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THE IMPACT OF THE TAX REFORM ACT OF 1969 UPON INVESTMENT IN REAL ESTATE

BY

GROVER A. CLEVELAND

A Dissertation Submitted in Partial Fulfillment of the
Requirements for the Degree of Doctor of Business
Administration in the Graduate School of
Business of Indiana University

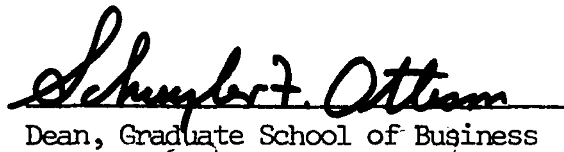
INDIANA UNIVERSITY
GRADUATE SCHOOL OF BUSINESS

1973

ACCEPTANCE

This dissertation has been accepted in partial fulfillment of the requirements for the Degree of Doctor of Business Administration in the Graduate School of Business of Indiana University.

Date 7-19-73



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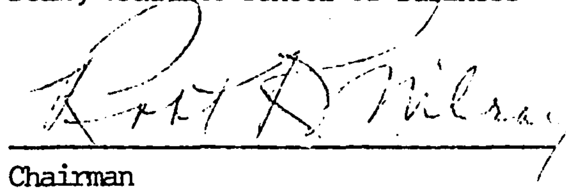

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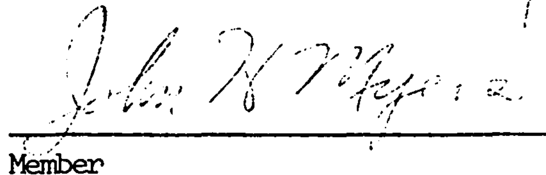

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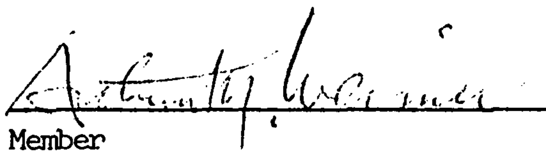

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PREFACE

The preparation of this dissertation would not have been possible without the cooperation of over forty real estate investors. I appreciate the willingness of these men to take time out of a busy schedule to participate in the interviews. The personal interviews were a major source of information used in writing the dissertation.

My dissertation committee deserves much of the credit for this study. The chairman, Professor Robert R. Milroy, was instrumental in the initial formulation of the study and has been a constant source of encouragement and assistance. Professor Arthur M. Weimer provided valuable assistance in the formulation of the study and in obtaining interviews. Professor John H. Myers provided valuable suggestions and criticisms of the manuscript.

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I also wish to express my thanks to the ladies who have typed the many drafts - Eileen Clark, Sandy Frye, and Martha Michelmann.

Finally, I acknowledge an everlasting debt to my parents.

Chicago, Illinois
March, 1973

Grover A. Cleveland

TABLE OF CONTENTS

	Page
PREFACE	iv
LIST OF TABLES	ix
ABSTRACT	xiii

Chapter

		Page
I	INTRODUCTION TO THE PROBLEM	1
	Background of the Problem	1
	Douglas Commission	1
	Kaiser Commission	3
	Housing and Urban Development Act	3
	Treasury Study	6
	Congressional Hearings	7
	Proponents of Real Estate Investment Incentives	7
	Opponents of Real Estate Investment Incentives	9
	Tax Reform Act of 1969	10
	Depreciation Policy	10
	Depreciation Recapture	12
	Rehabilitation Expenditures	13
	Tax Free Sales of Federally Assisted Housing	14
	Statement of the Problem	15
	Method of Research	16
	Selection of Investors	17
	Contacts with Initially Selected Firms	18
	Preparation for the Interviews	19
	Limitations of the Study	20
	Organization of the Dissertation	21
II	THE DEVELOPMENT OF THE APPLICATION OF FEDERAL INCOME TAXES TO INVESTMENTS IN REAL ESTATE PRIOR TO THE TAX REFORM ACT OF 1969	22
	Gain from the Sale of Real Estate	23
	Revenue Acts Prior to 1938	23
	Revenue Bill of 1938	25
	Revenue Act of 1939	27
	Revenue Act of 1942	28

Chapter | Page

Revenue Act of 1964 31
Illustration of conditions prior to 1964 33
Congressional reaction in 1964 40
Statutory terminology 42
Section 1250 Property 42
Depreciable realty 43
Dispositons which did not trigger recapture . . 45
Disposition by gift 45
Transfers at death 45
Non-recognition exchanges 46
Dispositions involving involuntary conversion 50
Liquidation of a controlled subsidiary . . . 51
Transfers to a controlled corporation 52
Exchanges in connection with reorganizations 52
Transfers to a partnership 53
Disposition of principal residence 54

Method of Depreciation 54
Internal Revenue Code of 1954 55

Treasury Study 58

III EXPLANATION OF THE PROVISIONS OF THE TAX REFORM ACT OF 1969 AFFECTING REAL ESTATE INVESTMENT 62

"Typical" Real Estate Investment 63

Depreciation Policy and Depreciation Recapture 68
Changes in Depreciation Policy 68
Residential Rental Property 69
Pre-July 25, 1969 Exceptions 70
Changes in Depreciation Recapture 71
Effects of Changes 74
New Commercial and Industrial Property 74
New Residential Rental Property 79
Used Commercial and Industrial Property 82
Used Residential Rental Property 88
Effects of Changes - Different Assumptions 90
New Commercial and Industrial Property 90
New Low-Income Housing 98
Used Real Property 110

Rehabilitation Expenditures 110

Tax Free Sales of Federally Assisted Housing 114

IV PRESENTATION OF RESEARCH FINDINGS 118

Discussion of Two Problems 120

Depreciation Policy and Depreciation Recapture 125
New Real Property 126
Used Real Property 134

Chapter Page

Provisions Affecting Low-Income Housing 137
Rehabilitation Expenditures 137
Tax Free Sales of Federally Assisted Housing . . . 140
Other Comments Concerning Low-Income Housing . . . 142

Comments on Tax Policy 145

V CONCLUSIONS AND RECOMMENDATIONS 153

Introduction 153

Conclusions 154
Depreciation Policy and Recapture of Depreciation 154
Provisions Affecting Low-Income Housing 156
Tax Policy 157

Recommendations 158

Future Research 160

Appendix

A ARE REAL ESTATE INVESTMENT INCENTIVES ADEQUATE? 162

B REVENUE ACT OF 1964: GAIN FROM DISPOSITIONS OF CERTAIN DEPRECIABLE REALTY 174

C TAX REFORM ACT OF 1969: PROVISIONS AFFECTING REAL ESTATE INVESTMENT 187

BIBLIOGRAPHY 210

LIST OF TABLES

Table		Page
I	Total Housing Starts and Assisted Rehabilitation . . .	5
II	Annual Cash Flows and Taxable Incomes of "Typical" Real Estate Investment.	35
III	Cash Benefits from "Typical" Real Estate Investment to Taxpayers with Three Different Marginal Tax Rates	37
IV	Pre-Revenue Act of 1964: Proof of Internal Rate of Return of 7.1% for New Section 1250 Property Sold at the End of Eight Years	39
V	Annual Cash Flows and Taxable Incomes of "Typical" Real Estate Investment.	66
VI	Cash Benefits from "Typical" Real Estate Investment to Taxpayers with Three Different Marginal Tax Rates	67
VII	Pre-Tax Reform Act of 1969: Internal Rate of Return for New Section 1250 Property If Sold at the End of the Indicated Holding Period by Taxpayers with Three Different Marginal Tax Rates	75
VIII	Post-Tax Reform Act of 1969: Internal Rate of Return for New Commercial and Industrial Property If Sold at the End of the Indicated Holding Period by Taxpayers with Three Different Marginal Tax Rates	76
IX	Internal Rate of Return Under Pre '69 Act for New Section 1250 Property and Post '69 Act for New Commercial and Industrial Property If Sold at the End of the Indicated Holding Period by Taxpayers with Three Different Marginal Tax Rates . .	77
X	Post-Tax Reform Act of 1969: Internal Rate of Return for New Residential Rental Property If Sold at the End of the Indicated Holding Period by Taxpayers with Three Different Marginal Tax Rates . .	80

Table		Page
XI	Pre- and Post-Tax Reform Act of 1969: Internal Rate of Return for New Residential Rental Property If Sold at the End of the Indicated Holding Period by Taxpayers with Three Different Marginal Tax Rates	81
XII	Pre-Tax Reform Act of 1969: Internal Rate of Return for Used Section 1250 Property If Sold at the End of the Indicated Holding Period by Taxpayers with Three Different Marginal Tax Rates	83
XIII	Post-Tax Reform Act of 1969: Internal Rate of Return for Used Section 1250 Property (excluding Used Residential Rental Property) If Sold at the End of the Indicated Holding Period by Taxpayers with Three Different Marginal Tax Rates.	84
XIV	Pre- and Post-Tax Reform Act of 1969: Internal Rate of Return for Used Section 1250 Property (excluding Used Residential Rental Property) If Sold at the End of the Indicated Holding Period by Taxpayers with Three Different Marginal Tax Rates . .	85
XV	Post-Tax Reform Act of 1969: Internal Rate of Return for Used Residential Rental Property (With a Depreciable Life Greater than Twenty Years) If Sold at the End of the Indicated Holding Period by Taxpayers with Three Different Marginal Tax Rates	87
XVI	Pre- and Post-Tax Reform Act of 1969: Internal Rate of Return for Used Residential Rental Property (With a Depreciable Life Greater than Twenty Years) If Sold at the End of the Indicated Holding Period by Taxpayers with Three Different Marginal Tax Rates	88
XVII	Pre '69 Act: Internal Rate of Return for New Section 1250 Property Sold at the End of the Year Indicated by Taxpayers with Three Different Marginal Tax Rates	91
XVIII	Pre '69 Act: Selected Internal Rates of Return for Comparing Effects of Different Mortgage Terms Upon New Section 1250 Property	92
XIX	Pre '69 Act: Internal Rate of Return for New Section 1250 Property Sold at the End of the Year Indicated by Taxpayers with Three Different Marginal Tax Rates	95

