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An Evaluation of Real Estate as a Tax Shelter

Larry J. Zine

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Bachelor of Science, in Business Administration

University of North Dakota 1977

An Independent Study

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CHAPTER I

INTRODUCTION

In today's society, where people are constantly looking for ways to decrease their income tax liability, thoughts may turn to tax shelters. Unfortunately, many people do not actually understand what a tax shelter is or how it operates. "One commonly held view-which happens to be quite wrong-is that a tax shelter is any device that reduces the income tax bill which a man would otherwise pay. Under this definition, a cut in salary would qualify as a tax shelter."[1]

A tax shelter is employed to shield income from taxation. In its most perfect form it combines current tax loss with a positive cash flow.[2] Investment in real estate is commonly used as a tax shelter. In recent years, the traditional tax incentives to invest in real estate have come under attack from the Internal Revenue Service,

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[1]Michael F. Klein, "What are the Current Considerations in Evaluating Real Estate as a Tax Shelter?", Taxation for Accountants, 8 (December 1972):338.

[2]Cynthia D. Dailey and Dennis J. Gaffney, "Anatomy of a Real Estate Tax Shelter: The Tax Reform Scalpel", TAXES-The Tax Magazine, February 1977, p. 127.

the courts and "tax reformers" in the Congress and the White House.[3] These attacks on real estate investment have limited the deductions available to a taxpayer and in some cases eliminated the deductions available.

In light of these attacks on real estate it continues to be one of the most popular tax shelters. The purpose of this paper is to examine some of the changes in the tax law brought about by the Tax Reform Act of 1976 and to evaluate the benefits and problems of investing in real estate in light of the recent changes in the tax law. The prime emphasis of this paper is the individual investor-taxpayer in real estate. No attempt will be made to discuss any other type of investor.

This paper will be presented in three sections. The first section will discuss some of the many changes brought about by the Tax Reform Act of 1976 which directly or indirectly, as the case may be, affect the investment in real estate. The second section will examine the benefits and problems of holding real estate in light of the changes in the tax law. The third section will examine the benefits and problems in the disposition of real estate.

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[3]Martin J. Rabinowitz, "Real Estate and the Federal Income Tax: The Status of the Law Today", <u>32nd Annual N.Y.U. Institute on Federal Taxation</u> (1974):1593.

CHAPTER II

CHANGES IN THE TAX LAWS

Real estate has always been, and will probably continue to be, one of the most popular tax shelters. Both the investment return and the tax benefits are usually predictable within acceptable limits, and real estate investment in successful projects has proven an effective inflation hedge over the years.[4]

The Tax Reform Act of 1976 has numerous provisions which affect the real estate industry. Many of the changes continue the trend toward tighter restrictions and limitations upon real estate investments, particularly those that are shelter orientated. The new provisions will, in all probability, make passive real estate investments less attractive to the high tax bracket taxpayer. Although real estate investments have probably come through the most unscathed from the Congressional deliberations which produced the Act,[5] there are still many changes which will affect real estate investment. This chapter will discuss

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[4]Benjamin Benson, "A New Look at Tax Shelters after the Tax Reform Act of 1976," <u>Land H Perspective</u>, Spring/Summer 1977, p. 11.

[5]Gerald W. Padwe, "Tax Shelters after the Tax Reform Act of 1976," <u>The Tax Advisor</u>, November 1976, p. 644.

some of the major changes which have an effect on real estate taxation.

The Internal Revenue Service Tax Shelter Training Manual, issued in early 1976, instructed agents that the principal elements of a tax shelter, regardless of type, are: (1) deferral, (2) leverage and (3) conversion.[6] Each of these elements will be discussed in turn with the changes that will have an effect on them.

Deferral of Tax

The deferral element of the tax shelter refers to the postponement of taxation by the acceleration and bunching of deductions in the early years of a project before income is earned from the project.[7] The deductions in excess of income from the project are available to the investor to reduce his tax on income from other sources. This results in an interest-free loan from the government. The tax rules giving rise to deferral were those permitting cash basis taxpayers to deduct interest and taxes during the construction period, to deduct prepaid interest, and to elect accelerated depreciation. Congress adopted several new rules which directly limit the deductions on which the deferral element was based.

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[6] Allan G. Donn, "Real Estate Tax Shelters After the Tax Reform Act of 1976," The Virginia Accountant, March 1977, p. 26.

[7] Ibid.

Capitalization and Amortization of Real Property Construction Period Interest and Taxes

In the past, real estate investors have enjoyed the benefit of immediately expensing construction-period interest and property taxes when paid or incurred on improved property. The Tax Reform Act will end this practice. Under the Act, new Code Section 189 provides that in the case of a taxpayer other than a corporation which is not a Subchapter S corporation or personal holding company, real property construction period interest and taxes must be capitalized rather than currently deducted. The capitalized amounts are not added to the basis of improvements to which they relate, but instead are deducted over an amortization period, which bears no relation to the useful life of the improvement or to the period of the loan.[8] This will be illustrated in Table I.

A couple of definitions are in order here. The internal Revenue Code Section 189(e)(1) defines construction period interest and taxes as interest paid or accrued on indebtedness incurred or continued to acquire, construct, or carry real property and real property taxes to the extent such interest and taxes are attributable to the construction period for such property and would be allowable as a deduction for the taxable year in which it was accrued or paid.[9] The construction period for this code section means the period

[8]Internal Revenue Code, Section 189.

[9]Ibid. (e)(1).

beginning on the date on which construction of the building or other improvements begins, until the date on which the item of property is ready to be placed in service or is ready to be held for sale.[10] Taxpayers will be permitted expense currently only a portion of these costs, with the balance to be capitalized and amortized over a ten-year period subject to certain phase in amounts set forth in Table 1.

The capitalization rules apply immediately to non-residential (i.e. commercial property), apply for tax years beginning in 1978 to residential property, and apply for tax years beginning in 1982 to low-income housing. As the phase-in period progresses, the annual fraction of interest and taxes subject to immediate deduction decreases.

