increase the relative attractiveness of investment in new commercial and industrial buildings. Moreover, housing, which is still permitted the most accelerated methods of tax depreciation, gains a relative advantage to investment both in commercial and industrial building and in equipment. Thus, the changes in the law should increase the flow of investment into real estate and especially into housing.

B. Changes in Treatment of Capital Gains: Alternative Rate and Income Averaging

The bill repeals the twenty five percent alternative long term capital gains rate for individuals with the exception that \$50,000 (\$25,000 in the case of a married individual filing a separate return) of long term capital gains will continue to qualify for the alternative rate. The maximum tax rate for long term capital gains when this provision is fully phased-in after 1971 will be thirty five percent, or one half the maximum seventy percent rate on ordinary income.⁹⁶

To the extent that real estate investments depend on the ability to realize gain on a later sale at the preferential twenty five percent rate, the limitation on the use of the alternative capital gains rate may discourage investments. The increase in the tax on long term capital gains will tend to be a greater disincentive to investment in housing than investment in commercial and industrial structures: since the changes in the recapture rules and allowable depreciation applicable to commercial and industrial structures are more severe than the changes applicable to housing, housing presents the greater opportunity to convert ordinary income into capital gain.

However, the net practical effect of the capital gains changes are minimal. Investors are still permitted to recover \$50,000 at the twenty five percent alternative rate, and the excess gain will be taxed at only half the rate applicable to ordinary income. In addition, the investor will continue to be able to recapture the straight-line depre-

95. *Id.* at § 49.

96. *Id.* at § 1201.

ciation at capital gains rates and to use favorable installment sale reporting to spread the gain over a number of years. What may be more significant to real estate investors is that the new law permits capital gains to be included in income averaging.⁹⁷ For many, the new law will tax capital gains at even a lower rate than under the old law.

C. *The Minimum Tax*

Secretary Barr touched off the year of tax reform by publicizing the cases of millionaires who pay little or no federal income tax. These individuals, by taking advantage of the many tax preferences in the Internal Revenue Code, are able to pay tax on only a small portion of their true economic income. The minimum income tax, probably the most novel feature of the Tax Reform Act, is an attempt to insure that high income taxpayers pay at least some tax to the government.

As finally enacted, the minimum tax imposes a ten percent tax, applicable to both corporations and individuals, on preference income in excess of \$30,000 plus the taxpayer's regular federal income tax. Nine items of tax preference are included under the minimum tax.⁹⁸ The most important ones affecting investors in real estate are accelerated depreciation on real property in excess of straight-line depreciation and the excluded half of long-term capital gains in the case of individuals and a corresponding portion of the gain in the case of corporations.⁹⁹ Excess depreciation attributable to the special five year useful life for rehabilitation expenditures is also included as an item of tax preference,¹⁰⁰ a rule similar to the provision subjecting the write-off to recapture.¹⁰¹

The minimum tax is an important innovation because for the first time a number of the most important tax preferences are recognized as being income. The flat ten percent rate makes the minimum tax resemble in many ways an excise tax which is somewhat at odds with a progressive income tax.¹⁰² However, in the future, taxpayers

97. *Id.* at § 1302.

98. *Id.* at § 57.

99. Three major preferences were not included in the minimum tax: the interest on State and local municipal bonds, the unrealized appreciation on long-term capital assets donated to charity and the expensing of intangible drilling costs.

100. INT. REV. CODE § 57(a)(3). HOUSE COMM. ON WAYS AND MEANS, TAX REFORM ACT OF 1969, CONFERENCE COMMITTEE REPORT, H.R. REP. No. 782, 91st Cong., 1st Sess. 302 (1969).

101. INT. REV. CODE § 1250(b)(4).

102. The House-passed revision would have preserved the progressive nature of the minimum tax. Under the limitation on tax preferences (LTP), individual taxpayers would have been required to aggregate taxable and tax-free income, and to include at least one-half this amount in the tax base. HOUSE REP., *supra* note 27, at 78-80.

who pay thirty, forty or even fifty percent of their income taxes will increase the political pressure to raise the tax on those sources of income taxed at only ten percent. It is because of what the minimum tax may portend for the future that this tax may have important psychological effects on investment which would appear irrational from a strictly economic analysis of the impact of this tax.