Table		Page

Table		Page
XX	Post '69 Act: Internal Rate of Return for New Commercial and Industrial Property Sold at the End of the Year Indicated by Taxpayers with Three Different Marginal Tax Rates	96
XXI	Pre- and Post-Tax Reform Act of 1969: Internal Rate of Return for New Commercial and Industrial Property If Sold at the End of the Indicated Holding Period by Taxpayers with Three Different Marginal Tax Rates	97
XXII	Post '69 Act: Internal Rate of Return for New Low-Income Housing Sold at the End of the Year Indicated by Taxpayers with Three Different Marginal Tax Rates (Assumes 9% Mortgage and other facts of modified "typical" real estate investment) . . .	100
XXIII	Post '69 Act: Internal Rate of Return for New Low-Income Housing Sold at the End of the Year Indicated by Taxpayers with Three Different Marginal Tax Rates (Assumes 7% Mortgage and other facts of modified "typical" real estate investment)	101
XXIV	Post '69 Act: Selected Internal Rates of Return for Comparing Effects of Different Interest Rates Upon Investment in Low-Income Housing	102
XXV	Post '69 Act: Internal Rate of Return for New Low-Income Housing Sold at the End of the Year Indicated by Taxpayers with Three Different Marginal Tax Rates (Assumes 40% operating ratio and other facts of modified "typical" real estate investment)	105
XXVI	Post '69 Act: Internal Rate of Return for New Low-Income Housing Sold at the End of the Year Indicated by Taxpayers with Three Different Marginal Tax Rates (Assumes 35 year depreciable life and other facts of modified "typical" real estate investment).	106
XXVII	Post '69 Act: Internal Rate of Return for New Low-Income Housing Sold at the End of the Year Indicated by Taxpayers with Three Different Marginal Tax Rates (Assumes 40% operating ratio, a 35 year depreciable life, and other facts of modified "typical" real estate investment)	107
XXVIII	Selected Internal Rates of Return for Comparing Effects of Lower Operating Ratios and Shorter Depreciable Lives Upon Investment in Low-Income Housing	108

Table		Page
XXIX	The Responses of the Interviewees as to the Effect of the Changes in Depreciation upon Various Types of Real Estate Investment	127
XXX	The Responses of Specific Types of Interviewees as to the Effect of the Changes in Depreciation upon Various Types of Real Estate Investment	128
XXXI	The Responses of the Interviewees as to the Effect of the Changes in Depreciation Recapture upon Various Types of Real Estate Investment	129
XXXII	The Responses of Specific Types of Interviewees as to the Effect of the Changes in Depreciation Recapture upon Various Types of Real Estate Investment	130
XXXIII	Responses of Different Types of Interviewees as to the Effect of the Changes in Depreciation and Depreciation Recapture Upon Investment in Used Real Property	135
XXXIV	Responses of Different Types of Interviewees as to the Effect of the New Provision for Rehabilitation Expenditures	136
XXXV	Responses of Different Types of Interviewees as to the Effect of the New Provision for Tax Free Sales of Federally Assisted Housing	140

ABSTRACT

The Tax Reform Act of 1969 made several changes in the Internal Revenue Code including modifications of existing provisions and the addition of several new provisions. Four of the provisions had a direct effect upon investment in real estate. Of these provisions, two were modifications of existing provisions affecting (1) depreciation policy and (2) depreciation recapture. One of the new provisions affecting real estate investment permitted the amortization of qualified rehabilitation expenditures over a sixty month period; another permitted the tax free sale of, and reinvestment in, federally assisted low- and moderate-income housing.

It is the purpose of this study to determine the effects the aforementioned provisions of the Tax Reform Act of 1969 affecting investment in real estate have had with respect to investors' thinking and actions. In addition, the study has been interested in closely examining the impact of the four provisions upon investment in low-income housing. Finally, the problem of determining the most feasible device to be used by the Federal government in stimulating desired real estate investment has been investigated.

The data were gathered by using the survey approach and the personal interview technique. Business and investment executives who actually formulated investment policy for their companies were interviewed. In addition, selected individual investors and tax experts in real estate investment were contacted.

The effects of the changes in depreciation policy and recapture of depreciation upon different types of real estate investment were examined. Three categories - commercial and industrial property, conventional apartments, and low-income apartments - were identified and used. The interviewees' responses were broken down by type of interviewee as to the effect of the changes upon investment in the three categories of real estate.

As a kind of check upon the validity of the interviewees' responses, several facts were assumed as comprising a typical real estate investment. The intention was to compare the effect upon the internal rate of return caused by the changes in depreciation policy and depreciation recapture. The examples compared the rates of return obtainable prior to the Act with those obtainable after the Act for forty different holding periods. Comparisons were made of the effect of the changes upon the rate of return obtainable from both new and used real property.

Conclusions were made based upon the responses of the interviewees and the examples. Several recommendations for possible future interaction between federal income taxes and real estate investment were made. Finally, three areas of possible future research were suggested.

CHAPTER I

INTRODUCTION TO THE PROBLEM

Background of the Problem

In 1949 the Congress established a national objective, expressed as the "realization as soon as feasible of the goal of a decent home and suitable living environment for every American family."[1] Since then the Congress has tried to create incentives for residential construction. It has enacted legislation guaranteeing mortgages; it has provided for rental subsidies, for government housing for low- and moderate-income families, and for the rehabilitation of existing structures. In 1968 the Congress reaffirmed this goal. At the same time it was forced to admit that the accomplishments thus far attained had "fallen far short of today's needs."[2] This lack of success in attaining the national housing goal was highlighted in reports by two recent Presidential Commissions.

Douglas Commission

The National Commission on Urban Problems, chaired by former Senator Paul Douglas of Illinois, (hereinafter referred to as the

---

[1] Housing Act of 1949, U.S. Code Annotated, Title 42, Sec. 1441 (1969).

[2] U.S. Congress, House, Housing and Urban Development Act of 196[illegible] [illegible]ouse Report No. 1585 to Accompany H.R. 17989, 90th Congress, 2nd [illegible]sion, 1968, p. 1.

Douglas Commission) made extensive studies on all urban problems including housing. The commission summarized its beliefs thus:

> "(1) That special tax preferences should not be relied upon as the sole or even the primary instrument to deal with urban housing problems;
>
> (2) That some changes in federal income tax laws and regulations should be made as soon as possible; and
>
> (3) That there should be vigorous official exploration of certain other potentially significant changes that might improve tax climate for urban housing."[3]

As part of its conclusions it made specific recommendations concerning tax policy as it relates to housing. The three recommendations were:

(1) The Treasury Department should make analyses and submit findings and recommendations as how best to change the tax law to provide materially more favorable treatment for investment in new residential construction (including major rehabilitation) than in other forms of real estate investment; in other words, how to prefer investment in residential construction over other types;

(2) ". . . prompt revision of the Federal income tax laws to provide increased incentives for investment in low- and moderate-income housing, relative to other real estate investment, where such housing is governmentally subsidized and involves a legal limit upon the allowable return on investors' equity capital."[4]

(3) That ". . . the Internal Revenue Code be amended to provide specific incentives for adequate maintenance and rehabilitation of rental residential property by allowing, within appropriate limits, for especially

---

[3]U.S. Congress, House, Building the American City--Report of the National Commission on Urban Problems to the Congress and to the President of the United States, House Document 91-34, 91st Congress, 1st session, 1968, p. 399.

[4]*Ibid.*, p. 406.

> generous tax treatment of investor-owners' expenditures for these purposes with respect to structures of more than some specified age, . . ."[5]

Kaiser Commission

The President's Commission on Urban Housing, chaired by Edward F. Kaiser, (hereinafter referred to as the Kaiser Commission) submitted its final report on December 11, 1968.[6] From June of 1967 until December of 1968 it had submitted interim reports and recommendations. A portion of its recommendations were incorporated in the Housing and Urban Development Act of 1968. The recommendations of this commission relied heavily upon the use of tax incentives to stimulate construction of low-income and moderate-income housing. The Kaiser Commission concluded that, while many existing tax rules do act as incentives for investment in this type of construction, that some of the rules arbitrarily discourage such investment.

Housing and Urban Development Act

The Housing and Urban Development Act of 1968 was considered "one of the most comprehensive and forward-looking bills in the field of housing and urban development ever proposed."[7] In it, Congress reaffirmed the national housing goal established by the Housing Act of 1949. The Congress determined that the national housing goal could be "substantially achieved within the next decade by the construction or

---

[5]Ibid., p. 406.

[6]The President's Committee on Urban Housing, The Report of the President's Committee on Urban Housing: A Decent Home, Washington, D.C., Government Printing Office, 1969.