An example comes from an Arthur Andersen and Company publication[11] on the Tax Reform Act of 1976:

> Assume a taxpayer invests in residential real property in 1978. He can immediately deduct 25% of the construction-period interest and property taxes paid or accured in 1978 on such residential property. The balance, 75%, must be deferred until the building is "ready to be placed in service or is ready to be held for sale." At that time, the taxpayer may deduct one-third of the capitalized costs paid or accrued in 1978 in each of the next three years.

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[10]Ibid.

[11]Arthur Andersen and Company, Tax Reform Act of 1976, Summary of Changes and Impact on Selected Businesses (Arthur Andersen and Company, September 1976), p. 83.

Table 1

Phase-in Schedule for Capitalization Rule

If the amount of construction period interest and taxes is paid or accrued in a taxable year beginning in			
Nonresidential Real Property	Residential Real Property	Low-Income Housing	The percentage of such amount allowable for deduction in each amortization year* is the following percent of such amount.
1976	-	-	Special rule permits deductions of 50 percent in 1976 and amortization of remaining 50 percent over three years.
-	1978	1982	25%
1977	1979	1983	20
1978	1980	1984	16-2/3
1979	1981	1985	14-2/7
1980	1982	1986	12-1/3
1981	1983	1987	11-1/8
after 1981	after 1983	after 1987	10

* Amortization years are the years in which the interest and taxes are paid or accrued, the year in which the property is ready to be placed in service or ready to be held for sale, and the succeeding years until amortization is complete.

SOURCE: Internal Revenue Code, Section 189.

Prepaid Interest

Under prior law it was sometimes possible for a cash-basis taxpayer to prepay up to one year's interest on a loan and deduct the amount in the year when paid. The 1976 Tax Reform Act now requires cash-basis taxpayers to allocate prepaid interest over the period to which the interest relates. This has the effect of taxing them in the same manner as accrual basis taxpayers.[12] The Internal Revenue Code Section 446(a) states that as a general rule taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.[13] This leaves the impression that if a taxpayer has accounted for his previous transactions, though they may not be regular, in the same manner this would be allowed for income tax purposes. However, Code Section 446(b) goes on to say, if no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income.[14]

New Code Section 461(g) has the effect of placing all cash basis taxpayers, including individuals, corporations,

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[12]Mike Miles, "Impact of the 1976 Tax Reform Act: A Real Property Tax Planner's Review," <u>The Appraisal Journal</u> (October 1977):495.

[13]Internal Revenue Code, Section 446(a).

[14]Ibid. Section 446(b).

estates and trusts, on the accrual basis as to interest. They are required to capitalize amounts paid as prepaid interest. These capitalized amounts may be deducted over the period of the loan to the extent the interest represents the cost of using borrowed funds during each taxable year.[15]

Limitations on Deduction of Investment Interest

The deductibility of interest paid by individuals on indebtedness to carry investments has now changed twice in the last ten years. Prior to the 1969 Tax Reform Act, this interest could be deducted without limit. In 1969 the deduction was limited to $25,000 plus net investment income, including long-term capital gains plus one-half the remainder, each year.

The 1976 Act makes the limitations on deductibility of investment interest more stringent. The deductions will now be limited to $10,000 per year plus the taxpayer's net investment income not including long-term capital gains.[16] Any disallowed interest deductions can be carried over indefinitely and deducted in future years to the extent of the limitations applicable in the year of excess interest. An example of the effect of this is taken from an article in the Appraisal Journal by Mike Miles:[17]

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[15]Ibid. Section 446(g).

[16]Padwe, "Tax Shelters," p. 646.

[17]Miles, "Impact of the Tax Reform Act," p. 490.

An apartment complex is purchased for $800,000. Equity is $200,000 and $600,000 is financed at 8%. The total interest charged in the first year is $48,000 (8% of $600,000). The net operating income from the complex during the first year of operations is $20,000. The deduction for interest is limited to $30,000 ($10,000 plus net investment income of $20,000). The disallowed $18,000 may be carried forward and deducted in future years, subject to application of new limitation rules. The investor now is losing the time value of money on the disallowed interest that was immediately deductible before the 1976 Tax Reform Act.

Leverage

Leverage involves the use of non-recourse debt, which for tax purposes permits an owner to take deductions in an amount greater than that which he has "at risk" in the venture.[18] The major thrust of the Tax Reform Act of 1976 in the tax shelters area involves leverage. The activities covered by the Act include only the following: (1) holding, producing or distributing motion picture films or video tapes; (2) farming (except tree farming other than fruit or nut trees); (3) equipment leasing; and (4) oil and gas exploration.[19] These provisions in the new law restrict the availability of deductions for property financed by non-recourse loans. The taxpayer's deductions for investment property are limited to the amount that is "at risk" in the investment. This includes both actual cash investment and the amount of debt on which the taxpayer has personal

[18]Donn, "Real Estate Tax Shelters," p. 26.

[19]Internal Revenue Code, Section 465.

liability.

Although these provisions do not apply to real estate, the effects on real estate may be best summarized, again by Mike Miles.[20] He states:

> The future economic effect of the new "at risk" provisions on real estate are obvious. Because these rules do not apply to real estate under either the specific or partnership basis restrictions, real estate becomes the only investment where nonrecourse financing may be used to accomplish the old-style tax-shelter objectives. Thus, capital that is invested in oil and gas, leasing, motion picture, and other tax-sheltered investments to which the new rules apply will have an incentive to flow into real estate.

Conversion

Conversion refers to the conversion of ordinary income into capital gain through the use of ordinary income tax deductions during the time the property is owned, followed by capital gain treatment on the disposition of the property. This is usually accomplished by use of the depreciation deduction that reduces the tax basis of the property. To the extent that the basis for the property is reduced, a future gain from its sale will be increased. The future gain often is capital gain. Thus, at the present time, the taxpayer is encouraged to maximize the depreciation deduction at the cost of having an increased capital gain that receives preferential tax treatment.[21]

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[20]Miles, "Impact of the Tax Reform Act," p. 490.