In its testimony before the Senate Finance Committee, the Treasury Department recommended that the excess of interest, taxes and ground rent over receipts (if any) from real property during the period of construction (other than housing construction) be included in the list of tax preferences subject to minimum tax.¹⁰³ The Senate Finance Committee rejected this Treasury recommendation. The acceptance of the recommendation would have affected the tax position of the developers of real estate who gain a significant tax advantage from the deduction of certain carrying charges during the construction period. Good accounting theory suggests that payments such as interest, insurance and property taxes during the period of construction are costs necessary for the development of a capital asset which will yield income over a period of years. Under this reasoning, these payments should be capitalized and written off over the useful life of the building. However, tax accounting permits these carrying charges to be deducted as incurred.

In the typical case of the development of a real estate project, the carrying charges which may be deducted for tax purposes constitute anywhere from six to nine percent of the total construction costs. If an investor in the seventy percent tax bracket with ten percent original equity can deduct, for example, seven percent of the construction costs during the construction period, he is able to reduce his original equity to just over five percent by virtue of the tax benefit of seventy percent of the seven percent. The failure of the Senate Finance Committee to include the deduction of the carrying charges as a tax preference means that a significant preference of the real estate industry was left completely unaffected by the minimum tax.¹⁰⁴

D. Rate Reduction: Maximum Tax on Earned Income

The maximum tax on earned income also has important indirect effects on real estate investment. The Tax Reform Act of 1969 establishes a fifty percent maximum marginal tax rate on earned income (wages, salaries and fees),¹⁰⁵ and will decrease the attractiveness of real estate investments for persons with largely earned income. As

103. SENATE HEARINGS, *supra* note 28, p. 1 at 813, 818-19.

104. However, the deduction of construction interest on net based property may be subject to partial disallowance. See INT. REV. CODE of 1954, § 163(d)(4)(D).

105. INT. REV. CODE of 1954, § 1348.

discussed earlier, the taxpayer in the higher bracket gets more benefits from the real estate shelter. As the tax bracket goes down, so does the attractiveness of real estate investments.

A general rate reduction along with the repeal of the surtax would have had an even greater effect on the relative attractiveness of investing in real estate. Since the maximum tax on earned income does not apply to investments which yield a positive taxable income, such as dividend yielding securities, the after-tax yields of these investments are not increased. A general rate reduction would increase the rate of return from investments which throw off positive taxable income and at the same time decrease the rate of return from investments which throw off negative taxable income. This would tend to decrease the relative attractiveness of investments yielding negative taxable income.

E. Disallowance of Certain Interest Deductions

The deduction of interest as paid or accrued permits taxpayers to incur substantial interest expenses on funds borrowed to purchase and hold investments which produce little or no income. For example, one of the most important factors in creating tax losses from real estate is the deductibility of interest charges on the mortgage. In the early years of a long-term mortgage, the interest element of the debt service payments is typically ninety percent or more of the total payment. The interest deduction coupled with the generous depreciation deductions enables the taxpayer to shield not only the income from the real estate investment but also income from other sources. When the taxpayer finally sells his investment, the income obtained from the sale receives favorable capital gains treatment except for the limited recapture of part of the gain as ordinary income.

The Tax Reform Act disallows the deduction of interest to the extent of fifty percent of the investment interest in excess of net investment income (dividends, interest, rent, etc.), plus long-term capital gains, plus \$25,000.¹⁰⁶ Interest deductions on real estate investments will be subject to this limitation only if the property is not used in a trade or business. Under section 163(d)(4)(A), property subject to a lease is generally considered held for investment, and not held in a trade or business, if the deductions allowable *solely* under section 162 (thereby excluding taxes, interest and depreciation) are less than fifteen percent of the rental income from the property or if the lessor is guaranteed in whole or in part against loss of income.