[7]House, Housing Act of 1968, Report No. 1585, p. 2.

rehabilitation of twenty-six million housing units, six million of these for low and moderate income families."[8] "In addition, the bill continues the emphasis of recent years of increased reliance on private sponsorship under our housing programs and participation by private enterprises in the financing and production of housing."[9] One year later, however, Jerrard Gross, Chairman of the Legislative Committee of the National Apartment Association, pointed out in prepared testimony before the House Ways and Means Committee that only 1,500,000 housing units were constructed in 1968 and it was estimated that not more than 1,700,000 units would be constructed in 1969.[10]

One section of the act provided that the President submit to Congress an annual report on the nation's progress in attaining the housing goal. In the first report submitted in January, 1969, President Johnson cited figures which stated that 1,491,000 conventional units and subsidized rehabilitations were constructed in the fiscal year 1968. In addition, production targets were given for the ten year period 1969-1978.[11] These are given in Table I under the

---

[8]U.S. Congress, House, Housing and Urban Development Act of 1968, Conference Report No. 1785 to Accompany S. 3497, 90th Congress, 2nd session, 1968, p. 137.

[9]House, Housing Act of 1968, Report No. 1585, p. 2.

[10]U.S. Congress, House, Committee on Ways and Means, Tax Reform, 1969, Hearings, before the Committee on Ways and Means House of Representatives, on the Subject of Tax Reform, 91st Congress, 1st session, 1969.

[11]U.S. Congress, House, First Annual Report on National Housing Goals, Message from The President of the United States, House Document 91-63, 91st Congress, 1st session, 1969, pp. 8, 9.

the column heading "Johnson Administration Forecast."

TABLE I

Total housing starts and assisted rehabilitations (000's omitted)

Fiscal Year	Johnson Administration Forecast (1/69)	Nixon Administration Forecast (4/70)
1969	1,675	2,001*
1970	2,000	1,850
1971	2,225	2,040
1972	2,375	2,330
1973	2,575	2,650
1974	2,650	2,930
1975	2,950	3,085
1976	3,200	3,060
1977	3,250	3,060
1978	3,300	2,994
Total	26,200	26,000

*Actual

In the second annual report, submitted in April, 1970, President Nixon reported that 1,638,000 conventional units and subsidized rehabilitations were begun in fiscal year 1969. For fiscal year 1970, housing production was estimated to decrease to 1.4 million conventional units and subsidized rehabilitations.[12] Thus, if production is as forecast for fiscal year 1970, production will be more than 25% below the Johnson Administration Forecast.

The Nixon Administration made a change in the method of counting production. It included mobile home shipments as part of the

---

[12] U.S. Congress, House, Second Annual Report on National Housing Goals, Message from The President of the United States, House Document 91-292, 91st Congress, 2nd session, 1970, pp. 5, 12.

conventional unit production. Thus, for fiscal year 1969 it added 363,000 mobile home shipments to 1,638,000 conventional units and subsidized rehabilitations begun to arrive at the reported actual production figure of 2,001,000 units. For fiscal year 1970, 450,000 estimated mobile home shipments were added to the 1.4 million estimated conventional units and subsidized rehabilitations to arrive at the 1,850,000 units forecast. After making this change, the Nixon Administration re-estimated housing production for the period 1969-1978. This forecast is given in Table I under the column heading "Nixon Administration Forecast." These figures include actual production for fiscal year 1969 and estimated production for the remaining years.

Treasury Study

On February 5, 1969, the Treasury Department published its Tax Reform Studies and Proposals.[13] This study was a proposal for overall federal tax reform. It was not designed to deal primarily with the housing problem. A major thrust of the study was toward the elimination of what were considered "tax loop-holes" with minimal regard to the ramifications the suggested reforms might have upon real estate investment and upon national social problems, such as the lack of adequate low-income housing. The Study did note that the Treasury considered it impossible to make reliable quantitative estimates of the effect of tax provisions on construction and on the supply of housing. No attempt was made to determine the effect of the then

---

[13]U.S. Congress, House, Tax Reform Studies and Proposals, U.S. Treasury Department, Joint Publication, Committee on Ways and Means of the U.S. House of Representatives and Committee on Finance of the U.S. Senate, 91st Congress, 1st session, Washington, D.C., Government Printing Office, 1969.

current tax provisions upon the housing supply. While the Treasury Study appeared to take an attitude of indifference toward the housing problem, being primarily concerned with tax reform, the Douglas and Kaiser Commissions, and Congress in the Housing and Urban Development Act of 1968, had been primarily interested in this social problem.

Not only did the Treasury Study fail to endorse the positive effects of existing tax provisions on real estate investment, it emphasized the preferential nature of the tax treatment. It pointed out examples of taxpayers who offset income from other sources by tax losses from real estate investments. These investments or "real estate tax shelters" derived their preferential treatment from more than one provision. The Treasury cited the use of accelerated depreciation, thin equity financing, and limited recapture of prior over-depreciation as the major reasons why the ownership of real estate generates tax losses. These losses existed even though there was an economic profit from the investment. Thus, the import of the examples was that the provisions affecting real estate were being abused by certain taxpayers to avoid taxation or to greatly reduce their taxes.

Congressional Hearings

Proponents of Real Estate Investment Incentives

A number of representatives of real estate associations appeared before the Ways and Means Committee to protest the inference given by the Treasury Study. Mr. Wallace R. Woodbury, Chairman of the National Association of Real Estate Boards Sub-committee on Federal Taxation began his testimony by stating:

> A cutback in accelerated methods of depreciation, with its resulting sharp reduction in yield to equity investors, would substantially reduce the sources of risk capital in the construction industry.[14]

Mr. Louis R. Barba, First Vice President of the National Association of Home Builders, stated that:

> Withdrawal of depreciation benefits presently extended to income-producing real estate would constitute a disastrous blow to that attempt [to attain the national housing goal].
>
> This is so for the simple fundamental reason that the yield--considered over the years--from the operation of residential income properties is so low and uncertain and subject to such high risks that, absent favorable depreciation treatment, there is simply little incentive for a builder to invest in the equity of a rental property his skill and experience, a year or more of his time, and possible large sums of limited capital. Compared to other available investments, even under the most favorable circumstances, residential real estate is just not attractive to a builder or a real estate investor if the return is solely from the net rental proceeds of the property after payment of taxes, operating expenses and mortgage interest and amortization.
>
> We say categorically that should accelerated depreciation for real estate be eliminated, the construction of income-producing real estate--particularly multifamily housing--would drop to a fraction of its present level--to a negligible amount compared with the need for it during the next ten years.[15] (Emphasis supplied)

Jerrard M. Gross, Chairman of the Legislative Committee of the National Apartment Association asserted:

> Given the serious disadvantages which real estate has in raising capital as compared to other forms of capital investment, if these rules were changed adversely to real estate, it would be even more difficult to obtain capital, and fewer units would be built, which is going to cause higher rents, which is going to cause greater dislocation.[16]

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[14]House, Tax Reform, 1969, Hearings, p. 2656.

[15]Ibid., pp. 2702-2703.

[16]Ibid., p. 2751.

In addition, it was argued that to give incentives for low- and moderate-income housing but not for other types of structures would not succeed. Robert H. Pease, Vice-President of the Mortgage Bankers Association of America, testified before the Ways and Means Committee that:

> I hope you would not fall into the trap of giving accelerated depreciation to low-income housing or moderate-income housing alone. This I think would be the death knell of American cities. We cannot afford a policy which forecloses out all but low-income new construction in our American cities. All types are necessary.[17]

Opponents of Real Estate Investment Incentives

Just as there were those in favor of retaining the investment incentives, a number of individuals opposed it. Their opposition centered around the concept of "equity." The main argument against these incentives was expressed by Arnold Fisher, formerly of the Treasury, as:

> The principal tax inequity of the depreciation shelter is the manner in which it enables persons in the higher income brackets to use real estate as an artificial means of converting their ordinary income into capital gains.[18]

A similar argument was given by George Meany, President American Federation of Labor and Congress of Industrial Organizations, in his written statement. He stated:

> A host of special tax-forgiveness provisions apply to real estate. Taken by themselves, these privileges are hardly justifiable but when manipulated and combined,

---

[17] Ibid., p. 2753.

[18] Ibid., pp. 2784-85.

> they result in unconscionable tax-avoidance opportunities for wealthy real-estate operators, investors, and speculators.[19]

Dan Throop Smith, Professor of Finance, Harvard Business School and Stanford Business School, expressed a slightly different concern when he stated:

> It is unquestionably true that the effect of this differential treatment [Section 1245 recapture versus Section 1250 recapture] has encouraged investment in real estate but the economic results are of questionable social value and in any case hardly seem to justify the inequities available to one group of investors.[20]

Tax Reform Act of 1969

Depreciation Policy

As a result of the two Presidential Commissions, the Treasury Study, and a greal deal of publicity given to a "taxpayers' revolt"[21] Congress was somewhat forced to reduce the incentives which were in the tax provisions. One of the incentives reduced by the House Ways and Means Committee was the maximum depreciation allowable to a new structure. Previously, owners were entitled to use the 200% declining balance method of depreciation or the sum-of-the-years digits method on all types of new buildings. This was changed so that the maximum depreciation allowable on new commercial and industrial buildings was the 150% declining balance method. The 200% declining balance method

---

[19] *Ibid.*, p. 4344.

[20] *Ibid.*, p. 2773.

[21] U.S. Congress, Joint Economic Committee, *The 1969 Economic Report of the President, Hearings*, before the Joint Economic Committee, Congress of the United States, 91st Congress, 1st session, 1969, pp. 5-6.

remained in effect for conventional and low-income housing.[22] The Senate agreed with the change. It concluded that there was no justification for such an incentive to be given to commercial and industrial buildings.