[21]Ibid. p. 488.

By using the combination of depreciation and capital gains tax rates, both deferral and the switching of brackets are achieved. Although the switching of brackets benefit is limited, it is not eliminated by depreciation recapture provisions. Generally, recapture rules require that depreciation-induced gains be recaptured at ordinary rates. However, real property receives a special exception which provides that only the excess of accelerated depreciation over straight-line depreciation must be recaptured at ordinary rates. As a result, deferral is achieved on total depreciation taken in excess of the true reduction in market value, and a switching of brackets is achieved up to the amount of straight line depreciation.[22]

The Tax Reform Act of 1976 has made changes in these two areas of capital gains and depreciation recapture. Each one will be discussed.

Capital Gains

In the area of capital gains two important changes have come about as a result of the Tax Reform act. First, the Act changes the holding period for long-term capital assets. Under prior law, a capital asset had to be held for more than six months to obtain a long-term gain or loss treatment when it was sold or exchanged. The Act extended the holding period to nine months for 1977, and to one year for

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[22] Ibid. p. 489

taxable years beginning after 1977.[23]

Secondly, the Tax Reform Act of 1976 changes the deduction for capital losses. Under prior law, an individual could use a net capital loss to offset up to $1000 of ordinary income. The Act increases this offset amount for taxable years beginning after 1976. It went to $2000 for the tax year beginning in 1977, and is set at a $3000 maximum for taxable years beginning after 1977.[24] Since capital losses must be offset against ordinary income on a two for one basis, the maximum usage of capital losses to offset ordinary income will rise to $6,000 annually for the tax years after 1977.

Neither the change in the holding period of a capital asset or the capital deduction should have much of an impact on real estate investments. Typically, real property interests do not turn over in less than a year because of the economic considerations as well as the substantial costs often incurred in a sale or exchange.

Depreciation Recapture

The 1976 Act does not make wading through the real estate depreciation recapture rules any simpler, but it does attempt to tighten them up and to do away with some of the

[23] Internal Revenue Code, Section 1223.

[24] Ibid.

distinctions between nonresidential and residential property.[25] Under prior law, gain on the sale or exchange of nonresidential real property would be converted from capital gains to ordinary income to the extent of accelerated depreciation taken on the property in excess of what the depreciation would have been if the straight line depreciation method had been used. For residential property, prior law permitted the amount of the excess depreciation taken over the straight line amount to be reduced one percent for each month the property was held over 100 months. If the property was held over 200 months, (16 2/3 years) there would be no recapture at all.

Under the Tax Reform Act of 1976, investors in residential real property will be required to recapture all depreciation taken after 1975 in excess of straight line depreciation to the extent of any gain on the sale.[26] This eliminates the distinction between residential and nonresidential property.

For low-income housing, the depreciation recapture rules were also tightened. Any accelerated depreciation in excess of straight line depreciation taken after 1975 will be subject to limited recapture.[27]

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[25]Padwe, "Tax Shelters," p. 648.

[26]Internal Revenue Code, Section 1250(a).

[27]Ibid. Section 1250(d)(8).

The following example provides some insight into how depreciation recapture normally works:[28]

> An investor purchased a new apartment house several years ago for $1,000,000. Depreciation deductions taken on the 200% declining balance method amount to $200,000. Straight line depreciation using the same useful life would have been $140,000. The investor sells the property for $1,200,000. The amount of gain and the depreciation recapture are calculated as shown below.

Sales price		$1,200,000
Adjusted basis		
Cost	$1,000,000	
Depreciation taken	200,000	800,000
Gain		$ 400,000

Accelerated Depreciation taken	$ 200,000
Straight line depreciation	140,000
Excess depreciation	$ 60,000
Ordinary Income (depreciation recaptured)	60,000
Long-term capital gain	340,000
Total Gain	$ 400,000

Even though the entire amount of excess depreciation taken must be recaptured as ordinary income, the taxpayer has still achieved the benefits of deferral on the entire depreciation amount and receives capital gain treatment on the amount of straight line depreciation taken.

There are other changes in the tax laws which will effect many investors in real estate. They also deserve mention.

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[28]Miles, "Impact of the Tax Reform Act," pp. 493-494.

Other Changes

The Tax Reform Act of 1976 contains several provisions creating incentives for the restoration or renovation of certain types of residential housing. These incentives may create attractive tax-planning opportunities.

Low-Income Rental Housing

There are special rules which will permit the rapid depreciation of expenditures to rehabilitate low-income rental housing. The Internal Revenue Code Section 167(k) provides that the taxpayer may elect to compute the depreciation deduction attributable to rehabilitation expenditures incurred with respect to low-income rental housing after July 24, 1969 and before January 1, 1982 under the straight line method using a useful life of 60 months and no salvage value. There are two limitations to this however. First, the aggregate amount of rehabilitation expenditures paid or incurred by the taxpayer with respect to any dwelling unit cannot exceed $20,000 per unit. Second, rehabilitation expenditures paid or incurred by the taxpayer in any taxable year shall be taken into account only if over a period of two consecutive years, including the taxable year, the aggregate amount of such expenditures exceeds $3,000.[29]

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[29] Internal Revenue Code, Section 167(k)

Certified Historical Structures

Under prior law, the availability of accelerated depreciation methods was restricted for used real estate. The new law relaxes these restrictions as an incentive for the restoration of historic structures. Under the new rules, a taxpayer may elect to treat the "substantially rehabilitated historic property" for depreciation purposes as if he were the original owner. Nonresidential real estate can use the 150% declining balance method and residential real property can use the 200% declining balance method. The accelerated depreciation applies not only to the rehabilitation expenditures, but also to the cost of the structure itself. These depreciation rules apply to expenditures made from June 14, 1976, until July 1, 1981.[30]

Minimum Tax

The Tax Reform Act of 1976 makes significant changes in the minimum tax on tax preference items. This is extremely important in real estate investment analysis because the excess of accelerated depreciation over straight line depreciation on real property and the untaxed one-half of long-term capital gains are tax preference items.[31] The new law strengthens the minimum tax considerably. The new minimum tax rate will be increased from 10 percent to 15 percent.