In computing the amount of investment income against which investment interest may be offset, depreciation may be taken into account on a straight-line basis. Provision is made for the carryover of excess investment interest to be deducted against investment income

106. *Id.* at § 163(d).

in later years or against long term capital gain. However, capital gains which are used to offset investment interest are treated as ordinary income for purposes of the alternative capital gains tax, the fifty percent of capital gains deduction and the minimum tax. In addition, amounts treated as ordinary income upon the sale of investment assets as a result of recapture rules are to be treated as income against which investment interest may be offset. The limitation on the deduction of interest is not to apply to taxable years beginning prior to 1972, but excess investment interest will be treated as an item of tax preference until that time.

Both the disallowance of interest and the recapture rules deal with the problem of taking deductions against ordinary income now and later realizing a gain taxed at preferential capital gains rates. In the case of recapture, the depreciation deductions are not disallowed but are instead recaptured as ordinary income at the time of sale. However, in the case of the interest deduction, it was decided to deny a portion of the interest deductions which shield non-investment income from taxation. This is a somewhat more severe approach because the taxpayer does not obtain the benefit of tax postponement which he does obtain under the recapture approach.

The Treasury Department opposed the House version of the disallowance of interest deductions on the ground that the provision would discriminate against taxpayers with only earned income out of which to pay interest expense. The Treasury believed that the only equitable solution would require the tracing of interest expense to the particular investments for which the funds were borrowed. This, however, would be administratively unworkable.¹⁰⁷

The disallowance of interest provisions may decrease the attractiveness of real estate investments, especially highly leveraged investments. On the other hand, many real estate investors will not be affected because the first \$25,000 of excess investment interest is not disallowed, even in part. Also, many real estate investors will have sufficient investment income from dividends and rents so as not to be affected.

V. CONCLUSION

The Tax Reform Act of 1969 has been both praised and condemned by students of tax policy. While applauding the effort to close the more flagrant loopholes, some observers say that by preserving the present structure of the tax system, the bill only tinkers, without making any real reforms.¹⁰⁸ Others argue that the "reforms"

107. SENATE HEARINGS, *supra* note 28, pt. 1 at 576-77.

108. See, e.g., Address by Norman B. Ture, "Reform: Tax Policy Will O' The Wisp," The National Tax Association's Sixty-Second Annual Conference on Taxation, in Boston, Mass., Sept. 30, 1969.

have been too severe on some industries, such as real estate, while leaving others virtually untouched.¹⁰⁹ The truth lies in between. In a political system, one cannot expect to achieve all desired reform at once; and even among disinterested students of the system, there is no consensus on a complete package for "real" tax reform.

Nevertheless, the 1969 Act is an important milestone — both because of the specific reform provisions and because this bill was the first concerted attempt by Congress and the Executive branch to identify and control the tax incentives and tax benefits accorded under the Internal Revenue Code. Special interest groups were called upon to justify their special tax preferences — many of which have slumbered unnoticed in the tax laws for years. As a result, even though all the incentives were not reduced,¹¹⁰ others only mildly affected,¹¹¹ while still others were increased or added,¹¹² Congress and the American people were finally forced to come to grips with the difficult economic and social problems underlying many of these preferences.

109. See, e.g., testimony of Leon Keyserling, SENATE HEARINGS, *supra* note 28, at 3977-4028.

110. The most obvious exception to the general reform was the retention of the tax-exempt status of interest paid on State and local bonds. INT. REV. CODE of 1954, § 103(a)(1). Although, as passed by the House, the Reform Act would have required an allocation of personal deductions among taxable and non-taxable income, and would have afforded local governments the option to issue federally-subsidized taxable bonds. See H.R. 13270, 91st Cong., 1st Sess. 1 (1969), and HOUSE REP., *supra* note 27, at 80-83, 172-74. Other notable exceptions from reform in the final bill include intangible drilling expenses and the non-recognition of long-term capital gains on charitable donations.

111. Examples include farm losses (INT. REV. CODE of 1954, § 1251), and the preferential treatment of capital gains (*Id.* at § 1201).

112. The three most important new tax preferences are the amortization of pollution control facilities (*Id.* at § 169); the amortization of railroad rolling stock and right-of-way improvements (*Id.* at § 184); and the amortization of rehabilitation expenditures for low-income rental housing (*Id.* at § 167(k)).