In the Presidential Commission reports and the Treasury Study the problem of turnover of used residential rental property was highlighted. This type of property was entitled to be depreciated by the 150% declining balance method. Using this method of depreciation, properties were bought, held until the property started to show a taxable profit, and then sold at a gain subject to the capital gains tax. In an attempt to reduce the frequency of this occurrence, the House voted to limit all used property to straight-line depreciation.[23] The Senate Finance Committee assented, noting that the reason for the provision was to "eliminate the repeated sale and resale of property for the purpose of tax minimization."[24] However, as the result of a Senate floor amendment, the Senate bill differed.[25] The Conference Committee compromised. The final bill permitted 125% declining balance depreciation for used housing with a useful life of twenty years or more. All other

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[22]U.S. Congress, House, Tax Reform Act of 1969, House Report No. 91-413 to Accompany H.R. 13270, 91st Congress, 1st session, 1969, p. 166.

[23]Ibid., p. 166.

[24]U.S. Congress, Senate, Tax Reform Act of 1969, Senate Report No. 91-552 to Accompany H.R. 13270, 91st Congress, 1st session, 1969, p. 213.

[25]Congressional Record, 91st Congress, 1st session, Vol. 115, Part 28, pp. 37568-69, 38269-277.

used property could only be depreciated under the straight-line method.[26]

Depreciation Recapture

The concept of recapture of prior "over-depreciation" generated some heated controversy. The Congress had enacted in 1964 a limited recapture provision applying to depreciable real property. The amount to be recaptured was a percentage of the excess of accelerated depreciation over straight-line depreciation. The recapture percentage phased out at one percentage point per month after the property had been held for twenty months. Hence, there was no recapture of excess depreciation after ten years.

The House Ways and Means Committee tightened the rules significantly. It decided to recapture all the depreciation in excess of straight line.[27] There would be no phasing out of recapture. The Senate Finance Committee decided to retain some incentive for investment in housing. The phase-out of recapture of excess depreciation was to begin after ten years.[28] Thus, there would be no recapture after eighteen years and four months. Pursuant to a floor amendment, the final Senate bill was changed so that recapture began to be phased out after five years for housing. In addition, the amendment provided for phasing out of recapture on non-housing investments after ten

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[26]U.S. Congress, Conference Report, Tax Reform Act of 1969, House Report No. 91-782 to Accompany H.R. 13270, 91st Congress, 1st session, 1969, p. 177.

[27]House, Tax Reform Act of 1969, p. 167.

[28]Senate, Tax Reform Act of 1969, p. 214.

years.[29] The Conference Committee agreed to follow the House's idea on recapture for non-housing structures, i.e., no phasing out of recapture. A compromise was reached whereby the phasing out of recapture for conventional housing structures began after one hundred months. Hence, for conventional housing structures there would be no recapture of excess depreciation after two hundred months or sixteen years and eight months. For low-income housing, the recapture provision was left unchanged, i.e., phasing out of recapture begins after twenty months. Thus, there are now three recapture rules in effect for structures.[30]

Rehabilitation Expenditures

One of the recommendations of the Douglas Commission was for the adoption of federal income tax incentives for rehabilitation expenditures. With almost no opposition, the House of Representatives inserted in the reform act a provision to permit amortization of qualified rehabilitation expenditures over a sixty-month period. In its report to the House, the Ways and Means Committee stated that it recognized "the importance of encouraging rehabilitation of buildings for low-cost rental housing."[31] The Senate Finance Committee made only one addition to the provision. The expenditures must be made prior to January 1, 1975 to qualify for the rapid amortization. The Senate Finance Committee's reason for this addition was: "This will provide

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[29] Congressional Record, 91st Congress, 1st session, Vol. 115, Part 28, pp. 37568-69, 38269-277.

[30] Conference, Tax Reform Act of 1969, pp. 178-180.

[31] House, Tax Reform Act of 1969, p. 167.

time for the Congress to evaluate the effectiveness and the cost of this new incentive."[32]

Tax Free Sales of Federally Assisted Housing

One of the recommendations of the Kaiser Commission supported the passage of a provision to aid low-income tenant groups in purchasing the housing in which they were living. The sales price of low-and moderate-income housing constructed with insured loans under Section 236[33] and 221(d)(3)[34] is specified by statute. The amount received upon sale cannot exceed the original equity investment, plus the remaining mortgage, plus the capital gains and/or recapture taxes which arise as a result of the sale. The Kaiser Commission recognized the point that the taxes incurred from the sale increased the price paid by the tenant groups. This increased the amount of necessary debt and tended to reduce the occurrence of such sales.[35]

In an attempt to alleviate this problem, the Senate Finance Committee passed a provision permitting the tax-free sale of, and reinvestment in, federally assisted low-and moderate-income housing.[36] Under this provision, no federal income taxes are due upon the sale of such property (section 236 or 221(d)(3) projects) if the proceeds are

[32]Senate, Tax Reform Act of 1969, p. 214.

[33]U.S. Code Annotated, Title 12, Section 1715Z-1 (1969).

[34]U.S. Code Annotated, Title 12, Section 1715l(d)(3) (1969).

[35]Committee on Urban Housing, A Decent Home, p. 84.

[36]Senate, Tax Reform Act of 1969, pp. 291-292.

reinvested in similar property. The provision is modeled after Section 1033 of the Internal Revenue Code[37] which permits the postponent of a tax upon the reinvestment of funds after the involuntary conversion of an asset.

The provision, Section 1039,[38] was amended on the Senate floor to include low-income projects assisted by state and local governments.[39] The Conference Committee, however, rejected this amendment and passed the provision in its original form.[40] Hence, low-income tenant groups are now able to purchase the federally assisted housing in which they live at a lower price than was previously possible.

Statement of the Problem

Since the Internal Revenue Code of 1954 the Federal government has attempted to influence investment in real estate via tax devices. Originally, these devices were intended to have a positive effect upon investment. Since then, Congress has been changing the law to reduce the abuses which have occurred. The problem is how to write a law which will channel funds into the desired market sector. One of Congress' shortcomings is the lack of data as to what investors feel would be a desirable federal tax policy. These investors' ideas and comments cannot be overlooked in the formulation of policy toward real estate investment.

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[37] Internal Revenue Code of 1954, Section 1033.

[38] Ibid., Section 1039.

[39] Congressional Record, 91st Congress, 1st session, Vol. 115, Part 28, pp. 37485-86.

[40] Conference, Tax Reform Act of 1969, pp. 251-255.

The entrance of the Federal government into the real estate investment sector is a relatively new Federal venture. The success of the devices thus far used as incentives has depended upon the reaction of investors to these devices. In addition, there has been a wide divergence of opinion about their effectiveness. This study is an attempt to evaluate investors' reactions to the government's devices. Specifically, the study attempts to determine what effect the provisions of the Tax Reform Act of 1969, concerning accelerated depreciation, recapture of depreciation, rehabilitation expenditures, and tax free sales of federally assisted housing, have actually had with respect to investors' thinking and actions. In addition, the study is interested in taking a particularly close look at the impact the provisions have had on specific and concrete decisions about the investment in low-income housing. Finally, the problem of what is the correct device to be used by the Federal government in the real estate sector will be investigated.

The plan of attack for this study is to talk to business and investment executives who actually formulate investment policy for their companies and to talk to selected individual investors. In addition, tax experts in real estate investment will be contacted with regard to the investment decisions of their clients. The study will attempt to determine what they think and how they have reacted.

Method of Research

The survey approach and the personal interview techniques have been used in gathering data for this study.

The interview technique was determined to be the most

satisfactory means of obtaining the views and opinions of investors and executives. At the same time, assurances were made to these individuals that the information and opinions obtained from them would be kept confidential to the degree that specific identification of any firm or investor would not be made. Advantages of the interview technique include:

1. Many investors are reluctant to put in writing present policies and opinions not otherwise previously published.

2. The personal give and take of the face to face interview enables the interviewer to evaluate the sincerity of the opinion expressed.

3. An opportunity is provided for the clarification of the opinions which would not be available if the information were obtained by written questionnaires.

4. Investors are afforded an opportunity to evaluate the interviewer's purpose, maturity, and sincerity before entering into frank discussion of matters of importance.

Personal interviews provided immediate opportunities to follow up the initial response. This strengthened the investors' responses and permitted the interviewer to discern divergencies of views among investors.

Selection of Investors

A brochure (which is included as Appendix A), describing the subject of the study, together with a cover letter was sent to forty

investors. No attempt was made to select a scientific random sample of investors. Almost all of the individuals interviewed are business associates or personal friends of members of the dissertation committee. An attempt was made to interview many types of investors including developers of apartment buildings, industrial and commercial properties, and shopping centers. Executives of the investment department of large life insurance companies and mortgage bankers were also interviewed. In addition, interviews were conducted with United States Treasury officials, officers of other federal departments, several trade association officials, and numerous tax experts.

Contacts with Initially Selected Firms

Investors connected with forty firms were contacted and asked if they would assist in the research effort by providing their opinions and thoughts. Interviews were arranged and held with thirty-seven of these forty firms. The three firms not participating declined to do so because their executives felt that their opinions would not provide any additional information for the study.

As previously indicated, copies of the brochure with a covering letter were mailed to the selected investors. The covering letter attempted to inform the investor of the plans for, and the scope of, the study and requested an opportunity to meet with the investor or someone in his firm responsible for policy decisions in this area. The brochures and covering letter were sent to each investor at least three weeks prior to the interview date requested.

A listing of the different sectors of the real estate industry covered in the study, together with the number of investors visited within each sector follows:

Developer	7
Insurance Company	10
Certified Public Accountant	6
Federal Department or Agency	4
Mortgage Banker	2
Trade Association	2
Economist	2
Real Estate Investment Trust	1
Lawyer	1
Miscellaneous	2

The miscellaneous category includes investors that could not be classified. During the six weeks devoted to field work, forty-nine investors or officers were interviewed. The number of individuals in the thirty-seven firms visited ranged from a minimum of one to a maximum of four.