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[30]Ibid. Section 167(o).

[31]Ibid. Section 57.

3. Although the tax recapture rules on accelerated depreciation will commence in 1976, taxpayers can still convert straight line depreciation into future capital gain benefits.

This chapter has summarized many of the changes in the tax law, brought about by the Tax Reform Act of 1976. It is in no way an exhaustive list of the changes brought about. This researcher has tried to present those changes in the law which will have the greatest impact on real estate investment. The next chapter will discuss some of the major benefits and problems which may confront investors in real estate.

CHAPTER III

THE BENEFITS AND PROBLEMS OF HOLDING REAL ESTATE

Tax shelter transactions are not an elimination of income tax, they are merely a deferral of the tax. One must always keep this in mind. Current deductions must, for the most part, be recaptured by the investor-taxpayer at some future date. This Chapter will follow the real estate tax shelter from the time of purchase up to the time of sale.

Leverage

Leverage is an important element of a tax shelter. The investor's tax basis in acquired property is normally his cost. However, the cost includes not only the investment of the taxpayer, but also any debt incurred to purchase or improve the property. The debt may include not only funds borrowed by the investor, but any debt the property is subject to at the time the property is acquired. In the Supreme Court case, Crane V. the Commissioner, the Supreme Court ruled that the basis of the property may include debt on which the investor has no personal liability.[34]

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[34]Crane V. the Commissioner, 331 U.S. 1(1947).

It is common practice for an investor in real estate to finance his investment by obtaining institutional mortgages. Often these mortgages furnish from 75 percent to 95 percent of the funds necessary to acquire and develop real estate. This means that the tax basis of the property is ordinarily several times greater than the initial cash investment of the investor. This financing is generally for a term of 25 to 30 years and, in the case of subsidized housing, can extend to 40 or even 50 years.[35] Since any borrowing is treated the same as the taxpayers own funds, the basis against which he can deduct tax shelter losses increases. The investor is able to deduct losses in excess of his cash investment. If enough leverage is used, the investment can be completely financed by the interest-free government loans, meaning the tax benefits generated from the increased basis of the investment offset the cash investment.[36]

The first few years of repayment of any mortgage received, for the most part, consists of deductible interest. During this period, the annual allowance for depreciation, which is calculated on the investor's basis in the property, may be quite large. The shelter is created because depreciation is a deduction which may be offset against the

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[35]Rabinowitz, "Real Estate and the Federal Income Tax," p. 1595.

[36]Lloyd E. Shefsky, "Tax Shelter Arrangements: What to Tell a Client in Light of New IRS Rulings," Taxation for Accountants 20 (January 1978):6

income generated by the property. The depreciation taken in excess of the reduction in the mortgage balance in effect shelters the income generated by the property from taxation. Further, to the extent that the annual depreciation deduction exceeds the annual taxable income from the property, a loss will be produced for tax purposes which may be used to offset or shelter the taxpayer's other income.[37]

An example of how the shelter would work is adapted from an article by Martin J. Rabinowitz.[38]

> Assume that a taxpayer can obtain 90 percent financing for a $10,000,000 project, of which $1,000,000 represents the cost of land and $9,000,000 represents the cost of the building. The project has a useful life, for tax purposes, of 25 years. If the loan carries a 9 percent interest rate with a 10 percent constant payment or $900,000 per year. The first year's mortgage repayment of $900,000 would consist of $810,000 of deductible interest and a $90,000 reduction in the mortgage principal balance. Further, assuming that the property generates $200,000 of income after deducting the $90,000 mortgage reduction, and that the taxpayer is using the straight line method of depreciation, the taxpayer will be considered to have received $290,000 of taxable income, against which he may deduct $360,000 of depreciation. For tax purposes, he has a net loss of $70,000 with respect to the property, which he may use as a deduction against his other income.

This goes to show that effective use of leveraged financing can be of real importance in investing in real estate. The additional dollars of non-recourse debt for each

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[37]Rabinowitz, "Real Estate and the Income Tax," p. 1596.

[38]Ibid.

dollar of cash invested, can result in greater tax benefits, and in some circumstances, even a first year positive cash flow.[39]

Using leveraged financing is not without problems. Problems may occur if the financing which is received plus any cash investment by the taxpayer causes the total purchase price of the assets being purchased to exceed their fair market value. In the case of the Estate of Franklin, the court held that, when the amount of the non-recourse debt exceeds the fair market value of the property, there is no investment in the property, and ownership deductions, such as depreciation, will be disallowed.[40] In this case, the taxpayer failed to demonstrate that the purchase price was at least approximately equivalent to the fair market value of the property. When the taxpayer can prove the purchase price is approximately equivalent to the fair market value there is no problem.

The court went on to say:

> No such meshing occurs when the purchase price exceeds a reasonable estimate of the fair market value. Payments on the principal of the purchase price yield no equity so long as the unpaid balance of the purchase price exceeds the then existing fair market value. Under these circumstances the purchaser by abandoning the transaction can lose no more than a mere chance to acquire an equity in the future should the value of the acquired property increase.[41]

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[39] Shefsky, "Tax Shelter Arrangements," p. 6.

[40] Charles T. Franklin, Estate V. Commissioner, 38 AFTR 2d 76-6164.

[41] Ibid.

> It is fundamental that depreciation is not predicated upon ownership of property but rather upon an investment in property. No such investment exists when payments of the purchase price in accordance with the design of the parties yield no equity to the purchaser. In the transaction before us and during the taxable years in question the purchase price payments by Franklin has not been shown to constitute an investment in the property. Depreciation was properly disallowed.

It should be kept in mind that this case is an extreme example of what may happen if one receives financing in excess of the fair market value of the property purchased. This is not a common occurrence.

This case did not decide the tax consequences of a transaction in a subsequent year if the fair market value of the property increases to an extent that permits the purchaser to acquire an equity. Presumably at that point in time the purchaser would be allowed to take the deductions.