Preparation for the Interviews

The initial period of the research was devoted to a thorough study of the literature on the subject. Periodicals in the fields of accounting, real estate, and management; government documents; and newspapers were reviewed. It became evident during this period of preliminary study, that the subject of the impact of the Tax Reform Act of 1969 upon investment in real estate can be divided into three areas: (1) changes in depreciation method and recapture provisions, (2) the new provisions affecting low-income housing, and (3) attitude toward use of federal income taxes as a policy instrument.

At no time was a rigid interview pattern followed. It was deemed advisable to direct the general pattern of the discussion during the course of the interview rather than adhere to a preconceived pattern. At no time were notes taken during the interviews. The meetings ran in length from thirty minutes to three hours. On most days, two meetings were scheduled; one in the morning and one in the afternoon. As soon as possible after each interview, the author reviewed

the various investors' comments and dictated a statement of the expressed views. The dictated material was subsequently transcribed. These transcriptions form the basis for the analysis of the interviews contained in Chapter IV.

With very few exceptions, the investors were willing to provide in full scope the desired information. The few exceptions were due to lack of applicability, i.e., a builder of shopping centers would not be knowledgeable about the effects of the provisions for low-income housing.

Limitations of the Study

The purpose of the study is to provide the reactions of investors to the Tax Reform Act of 1969, and to determine what they consider would be the best devices to be used as incentives in the real estate sector. It is believed that a satisfactory solution cannot be obtained without evaluation of the response of influential persons in the investment field. To determine what is a satisfactory solution, albeit a desirable achievement, is not the purpose of this study. The determination of a satisfactory solution is the next step to be taken after reviewing the results of this study.

The conclusions which are drawn from the interviews are based solely upon the reactions and responses of the individuals interviewed. The investors selected represent an approximate cross-section of investors in real estate.

Organization of the Dissertation

The remainder of the dissertation is divided into four chapters. Chapter II contains a review of previous federal income tax legislation which has affected real estate investment. Especial attention is given to the Internal Revenue Code section which determines the treatment of a gain when it arises from the sale of depreciable real property.

An analysis and explanation of the provisions affecting real estate investment contained in the Tax Reform Act of 1969 is presented in Chapter III. Examples are given which show the effects caused by the new legislation.

Chapter IV presents the results of the interviews and an analysis of these results. Chapter V contains the conclusions which can be drawn from the study. In addition, recommendations for possible future action are presented.

CHAPTER II

THE DEVELOPMENT OF THE APPLICATION OF FEDERAL INCOME TAXES TO INVESTMENTS IN REAL ESTATE PRIOR TO THE TAX REFORM ACT OF 1969

In 1909, the Congress of the United States proposed an amendment to the Constitution. The original Constitution required that all direct taxes be apportioned among the states according to population.[1] The intent of the amendment was to permit the Congress to tax all income without the infeasible requirements of apportionment among the states according to population. On February 25, 1913, the required number of states had approved the amendment. This became the Sixteenth Amendment to the Constitution. It provided as follows:

> The Congress shall have the power to lay and collect taxes on incomes from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.[2]

In October 1913, the Congress enacted the first income tax law under the Sixteenth Amendment. It was to be applied retroactively to March 1, 1913. Since the enactment of this law, Congress has added new acts, provisions, and amendments in almost every session of Congress.

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[1]U.S., Constitution, Art. I, sec. 9.

[2]U.S., Constitution, Amendment XVI.

It is the purpose of this chapter to trace the development of the application of federal income taxes to investments in real estate. The first law enacted in 1913 will be the starting point. The chapter will conclude with an evaluation of the Treasury's Tax Reform Studies and Proposals issued in 1968.

Most of the changes relating to real estate have been made in the law in an attempt to solve two problems. The first of these is how to treat the gain or loss which arises upon the sale of land or buildings; the second is how to determine the proper amount of depreciation on the property which should be allowed as a deduction for tax purposes. It is the author's opinion that prior to the Tax Reform Act of 1969 Congress did not realize that the two problems were interrelated. Furthermore, it is believed that a satisfactory solution can only be attained by attempting to solve the two together. Since prior to the 1969 act the two problems were treated separately, the explanation of the attempted solutions will be given separately.

Gain from the Sale of Real Estate

Revenue Acts Prior to 1938

Under the Revenue Act of 1913, gains from the sale of real estate, either buildings or land, were taxed as ordinary income.[3] The Revenue Act of 1921 was the first to give special consideration to limiting the impact of tax rates on gain derived from disposition of so-called capital assets. The statute provided that:

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[3]Tariff of 1913, Statutes at Large, XXXVIII, section II (1915).

> The term "capital assets" as used in this section means property acquired and held by the taxpayer for profit or investment for more than two years (whether or not connected with his trade or business), but does not include property held for the personal use or consumption of the taxpayer or his family, or stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year.[4]

Except for a slight modification in 1934, this definition of capital assets remained in effect until 1938.

Also contained in the Revenue Act of 1921 was a provision which had a direct effect upon dispositions of real estate. It stated that all gain or loss arising from a sale or exchange of property would be recognized (that is, would be taxable) unless an exception applied. One of the exceptions covered the exchange of:

> . . . property held for productive use in trade or business or for investment (not including stock in trade or other property held primarily for sale, nor stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest) . . . for property of a like kind to be held either for productive use in trade or business or for investment or if common stock in a corporation is exchanged solely for common stock in the same corporation, or if preferred stock in a corporation is exchanged solely for preferred stock in the same corporation.[5]

As a result of this provision, it was, and still is, possible to exchange a piece of property held for investment purposes for another piece of property to be held for investment purposes and to have no gain or loss recognized. This type of exchange is referred to as a "like-kind exchange."

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[4] Revenue Act of 1921, Statutes at Large, XLII, section 214 (1923).

[5] Ibid., section 203.

Another exception provided:

> If property (as a result of its destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation, or the threat or imminence thereof) is compulsorily or involuntarily converted into property similar or related in service or use to the property so converted, or into money which is forthwith in good faith, under regulations prescribed by the Commissioner with the approval of the Secretary, expended in the acquisition of other property similar or related in service or use to the property so converted, or in the acquisition of control of a corporation owning such other property, or in the establishment of a replacement fund, no gain or loss shall be recognized. If any part of the money is not so expended, the gain, if any, shall be recognized, but in an amount not in excess of the money which is not so expended.[6]

This non-recognition provision was elective with the taxpayer, i.e., he could choose to have the gain not recognized or he could choose to have it recognized.

In addition, one section explained what occurred when money and/or other property of an unlike kind was included in an exchange which would have been a like-kind exchange were it not for the fact that money and/or other property were included. If a gain arose from such a transaction, the gain would be recognized in an amount not to exceed the sum of the money and the fair market value of the other unlike property. If a loss arose from such a transaction, no loss on the exchange would be recognized. When money and/or unlike property are included in a like-kind exchange, they are referred to as the "boot" included in the exchange.

Revenue Bill of 1938

In attempting to come to grips with problems which had arisen, the House Ways and Means Committee in 1938 enunciated a principle which

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[6] Ibid., section 203.

is still valid:

> It must be recognized that differences exist in the characteristics of ordinary income in comparison with the characteristics of income from capital gain. For example, no matter how high the rates, a taxpayer always benefits from an increase in salary. On the other hand, there is no tax on the appreciation in value of property unless such appreciation is realized through sale or exchange. Thus, it becomes optional with a taxpayer whether to pay a tax on capital gains, since he avoids the tax by refraining from making the sale. It is the opinion of the committee that too high taxes on capital gains prevent transactions and result in loss of revenue. On the other hand, the committee is also of the opinion that there is no justification for a lower tax on a speculator on the stock market than on an individual receiving a like income from salary or business.[7]

The committee attempted to revise the statute covering capital gains in order to improve the tax system without a lost of revenue. It hoped, that as a result of the changes, revenue from the tax on capital gains would increase. Of these changes, only one had a direct effect upon real estate. The definition of capital assets was modified so as to exclude from the definition property used in the trade or business which was subject to a depreciation allowance. The committee believed that, in the majority of cases, the modification would benefit the taxpayer because it would permit him to offset losses from the sale of such property against his ordinary income. The committee specifically pointed out that the modification did not apply to land used in the trade or business. The reason given for the separate treatment was that, as a general rule, land did not decrease in value from usage; whereas, buildings and their improvements normally do decrease in value

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[7] U.S. Congress, House, Committee on Ways and Means, The Revenue Bill of 1938, House Report No. 1860, 75th Congress, 3rd session, 1938, House Reports, p. 7.

with usage. In addition, the committee stated:

> It is not believed, however, that in most cases the allocation of basis and of purchase price between the land and the improvements will involve serious difficulties, because for the purposes of the allowance for depreciation under the revenue laws, the cost allocable to the depreciable improvements will already have been determined.[8]

The Senate concurred with the views of the House Ways and Means Committee. It expressed its agreement thus:

> There is an essential difference between income derived from salaries, wages, interest, and rents and income derived from capital gains. It is always to the advantage of the taxpayer to receive the first class of income, no matter what the rate of tax as long as it is less than 100%. On the other hand, the tax in respect of capital gains is optional--the taxpayer is not obliged to pay any tax unless he realizes a gain by the sale of the asset. There is not tax under existing law if a taxpayer transfers his money from one bank to another, but there may be a very heavy tax if he wishes to transfer his investment from a bond in one company to a bond in another company. Thus, an excessive tax on capital gains freezes transactions and prevents the free flow of capital into productive investments. The effect of the present system of taxing capital gains is to prevent any individual with substantial capital from investing in new enterprises. This is most unfortunate, because it adversely affects the employment situation.[9]

Revenue Act of 1939

In the Revenue Act of 1939 Congress made one small addition to the section covering like-kind exchanges. If, as part of the consideration to the taxpayer, the other party to the exchange assumed a liability of the taxpayer or acquired property subject to a liability,

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[8] Ibid., p. 35.