Construction Period Interest and Taxes

Prior to the passage of the Tax Reform Act of 1976, real estate investors were allowed to immediately deduct interest and property taxes which they paid or incurred during the construction period. Because of leveraged financing just discussed, the amount of construction interest and taxes paid could be substantially in excess of the cash invested, creating tax losses in excess of the investment.

As the law reads now, construction period interest and taxes may no longer be expensed in total when incurred or paid, instead these costs must be capitalized and amortized according to a series of transition rules previously presented.[42]

The impact of this change in the law will widely affect real estate investors. Although, one is no longer able to deduct these amounts in their entirety in the year they are paid, they can still be used as a deduction in the following years.

Depreciation

Depreciation is probably the single most important aspect of any real estate tax sheltered investment. The use of investment real property as a tax shelter has been largely dependent upon the existence of the deduction from ordinary income permitted by depreciation of the taxpayer's investment in buildings. As a non-cash deduction, the deduction for depreciation permits an immediate cash savings in the form of reduced income taxes currently payable.[43]

The Internal Revenue Code Section 167(a) states that as a general rule there shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear, including a reasonable allowance for obsolescence, of property used either in a trade or business or property used in the production of income.[44] Code Section 167(j)

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[42]Stephen R. Blank, "Real Estate Tax Sheltered Investments Today," Trusts and Estates 116 (July 1977:467.

[43]Allan J.B. Aronsohn, "Real Estate: Tax Shelter for Personal Holding Companies and Individuals," 25th Annual N.Y.U. Institute on Federal Taxation (1967):747.

[44]Internal Revenue Code, Section 167(a).

provides that the following methods of depreciation may be used to determine what a reasonable allowance will be:

1) The straight line method
2) the declining balance
3) sum of the years-digits method
4) any other consistent method productive of an annual allowance which, when added to all allowances for the period commencing with the taxpayer's use of the property and including the taxable year, does not, during the first two-thirds of the useful life of the property, exceed the total of such allowances which would have been computed under the declining balance method using a rate not exceeding 150 percent of the straight line rate.[45]

There are other limitations which apply to the depreciation which may be allowed. The Tax Reform Act of 1969 brought about a dramatic change in the depreciation allowance for realty. Under prior law, depreciation on real property could be computed under the straight line method or under a method of accelerated depreciation. Generally in the case of newly constructed property, the taxpayer could use the sum of the years digits method or the declining balance method using 200 percent of the straight line rate; in the case of used property, the declining balance method of 150 percent of the straight line rate.

The following table may help to explain the changes brought about by the Tax Reform Act of 1969.

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[45]Ibid. Section 167(j).

TABLE 2

Type of Property	Maximum Depreciation
(1) New property constructed before July 25, 1969	prior law applies: sum-of-the-years-digits and 200 percent declining balance
(2) New property constructed after July 24, 1969:	
(a) residential rental property located within the U.S. or its possessions or in certain foreign countries	prior law applies: sum-of-the-years-digits and 200 percent declining balance
(b) all other property (office buildings, shopping centers, etc.)	150 percent declining balance
(3) Used property acquired after July 25, 1969	prior law applies: 150 percent declining balance
(4) Used property acquired after July 24, 1969:	
(a) residential rental property located anywhere, having a useful life of 20 years or more	125 percent declining
(b) all other property	straight line
(5) Rehabilitation expenditures made after July 24, 1969, and before January 1, 1982, for low-income rental housing	straight line over a 5-year

SOURCE: Martin J. Rabinowitz, "Real Estate and the Federal Income Tax: The Status of the Law Today," <u>32nd Annual N.Y.U. Institute on Federal Taxation</u> (1974):1603.

In order to qualify for the favorable treatment afforded to residential property, 80 percent or more of the gross rental use of presently.

To illustrate the effects of depreciation on real estate investment, consider the following example from Jules Silk and Harvey Shapiro:[47]

> Assume that A constructs a new residential building at a cost of $50,000 on land that cost him $10,000. He obtains a mortgage of $40,000, (interest 7 percent, 20-year term, yearly mortgage payments $3,721), the yearly rental income is $10,000 and yearly operating expenses are $4,000. The taxable income for the first five years would be as follows:
>
> | Year | 1 | 2 | 3 | 4 | 5 |
> |---|---|---|---|---|---|
> | Rent | $10,000 | $10,000 | $10,000 | $10,000 | $10,000 |
> | Less: Interest | 2,766 | 2,697 | 2,623 | 2,543 | 2,458 |
> | Depreciation* | 3,335 | 3,110 | 2,905 | 2,710 | 2,530 |
> | Operating Expenses | 4,000 | 4,000 | 4,000 | 4,000 | 4,000 |
> | Total Deductions | 10,101 | 9,807 | 9,528 | 9,253 | 8,988 |
> | Taxable Income | (101) | 193 | 472 | 747 | 1,012 |
>
> *Double Declining Balance, 30-Year Life.
>
> The cash flow would be as follows:
>
> | Year | 1 | 2 | 3 | 4 | 5 |
> |---|---|---|---|---|---|
> | Rent | $10,000 | $10,000 | $10,000 | $10,000 | $10,000 |
> | Mortgage Payment | 3,721 | 3,721 | 3,721 | 3,721 | 3,721 |
> | Operating Expenses | 4,000 | 4,000 | 4,000 | 4,000 | 4,000 |
> | Total Deductions | 7,721 | 7,721 | 7,721 | 7,721 | 7,721 |
> | Cash Flow | 2,279 | 2,279 | 2,279 | 2,279 | 2,279 |
>
> | | |
> |---|---|
> | Total Cash Flow | $11,395 |
> | Total Taxable Income | 2,323 |
> | Cash Flow Untaxed | $ 9,072 |

A couple of items should be kept in mind. First, the longer the property is held the less income the shelter will

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47 Harvey N. Shapiro and Jules Silk, Depreciation of Real Estate (Washington D.C. Tax Management Inc. 1972), p. A-1.

Description	Cost	Life	Annual Depreciation
Building	$ 600,000	40 years	$15,000
Wiring	60,000	15 years	4,000
Plumbing	45,000	15 years	3,000
Roofing	50,000	10 years	5,000
Heating	100,000	10 years	10,000
Paving	25,000	10 years	2,500
Ceiling	25,000	10 years	2,500
Air Conditioning	50,000	10 years	5,000
Elevators	45,000	15 years	3,000
	$1,000,000		$50,000

Composite or Weighted Average Rate= $50,000 divided by $1,000,000= 5 percent (straight line).

Composite Life= $1,000,000 divided by $50,000 = 20 years

Another alternative is the straight line method using component lives. Under this method the taxpayer allocates his purchase price to various elements of the building, such as the shell, plumbing, wiring, heating and air conditioning systems, and roof. The component method is advantageous because normally the useful life of the components is much shorter than the useful life of the building. This has the effect of accelerating the depreciation on the property while using the straight line method of depreciation.

It should be emphasized that to use either composite lives or component lives, the investor should secure an appraisal of the building and its components at the time of acquisition.

While discussing depreciation there are several other items which deserve to be mentioned. First of all, for purposes of the depreciation deduction, an allocation must be made between the land which may not be depreciated and buildings.[49] Arbitrary allocations should not be made, if the property has just been purchased, the contract may provide for a valuation of the land and building. If the contract does not provide this information, an independent appraisal may be made or collateral documents such as mortgage appraisals or real estate tax valuations may be used in determining the proper allocation.[50]

Property held solely for resale is not allowed any depreciation since the property will not be held for the production of income. However, one court held differently. In the case of Frank A. Newcombe, the Tax Court explained:

> that in order to conclude that property held for sale is held for the production of income, there must be (1) a holding for sale at a price which will result in a profit to the taxpayer and (2) the profit or part of it must be attributable to the period after which the purpose of the holding has been converted to a holding for appreciation.[51]

Later, the government was able to argue successfully to the Tax Court that such property has no ascertainable useful life, and that in all events, the salvage value is at least equal to the fair market value of the property on the date of conversion. For these reasons, no depreciation deduction is allowed.[52] This follows along with the Internal Revenue Code,

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[49] Internal Revenue Code. Regulations Section 1.167(a)-5.

[50] Shapiro and Silk, "Depreciation," p. A-8.

[51] Frank A. Newcombe, 54 T.C. 1298(1970).

[52] Richard N. Newbre, 54 T.C. 1298(1970).

which says that a reasonable allowance for wear and tear, exhaustion, and obsolescence. If the holding of property is intended not to result in an economic loss, but rather an economic gain, it is not clear what purpose depreciation is supposed to serve.[53]

Often times when a taxpayer uses part of his principal residence for a business purpose or rents part of it out to another, he will be entitled to a depreciation deduction up to the amount of income derived therefrom. It is important to remember that depreciation can only be taken on the leased portion or the portion used for business purposes. Any depreciation taken reduces the basis of the property.

Many times, a principle residence may be abandoned and offered for rent by the owner. Once this is done, the property is entitled to a depreciation deduction, even though the property is simultaneously offered for sale. However, it must be emphasized in this case, that there must be a genuine intent to rent the property and the taxpayer should take pains to make that intent clear.[54]

A property owner is not entitled to take a depreciation deduction until he obtains possession of the property and the burdens of ownership fall upon him. This normally occurs at the closing of the title when the deed is delivered, and not when the contract is signed. If the taxpayer is constructing

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[53]Shapiro and Silk, "Depreciation," p. A-10.

[54]Ibid., p. A-11.

property, depreciation is not allowed until the building is completed. Depreciation begins when the property is ready for use and not necessarily when it is placed in service.[55]

The next chapter will discuss some of the benefits and problems which may occur in the disposition of real estate. It will examine capital gains, depreciation recapture, and installment sales.

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[55]Ibid.

CHAPTER IV

THE BENEFITS AND PROBLEMS IN THE DISPOSITION OF REAL ESTATE

Capital Gains

The ultimate objective of an individual taxpayer in disposing of real estate is generally to secure capital gain treatment when the transaction produces a gain and ordinary loss treatment when it results in a loss. If real estate held by a taxpayer qualifies as a capital asset under Code Section 1221, gain realized on its sale will qualify as capital gain. A capital asset is generally property held by the taxpayer, whether or not connected with his trade or business, but does not include property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business and real property used in his trade or business.[56]

Although real estate used by a taxpayer in his trade or business will not constitute a capital asset in his hands, this property may qualify for the preferential treatment under Code Section 1231. This section provides that if real property is used in a trade or business and has been held

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[56]Internal Revenue Code, Section 1221.

for more than 12 months and is not held primarily for sale to customers, gain on its sale, along with any gain realized on the sale or exchange of other Section 1231 assets during the year must be netted against losses realized on Section 1231. If the gains exceed the losses, all Section 1231 transactions during the year will be deemed to have resulted in long-term capital gain or loss, as the case may be. If the losses exceed the gains, all such transactions will be deemed to have produced ordinary gain or loss.[57]

If the real estate used in the trade or business has not been held for more than 12 months at the time of the sale, the gain realized will be ordinary income since the property will not qualify as a Section 1231 asset or as a capital asset.

The bulk of the litigation relating to the sale of business real estate at a gain involves the question whether the property was held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.[58] This property is neither a capital asset or a Section 1231 asset. The gain on its sale is treated as ordinary income. The question arises as to whether the taxpayer is a dealer or an investor in real estate. Or is the taxpayer engaged in the business of selling real estate.

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[57]Ibid., Section 1231.

[58]Jerome B. Libin, "Transactions Entered Into for Profit, Regular Trade or Business, and/or Investment: Some Distinctions and Differences," <u>27th Annual N.Y.U. Institute on Federal Taxation</u> (1969): 1211.

In general terms, it is probably very easy to identify a dealer actively developing and promoting his inventory of properties in the normal course of his real estate business, in contrast to a passive investor expending little effort or expense to sell real estate held over a long period of time. Unfortunately, this distinction is not often the case in reality.