[9] U.S. Congress, Senate, Finance Committee, The Revenue Bill of 1938, Senate Report No. 1567 to Accompany H.R. 9682, 75th Congress, 3rd session, 1938, Senate Reports on Public Bills, Volume I, p. 6.

such assumption or acquisition (in the amount of the liability) would be considered as money received by the taxpayer upon the exchange. For example, assume a taxpayer exchanges an unimproved lot, subject to a mortgage, for another unimproved lot. Both are held for investment purposes and the transferree assumes the taxpayer's mortgage. The taxpayer would have to consider the assumption of the mortgage as "boot" received from the exchange. Assuming a gain was realized, the taxpayer would have to recognize as taxable income the lesser of the realized gain or the assumed mortgage. If a loss was realized, no loss would be recognized.

Revenue Act of 1942

With the advent of World War II, the Congress completely reassessed the revenue situation of the federal government. One of the areas affected by the reassessment was investment in real estate. Two changes were made which had a direct effect upon real estate investment. The House Ways and Means Committee proposed to change the definition of capital assets. It proposed to include buildings and similar real estate improvements in the definition. At the same time, land was to remain as a capital asset. The major reason given for the change was that the law, as enacted in 1938, caused considerable administrative difficulty. This difficulty arose from what the House had previously considered to be a simple matter, i.e., the allocation of cost and selling price between land and buildings.[10] Experience proved

[10]See page 27 for House statement.

that the assumption as to simplicity was invalid. The proposal was that the gain or loss resulting from the sale or exchange of land and/or building would be capital gain or loss.

The second change proposed by the Committee involved the treatment of the gain or loss resulting from the sale or exchange of depreciable property. Buildings and similar real estate improvements were specifically excluded from the provision, unless the gain or loss was the result of an involuntary conversion, since they were to be considered capital assets. Under then prevailing law, the gain or loss from the sale or exchange of depreciable property was treated as an ordinary gain or loss. The House Ways and Means Committee gave this explanation for the change:

> This rule was originally inserted as a relief provision to enable corporations to have the full benefit of a loss from the sale of machinery, instead of being limited by the capital loss provisions, which would permit it only a certain percentage of the loss. It was felt at that time that the taxpayer should not be denied the full loss because it sold the property at a loss instead of abandoning the property. While this rule provided relieve in case of [sic] a loss was realized, it appears that many taxpayers are able to dispose of their depreciable property at a gain over its depreciated cost. To treat such a gain as an ordinary gain will result in an undue hardship to the taxpayer.[11]

The solution proposed by the Ways and Means Committee was as follows:

> If the total gains in such cases exceed the losses, such gains shall be considered as gains from the sale or exchange of capital assets held for more than 15 months . . . If the gains do not exceed the losses in such cases, such

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[11]U.S. Congress, House, Committee on Ways and Means, Revenue Bill of 1942, House Report No. 2333 to Accompany H.R. 7378, 77th Congress, 2nd session, 1942, House Reports, Miscellaneous, p. 54.

> gains and losses will be treated as ordinary gains and ordinary losses instead of capital gains or capital losses. Where the losses exceed the gain the excess loss will be deductible from income as an ordinary loss.[12]

When the Senate Finance Committee considered the House bill, it made several changes and additions. The House bill defined short-term capital transactions as those involving assets held for fifteen months or less. The Finance Committee reduced the holding period to six months. The Committee believed that the lowering of the holding period would have the effect of encouraging the realization of capital gains and thereby result in increased revenue for the Treasury. It was believed that a holding period of six months would be sufficient deterant to the speculator as contrasted to the legitimate investor.

The Finance Committee deleted the House provision which would have included buildings and real property used in a trade or business in the definition of capital assets. Instead, it included them in the House provision covering depreciable property. Thus, the gain or loss resulting from the sale or exchange of depreciable property would be treated in the following manner. If the total of the gains exceeds the total of the losses, all such gains and losses are to be considered as resulting from the sale or exchange of capital assets held for more than six months. If the total of the losses exceeds the total of the gains, the losses and gains will be considered as ordinary losses and ordinary gains. The taxpayer would, therefore, receive the special capital gain treatment when he had a gain and would be able to deduct

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[12] _Ibid._, p. 54.

all of his losses, with no limitation, when a net loss was the result of a sale or exchange of depreciable property. In addition, the gain or loss from the sale or exchange of land used in a trade or business was included in the Senate Finance Committee proposal. The Committee believed ". . . that this Senate amendment will be of material benefit to businesses which, due to depressed conditions, have been compelled to dispose of their plant or equipment at a loss."[13]

When the bill went to the Conference Committee, the Senate version prevailed.[14] The provision for the treatment of the gain or loss resulting from the sale or exchange of land and depreciable property used in a trade or business is contained in Section 1231 of the Internal Revenue Code. Properties subject to the treatment provided by this section are generally referred to as "Section 1231 Assets."[15]

Revenue Act of 1964

Shortly after President Kennedy's death in November 1963, the House Ways and Means Committee began work on the tax reform bill which he had requested. One of the provisions of this reform bill affected the treatment of the gain, if any, which resulted from the disposition of depreciable real property. The changes were incorporated in a new

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[13]U.S. Congress, Senate, Finance Committee, Revenue Act of 1942, Senate Report No. 1631 to Accompany H.R. 7378, 77th Congress, 2nd session, 1942, Senate Reports, Miscellaneous, p. 50.

[14]House, Revenue Bill of 1942, pp. 45-46.

[15]Internal Revenue Code of 1954, U.S. Code, Volume XXVI, section 1231 (1967).

Internal Revenue Code section, section 1250.[16] The new section as then enacted, is reproduced in Appendix B.

In the House Report, several reasons were given for the changes. For example, while depreciation deductions were deductions against ordinary income, the gain from the disposition of real property was subject to the capital gains tax. Thus, it was possible to convert ordinary income into capital gains. This first reason was further magnified because most real estate purchases were financed by debt. The adjusted basis of the property for depreciation included the amount of the debt as well as the equity investment of the owner. In some instances the amount of depreciation deducted plus the deduction for the interest on the mortgage caused a tax loss to arise from operating the property. At the same time the operating income less cash operating expenses less the amount needed to service the mortgage resulted in a positive cash flow. This situation (tax loss and positive cash flow) permits what is commonly referred to as the tax-free amortization of a property's mortgage. A more detailed example of this situation is given on page 34.

In the Revenue Act of 1962 the Congress had passed a provision affecting the gain upon disposition of personal property. This provision is contained in Section 1245 of the Internal Revenue Code.[17] The 1964 House Report stated that in 1962 the Congress had been unable to agree upon a method by which to change the treatment of the gain

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[16]U.S. Congress, House, Committee on Ways and Means, Revenue Act of 196[illegible], House Report No. 749 to Accompany H.R. 8363, 88th Congress, 2nd session, 1963, p. 396.

[17]Internal Revenue Code of 1954, section 1245.

arising from the disposition of real property. The problem was how to treat the increase in values of real property which were caused by a rise in the general price level. The 1964 act attempted to give ordinary income treatment to that portion of the gain which resulted from excess depreciation deductions. The remaining portion of the gain, if any, Congress believed was caused by general price appreciation and, therefore, should be taxed as a capital gain.

Illustration of conditions prior to 1964: In order to understand this new section, it is necessary to appreciate certain tax aspects of real estate investment which existed prior to its adoption. It was possible, and to some extent still is possible, to frame a real estate investment so that three seemingly inconsistent tax advantages may be attained:

1. The investor will suffer a current tax loss from his real estate investment. This loss is fully deductible against his other income; that is, against such income as salary, interest, dividends, and the like.

2. Simultaneously, the investor will receive a tax free cash income from his real estate project, frequently referred to as a "cash throw-off."

3. If logical consistency were to be followed in the tax law, it would seem that if the losses referred to in point 1 above are subsequently recouped, they should be fully taxable since the losses were fully deductible. This may not be the case since the gain from the sale of a real estate investment held for more than six

months may be treated as a capital gain.

The three obviously appealing tax aspects of real estate investment enumerated above may be illustrated using certain assumed facts; these are:

1.	Owner's investment in apartment house or commercial building: $100,000 for the land and $100,000 toward cost of constructing the building	$ 200,000
2.	Cost of building	1,000,000
3.	Borrowed	900,000
4.	Depreciable life of building	40 years
5.	Term of mortgage	40 years
6.	Annual rental income	168,000
7.	Annual operating expenses	84,000
8.	Method of depreciation	200% declining balance
9.	Interest rate on mortgage	8%

Table II, page 35, shows the operating results of the project for forty years. Note that in the first seventeen years the investor suffers a tax loss. If it is assumed that the investor is, because of other income, in a tax bracket of 50 percent or higher, the minimum tax saving due to the loss will be 50 percent of the first year's taxable income, $18,942. The Table also shows the net cash flow after payment of operating expenses and the cash outlay necessary to service the mortgage. The investor will in each of the first seventeen years have a net tax free cash inflow of $8,906. Thus, after one year his total cash benefit to be derived from his $200,000 investment is:

Income tax saving	$18,942
Tax free cash inflow	8,906
	$27,848

TABLE II

Annual Cash Flows and Taxable Incomes
of "Typical" Real Estate Investment
(Assumes no sale of investment)

Length of Holding Period	Net Cash Flow	Taxable Income
1	$8906	$ -37,884
2	8906	-35,118
3	8906	-32,454
4	8906	-29,885
5	8906	-27,404
6	8906	-25,001
7	8906	-22,669
8	8906	-20,402
9	8906	-18,191
10	8906	-16,028
11	8906	-13,906
12	8906	-11,818
13	8906	- 9,756
14	8906	- 7,711
15	8906	- 5,677
16	8906	- 3,644
17	8906	- 1,605
18	8906	449
19	8906	2,528
20	8906	4,640
21	8906	6,795
22	8906	8,108
23	8906	9,529
24	8906	11,069
25	8906	12,736
26	8906	14,542
27	8906	16,497
28	8906	18,615
29	8906	20,908
30	8906	23,392
31	8906	26,082
32	8906	28,995
33	8906	32,150
34	8906	35,567
35	8906	39,268
36	8906	43,276
37	8906	47,616
38	8906	52,317
39	8906	57,407
40	8909	62,921

This amounts to a net after tax return of 13.82 percent on his $200,000 investment.