The statutory language in the Internal Revenue Code does not define either "dealer" or "investor". It also does not provide any assistance in determining how to classify a particular sale. The decisions have been left to the courts. With slight variations in expression and classification, to a large extent the courts have standarized the following nine factors in distinguishing dealers from investors:[59]

(1) the nature and purposes of the initial acquisition of the property;

(2) the purpose for which the property was subsequently held;

(3) the duration of its ownership;

(4) the extent of subdividing and construction of improvements;

(5) the frequency, continuity, and substantiality of sales;

(6) the extent of advertising, listing with brokers, and other promotional activities;

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[59]See Maddux Construction Company, 54 T.C. 1278 (1970); William B. Howell, 57 T.C. 546 (1972); Gault V. Commissioner, 332 F. 2nd 94 (2nd Cir. 1964).

(7) the time and effort devoted by the taxpayer to the sale of his property;

(8) the nature and extent of the regular business of the taxpayer;

(9) the purpose for which property was held at the time of the sale.

A thorough analysis of all the decisions in this area is beyond the scope of this paper. However, it should be briefly mentioned, since making a sale frequently requires engaging in activities which are characteristic of a dealer in real estate.

Single Parcel

Usually, no serious problem is presented if an investor purchases a single piece of property when his purpose is to hold the property appreciation in value and later sell the property to realize a gain. However, if the investor ultimately decides to sell portions of the property, his chances of receiving the favorable capital gain treatment will become more remote if he engages in substantial promotional and development activity. This may give him the appearance of a dealer in real estate.[60]

Rental or Sale

Many times property may be acquired and held with a dual purpose. The property may be held for either sale or rental. In determining if capital gain treatment is deserved, the courts look to the principal purpose for which the property

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[60] George W. Mitchell, 47 T.C. 120(1966).

is held during the time of ownership. If the principal purpose is to rent the property, it qualifies for capital gain treatment. If the principal purpose is to sell the property, it will receive ordinary income treatment.[61]

Real Property Subdivided for Sale

Internal Revenue Code Section 1237 was enacted to enable certain taxpayers to sell real estate held for investment purposes to obtain capital gain treatment even though they may have subdivided the property for sale and engaged in promotional activity. This section applies if the following conditions are met:[62]

(1) the taxpayer had not previously held this property primarily for sale to customers in the ordinary course of trade or business and in the same taxable year in which the sale occurs, no other real property is held primarily for sale to customers in the year of sale;

(2) the taxpayer may not make substantial improvements which substantially enhance the value of the property sold;

(3) the taxpayer must hold the property for a period of 5 years unless it is acquired by inheritance.

If the taxpayer qualifies for this section and fewer than six lots are sold from the same tract in the first year of sale, capital gain treatment will be received. In the year in which the sixth lot is sold, the gain will be deemed to be from the sale of property held primarily for sale to

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[61] Malat V. Riddell, 383 U.S. 569(1966).

[62] Internal Revenue Code, Section 1237.

customers in the ordinary course of trade or business to the extent of five percent of the selling price.

It is important to emphasize that a casual investor in real estate, in order to take advantage of the lower capital gain rates, should try to plan his real estate investment decisions to avoid the dealer status.

Once it is determined that an individual deserves capital gain treatment, they are allowed a deduction of 60 percent of the net capital gain, paying tax at ordinary rates on the remaining 40 percent of the gain.

Any discussion on the disposition of real estate would be incomplete without discussing the impact of depreciation recapture.

Depreciation Recapture

When property is sold or exchanged at a gain, the gain may initially qualify for capital gain treatment under Section 1231. However, the depreciation recapture provisions may reclassify part or all of the gain as ordinary income.[63] The Tax Reform Act of 1976 places all residential rental property, except for qualified housing projects and rehabilitation expenditures, on the same level as non-residential property. As a result any excess depreciation, the amount of accelerated depreciation taken over straight line depreciation, must be recaptured in full as ordinary income. This means that for

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[63]Dailey and Gaffey, "Tax Reform Scalpel" p. 130.

certain real property the amount of depreciation recapture may have to be calculated under three different sets of rules: post-1975 excess depreciation, post-1969 to pre-1976 excess depreciation, and pre-1970 excess depreciation.

A summary of the steps for the calculation of depreciation for residential rental property sold after 1975 comes from an article by Stefan F. Tucker as follows:[64]

(1) If such property has been held for 12 full months or less, all depreciation will be recaptured.
(2) If such property has been held during any period after 1975, all post-1975 excess depreciation will be recaptured in full.
(3) If such property was held during the period prior to 1976, but had been held for only 100 full months or less as of December 31, 1975, all excess depreciation is recaptured in full.
(4) If such property was held for more than 100 full months, and a portion of such holding period after the expiration of such 100 full months was during the period from January 1, 1970 through December 31, 1975, the recapture for such pre-1976 period will be 100% less 1% for each full month during such period that the property was held after the date the property was held 100 full months.
(5) If such property was held for more than 20 full months, but less than 120 months, and a portion of such holding period after the expiration of such 20 full months was during the period from January 1, 1964 through December 31, 1969, the recapture for such pre-1970 period will be 100% less 1% for each full month during such period that the property was held after the date the property was held 20 full months.

An example of how the recapture rules work is also taken from the same article by Stefan Tucker.[65]

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[64]Stefan F. Tucker, "Analyzing the Impact of the Tax Reform Act on Real Estate Investments," The Journal of Taxation 6 (December 1976): 348.

[65]Ibid.

> Assume that in January of 1969 the taxpayer completed construction of an apartment building for a total cost of $2,000,000 exclusive of land. Because the building qualified as residential rental property throughout its holding by the taxpayer, the taxpayer used the double declining balance of depreciation, with a useful life for the building of 40 years. If the building were to be sold in January of 1978, all excess depreciation (attributable to both the pre-1976 period and post-1975 period) would be recaptured, because the property will have been held for less than 100 full months as of December 31, 1975.