The tax loss of the fifty percent taxpayer decreases after the first year until a profit is shown after holding the property for eighteen years. The decline in the amount of tax loss is caused by declining deductions for depreciation and mortgage interest. In the twenty-eighth year the cash benefits become negative requiring the investor to supply additional funds in order to hold the property. Table III, page 37, gives the annual cash benefits which would be received from the example investment by taxpayers in the thirty percent, fifty percent, and seventy percent tax brackets.

It seems obvious that at some point, as the cash benefits decline, the owner should dispose of the property. This point is reached when the after tax yield to be obtained from an alternative investment is higher than that to be derived from holding the property. This determination will be made by comparing the after tax yield currently being obtained with that which would be obtained by selling the property and reinvesting the proceeds.

One who invests in rental real estate is generally considered for tax purposes to be engaged in a trade or business. Under section 1231 of the Internal Revenue Code if gains from the sale of depreciable personal property or depreciable real property used in a trade or business and held for more than six months exceed losses from such sales, the gains and losses are treated as long-term capital gains and losses. Where a single property is sold at a gain, it is clear that,

TABLE III

Cash Benefits from "Typical" Real Estate Investment
to Taxpayers with Three Different Marginal Tax Rates
(Assumes no Sale of Investment)

Length of Holding Period	30% Taxpayer	50% Taxpayer	70% Taxpayer
1	$20,272	$27,848	$35,425
2	19,442	26,465	33,489
3	18,643	25,133	31,624
4	17,872	23,849	29,826
5	17,127	22,608	28,089
6	16,407	21,407	26,407
7	15,707	20,241	24,775
8	15,027	19,107	23,188
9	14,363	18,002	21,640
10	13,715	16,920	20,126
11	13,078	15,859	18,641
12	12,452	14,815	17,179
13	11,833	13,784	15,735
14	11,220	12,762	14,304
15	10,609	11,745	12,880
16	10,000	10,728	11,457
17	9,388	9,709	10,030
18	8,771	8,682	8,592
19	8,148	7,642	7,137
20	7,514	6,586	5,658
21	6,868	5,509	4,150
22	6,474	4,852	3,231
23	6,048	4,142	2,236
24	5,586	3,372	1,158
25	5,086	2,538	-9
26	4,544	1,636	-1,273
27	3,957	658	-2,642
28	3,322	-401	-4,124
29	2,634	-1,548	-5,729
30	1,889	-2,790	-7,468
31	1,082	-4,135	-9,351
32	208	-5,591	-11,390
33	-739	-7,169	-13,599
34	-1,764	-8,877	-15,991
35	-2,874	-10,728	-18,581
36	-4,076	-12,731	-21,387
37	-5,378	-14,902	-24,425
38	-6,789	-17,252	-27,715
39	-8,316	-19,797	-31,279
40	-9,968	-22,552	-35,136

under the statute, the investor has a long-term capital gain.[18]

In continuing the foregoing example, let it be assumed that the property after 8 years of operation is sold for $900,000. The result is:

Sale			$900,000[19]
Tax basis of property:			
Land		100,000	
Building	1,000,000		
Depreciation deducted	336,330	663,670	763,670
Gain			$136,330

Prior to the application of the provision of the Revenue Act of 1964, the tax on the gain of $136,330 could not exceed $34,082.50, that is, the gain could not be taxed at a rate greater than 25 percent. This was true, despite the fact that it could be reasonably contended that the gain may have resulted from depreciating the property faster, by an accelerated method, than its decline in market value. And further, despite the fact that the operating tax loss, largely produced by the depreciation deduction, was fully deductible, the corresponding gain was taxed only at the long-term capital gain rate.

The internal rate of return of the real estate investment illustrated in the foregoing material and assuming a sale of the

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[18]If the operation of the real estate does not qualify as a trade or business, the property is, nevertheless, a capital asset since the property is not inventory, or held primarily for sale to customers in the ordinary course of business. See Internal Revenue Code, section 1221, defining capital assets.

[19]While not essential to the illustration, it is assumed that the property is sold for original cost less depreciation computed by the straight-line method ($1,100,000 - (1,000,000 x .025 x 8)).

property at the end of the eighth year is summarized in Table IV. It is further assumed that the purchaser assumes the mortgage.

TABLE IV

Pre-Revenue Act of 1964:
Proof of Internal Rate of Return of 7.1%
for New Section 1250 Property
Sold at the End of Eight Years
(Purchaser Assumes the Mortgage)

Year	Annual Cash Benefits	Present Value Factor	Present Value of Net After Tax Yield at Time of Investment	
1	$27,848	.934	$26,010	
2	26,465	.871	23,051	
3	25,133	.814	20,458	
4	23,849	.760	18,125	
5	22,068	.710	15,668	
6	21,407	.662	14,171	
7	20,241	.619	12,529	
8	19,107	.578	11,044	
Total			$141,056	$141,056

Gain on sale of property at end of eighth year	136,330.00	
Less long-term capital gain at 25 percent	34,082.50	
After tax gain on sale	102,247.50	
Present value factor	x .578	
Present value as of the time of investment of the net after tax gain upon sale		59,098
Total after tax yield adjusted to time of investment		$200,154
Initial Investment		$200,000

It seems clear from the foregoing illustration that, given the kind of ideal circumstances assumed, real estate investment was strikingly attractive to high bracket taxpayers. Of course, less favorable fact situations would produce a less attractive yield, but it appears undeniable that the interaction of available mortgage funds under long-term loans, statutory sanction of accelerated depreciation for real property, and treatment of gain on sale of real property at limited long-term capital gain rates produced a favorable climate for this type of investment.

Congressional reaction in 1964: It is an academic question as to whether or not the tax inducements to invest in real estate outlined above should have been continued. The fact is that the Congress, in the Revenue Act of 1964, adopted measures designed to lessen the tax advantages previously obtainable.

One of these measures sought to "recapture" excess depreciation on real property. Essentially, in tax jargon the phrase "depreciation recapture" means treating all or a part of the gain, which would normally be capital gain, on the sale of depreciable property as ordinary income. The Congress could, of course, provide that all gain on sale of depreciable assets is to be treated as ordinary income rather than capital gain. Where depreciation recapture is involved, however, the portion of the gain to be considered ordinary income is, in some way, related to the amount of depreciation previously deducted with respect to the property being sold.

In the Revenue Act of 1964, the Congress provided with respect

to real property that only "excess" depreciation should be recaptured, that is, only the amount of depreciation previously deducted which was in excess of the amount that would have been deducted if the straight-line method had been used. Under the 1964 Act, the recapture was to apply only to excess depreciation taken after 1963. A further restriction on the amount of excess depreciation to be recaptured is noted in the summary of the recapture provision outlined below.

The amount of depreciation recapture and hence the amount of ordinary income, as distinct from long-term capital gain, to be reported on sale of real property was to be computed as follows:

1. In no event could the amount of the depreciation recapture exceed the amount of the gain, that is, it could not exceed the difference between the selling price and the depreciated tax cost of the property.

2. The amount of depreciation to be recaptured was to have first priority; that is, only the amount of gain in excess of the depreciation to be recaptured would be capital gain.

3. With respect to real property, only the amount of depreciation computed by an accelerated method over the amount that would have been deducted under the straight-line method was to be recaptured.

4. Only the excess depreciation deducted after 1963 was subject to recapture.

5. The length of time the property had been held before sale had certain effects on the recapture of real property

depreciation under the 1964 act:

a. If the property had been held less than 21 months before sale all of the excess depreciation taken after 1963 was subject to recapture;

b. If the property had been held more than 20 months before sale, the total amount of excess depreciation to be recaptured was reduced by 1 percentage point for each month over 20. Thus, if the property were held 21 months, only 99 percent of the excess depreciation would be subject to recapture. If the property were held 22 months, only 98 percent would be subject to recapture. It follows that if the property were held more than 120 months (10 years), none of the excess depreciation would be subject to recapture.

Statutory terminology: It might have been reasonable, in the 1964 act, to deal with the recapture of depreciation on real property in those sections of the Internal Revenue Code related to the deduction of depreciation. This was not the procedure followed by the Congress. Instead, it provided for depreciation recapture in a wholly new provision of the Internal Revenue Code - section 1250. As is frequently the case, property having certain tax characteristics comes to be called by the section of the Code defining it. Thus depreciable real estate, gain on the sale of which is subject to recapture, is commonly, as well as technically, known as section 1250 property.

(a) Section 1250 Property: The definition of section 1250 property contained in the Internal Revenue Code is really made up of

two elements:

Element 1 indicates what is included within the term "depreciable realty."