Thus, while accelerating depreciation in the early years of an investment in real estate may prove to be an effective hedge in deferring a current tax liability, a day of reckoning will come when the property is sold for a gain and the excess depreciation will be recaptured as ordinary income. Also an important point to remember is that if real property such as in the example above is sold in 1978, the post-1975 rules would apply first, then the pre-1976, post-1970 rules apply next, and finally the pre-1970 rules would apply.

Installment Sales

Just as important as deferring tax when property is held, is deferring the gain when property is sold. A seller of real estate at a gain who does not receive the entire proceeds in the year of sale has an alternative for reporting the gain on sale. The basic idea of the installment sale method is that the taxpayer reports a gain on a sale only prorata as payment of the purchase is received over a period ot time. The requirements of eligibility for the installment method are relatively easy to satisfy.

The gain from any sale of real property involving deferred payments may be reported on the installment method whether or not the seller is a dealer in real estate. Even if no payments are received in the year of sale provided that the total of all payments received in the year of the sale does not exceed 30 percent of the selling price.[66] Selling price includes not only the payments actually received or to be received by the seller, but the amount of all mortgages and other liens to which the property is subject, or which are assumed by the buyer.[67]

In order to qualify for the installment sale method, it is necessary for there to be periodic payments. In Revenue Ruling 69-462 it was held that a taxpayer may not elect to report income from the sale of real property on the installment method where the total purchase price is payable in a lump sum in a taxable year subsequent to the year of sale.[68] It does appear however, if there are two payments along the way it will qualify.

The most important requirement for eligibility for installment sale method is that the payment in the year of sale not exceed 30 percent of the selling price. The taxpayer who wishes to report on the installment sales method should take as many precautions as possible to avoid going

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[67]Internal Revenue Code Regulations, Section 1.453-4(C).

[68]Revenue Ruling, 69-462.

over the 30 percent limitation as this will require the gain to be reported in the current taxable year.

In reporting a gain under the installment method, each payment received is divided into two parts, return of capital and income, in the same proportion that the gross profit expected on the entire transaction bears to the contract price. The gain is reported for the year in which the payment is received.[69] An illustration of how the installment sales method can be used comes from Prentice Hall Federal Taxes:[70]

> A, not a dealer in real estate, sells a building to B for $60,000 above a mortgage of $40,000. A's adjusted basis is $65,000. A pays a broker's commission of $5,000. A receives $20,000 in the year of sale.
>
> The contract price is $60,000. The gross profit is $30,000. The ratio of gross profit to contract price is 50%. A's installment income in the year of sale is $10,000, and 50% of each subsequent payment is income.

It must be remembered in an installment sale that the depreciation recapture cannot be overlooked. When a sale is made the recapture of depreciation occurs with the first dollars received, rather than prorata.[71]

The primary advantage of the installment sale method is that it defers the payment of the tax until cash is received, and provides a better cash flow to the seller. The

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[69]Internal Revenue Code Regulations, Section 1.453-1 (b)(1).

[70]Prentice Hall, P-H Federal Taxes (New Jersey: Prentice Hall, 1979) Section 20,453.

[71]Internal Revenue Code, Section 1250.

spreading of gain over a number of years may result in a reduced tax liability.

CHAPTER V

SUMMARY AND CONCLUSIONS

The tax benefit available from an investment in real estate have been significantly affected by the Tax Reform Act of 1976. However, taxpayers continue to invest in real estate and take advantage of the remaining benefits.

By using leveraged financing, the investor is given a much larger basis for the property than his cash outlay. This is an important factor, since it gives the property an increased depreciation base.

Construction period interest and taxes are no longer currently deductible. This will probably have some effect on new construction by individual investors. Previously, construction period interest and taxes could provide a substantial incentive for new property development, now however, only a portion of these costs can be deducted currently. The remainder will have to be capitalized and amortized over a ten-year period in the future.

The depreciation of the property will also be affected because of the Tax Reform Act of 1969. Although enacted 10 years ago, it is important because of the depreciation limits it places on real property, especially if one is not the "first user" of the property. Depreciation provides the biggest incentive for investing in real estate since it can create the greatest deductions especially if an accelerated method can be utilized. Taxpayers have in some cases gone to a composite life or a component life method of depreciation. This will, in most cases, accelerate the depreciation on the property and provide increased deductions.

After property has been held for a period of time many of the previous deductions will not produce as great a shelter as in the early years of ownership, such as accelerated depreciation. In this situation, the investor may have a decision to make. If he wishes to keep the benefits of the shelter he should make additional purchases of property for shelter purposes. The income from the previous shelter can then be shielded from taxation because of the resulting increase in non-cash deductions. This will reduce the exposure of the income from the first tax shelter. This consideration is extremely important.

Another possible alternative is to sell the property. In the past few years, property values have been on the upswing and in most instances the property could be sold at a gain and for the most part receive capital gain treatment. There may, however, be some disadvantages.

The taxpayer should be very careful to avoid any classification of being a "dealer" in real estate. Any sale of real estate by a "dealer" will result in the gain being taxed as ordinary income. This may not be a problem for many investors in real estate, but unfortunately for many tax planners, the property is already sold before they make the distinguishment of being an "investor" or "dealer" in real estate. At this point in time it may be too late to correct the situation.

Another problem is that any "excess depreciation" taken on the real property must be recaptured as ordinary income, before any capital gains. The Tax Reform Act of 1976 required that all "excess depreciation" taken on residential rental property after 1975 be recaptured as ordinary income. This brought residential rental property into line with nonresidential rental property. The only exceptions to this are qualified low-income housing projects and rehabilitation expenditures.

A possible advantage of a sale of real estate is that it may qualify as an installment sale. This will defer the tax on the gain until payment is received. Many times when real estate is sold at a gain, the taxpayer has no cash on hand to pay the income taxes on the gain. By using the installment sales method any payment of tax will be deferred until payment is received.

There has been much legislation which has affected in recent years yet it still remains as one of the most popular tax shelters. Through proper tax planning the real estate tax shelter can live up to its purpose of deferring current tax liability and allowing the taxpayer to take advantage of having additonal money currently.

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