Element 2 indicates the kinds of dispositions of real property which will trigger possible depreciation recapture. Actually, the statute provides that all dispositions of depreciable realty at a gain are subject to depreciation recapture except those within seven specifically enumerated exceptions. If the taxpayer disposes of depreciable realty at a gain and if he wishes to avoid recapture, he must be able to point to a provision of section 1250 bringing his disposition within one of the enumerated exceptions to the general rule.

(b) Depreciable realty: The Internal Revenue Code definition of depreciable real estate excludes a number of kinds of depreciable realty which, for purposes of recapture, are considered depreciable personal property. In the Revenue Act of 1962, which introduced depreciation recapture with respect to personal property, the following described real property was to be considered personal property for purposes of recapture:

> Other property which was not personal property (not including a building or its structural components) - but only if such other property was tangible, subject to depreciation or amortization, and was used as an integral part of manufacturing, production, or extraction or of furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services or constituted a research or storage facility used in connection with such activities, or an elevator or escalator, or property used in anti-pollution activity or railroad gradings or tunnel bases.[20]

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[20] Internal Revenue Code of 1954, section 1245(a)(3).

Under this provision many items attached to the land, which would be considered real property under the usual legal definition, were to be included under the Internal Revenue Code provision requiring recapture of depreciation on personal property. When the 1964 Act provided for recapture with respect to real property, these items remained under the provisions related to personal property.

The Internal Revenue Code definition also provided for recapture of amortization with respect to leaseholds and leasehold improvements even though property of this type might, under some classifications, be considered intangible. Excess depreciation, subject to recapture, in connection with a leasehold may be illustrated by the following assumed facts: A leases real property to B for a term of 20 years at an annual rental of $2,000. The lease provides for a renewal term of 10 years. After five years, B sells the lease to C for $10,000. C has a depreciable leasehold and amortizes its cost using the remaining 15 years of the original lease term in the computation. At the end of 5 years C sells the lease for $8,500. His realized gain is computed thus:

Sale of leasehold		$8,500
Cost of leasehold	$10,000	
Amortization $\frac{\$10,000}{15\text{ years}}$ x 5 years	3,333	
Adjusted cost		6,667
Realized Gain		$1,833

If C had included the 10 year renewal term in computing amortization, the deductible amortization would have been $2,000, instead of $3,333 computed above.

$$\frac{\$10,000}{15\text{ years} + 10\text{ years}} \times 5\text{ years} = \$2,000$$

Thus, C's excess depreciation is $1,333 since he must subtract from the amortization actually deducted the amount which would have been deductible if he had included the renewal term in his computation ($3,333 less $2,000 = $1,333). Thus, of the $1,833 realized gain, $1,333 is subject to recapture. The remainder of the realized gain ($1,833 less $1,333 = $500) is treated as gain arising from the sale of Section 1231 Assets and may be taxed as a capital gain. This same rule relating to the use of the renewal term also applies in computing excess depreciation with respect to leasehold improvements.

Dispositions which did not trigger recapture: Seven types of dispositions were not to result in recapture at the time of disposition.

(a) Disposition by gift - The general rule is that the tax cost of property (basis) carries over from a donor to a donee for purposes of determining the amount of gain realized by a donee upon a sale of the property. Section 1250 in effect provided that the donor and donee were to be treated as one person in determining the amount of depreciation recapture. Total gain was determined by comparing the donee's selling price with the original basis to the donor. Depreciation recapture was computed by taking into account the depreciation claimed by both the donor and donee. Since donor and donee were, in effect, to be treated as a unit for purposes of computing gain and depreciation recapture, section 1250 provided that neither gain nor recapture would be recognized at the time of the gift.

(b) Transfers at death - Under present law, one receiving property as a result of the death of the previous owner takes a tax cost (basis) equal to the fair market value at date of the decedent's death thus establishing a new basis for depreciation. All previous

depreciation is ignored and, upon a subsequent sale by the heir or devisee, only depreciation deducted by him is subject to recapture. Thus, there is no recapture at the point where death results in a transfer of the property.

(c) Non-recognition exchanges - The Congress has for many years recognized that one may exchange property for other property without modifying his economic position. These exchanges are of two types: (1) where the property received in the exchange is very similar to the property given up, and, (2) where the form of legal ownership of the property has changed without modification of the owner's basic economic interest. The general rule in these types of exchanges is that no gain or loss is recognized even though the fair market value of the property received may be much more or much less than the tax cost of the property given up. Correlative to this general rule is a second rule, that cost (basis) of the property received in the exchange is the same as the basis of the property given up. It should be emphasized that these rules do not, in general, apply to a sale of property (a transfer for a money consideration only) as distinct from an exchange (a transfer involving receipt of some consideration other than money).

To illustrate, suppose A exchanges an apartment house held for investment having a depreciated cost of $120,000 for a commercial building having a fair market value of $200,000. Clearly A has realized gain of $80,000; but this gain is not recognized because the tax law considers that investment real estate is "like property." The investor has merely exchanged properties without modifying the fundamental economic character of his investment - real estate. Suppose, in this

situation, that the investor giving up the apartment house with an adjusted cost of $120,000 had held the property eight years and that depreciation had been computed under an accelerated method; thus:

Cost of property	$210,000
Depreciation under accelerated method	90,000
Adjusted cost	$120,000

If depreciation had been computed unber the straight line method the result would have been:

Cost of property	$210,000
Straight line depreciation	40,000
Adjusted cost	$170,000

Of the $80,000 realized gain on the exchange of the property, $50,000 ($170,000-$120,000) is due to the use of an accelerated depreciation method. The obvious question is: Is any of the $80,000 gain recognized as depreciation recapture? Under these facts the answer is in the negative. The reason is that the tax cost of the property acquired in the exchange will have the same cost as the property given up; therefore, if the new property were sold for its fair market value ($200,000), the recapture rules would then apply to the $80,000 gain. It should be noted in this connection that the receipt of the commercial building in the exchange provides <u>depreciable</u> realty to which the recapture potential of the building given up may attach. The acquired building will have a sort of tax stigma - its sale will trigger depreciation recapture.

The above discussion deals with the simple case involving a non-recognition exchange. A more complicated situation must be considered. Not all exchanges of "like" property result in non-recognition

of gain. From the very inception of the concept of the non-recognition exchange the rule has been that realized gain would be recognized to the extent of the boot received. Boot is generally money or "unlike" property. Thus if A exchanges investment real property with a tax cost to him of $50,000 for a like piece of property having a fair market value of $80,000 and $10,000 boot, the result will be:

Received:

Fair market value of like property	$80,000
Boot	10,000
Total	$90,000
Basis of property given up	$50,000
Realized gain	$40,000

Recognized gain $10,000

The justification for the recognition of gain in this situation lies in the fact that the investor has, in a sense, "cashed in" on his investment - he has connected part of the potential gain in his property to a different and "unlike" kind of asset. This concept of the receipt of "unlike" property became still more important when section 1250 was introduced into the law.

The general rule set out in the Internal Revenue Code is that upon a non-recognition exchange, gain will, however, be recognized to the extent of the depreciation recapture. Thus if investment real estate having a basis of $50,000 and a depreciation recapture potential of $20,000 is exchanged for non-depreciable investment real estate worth $80,000, $20,000 of gain in the form of depreciation recapture will be recognized - and this will be true under the general rule even if no boot is received.

While the foregoing paragraph sets out the general rule, it is necessary to emphasize that the Code sets out a <u>ceiling</u> on the amount of depreciation recapture gain which is to be recognized under the general rule. This ceiling is the <u>greater</u> of two amounts.

First ceiling - The first limit on recapture on a non-recognition exchange is the amount of gain that would be recognized if section 1250 had not been enacted, that is the lesser of the realized gain or the boot received. To illustrate, assume a taxpayer held an apartment house having a basis of $100,000 as an investment. He exchanges it for a building with a fair market value of $150,000 and $10,000 cash boot. Assume also that there is $25,000 potential depreciation recapture on the exchange. While the general rule would indicate that all of the potential depreciation recapture should be recognized, the application of the first ceiling limitation indicates that only $10,000 of recapture will be recognized; this assumes, of course, that the second ceiling will not permit a greater amount of recapture.

Second ceiling - In considering this limitation, it should be remembered that before enactment of section 1250, realized gain on the exchange of investment real estate for investment real estate was non-taxable (barring receipt of boot) without regard to character of the real estate given up or received. For example, gain would not be recognized to the transferor on the exchange of an apartment house for unimproved land if both properties were held for investment. This treatment under the tax law caused difficulties with the advent of section 1250 since, if only unimproved land was taken in the exchange, there would be no depreciable property received to which potential depreciation recapture could attach. It was necessary, therefore, that

depreciation recapture be recognized on the exchange since it would not be logical to provide that depreciation could be recaptured on the sale of unimproved land which would, of course, not be subject to depreciation. The second ceiling was to be determined as the excess of the potential depreciation recapture involved in the property given up over the fair market value of depreciable real estate received in the exchange.

To illustrate, it may be assumed a taxpayer exchanges an apartment house having a basis to him of $100,000 and a depreciation recapture potential of $25,000 for unimproved land having a fair market value of $150,000 and $10,000 cash boot. The excess of the depreciation potential of $25,000 over the fair market value of the depreciable property (section 1250 property) received would be the excess of $25,000 over zero since no depreciable property was received. All of the $25,000 would be recaptured on the exchange. On the other hand, if the property received included a building with a fair market value of $12,000, only $13,000 recapture would be recognized.

(d) Dispositions involving involuntary conversion - The tax law has for many years contained provisions exempting from taxation gain involuntarily realized on the disposition of property. These situations generally involve sales of property at a gain under condemnation proceedings or the realization of gain where property is destroyed and the insurance proceeds exceed the basis of the property. The reasonable approach of the law has been that taxpayers should not be required to recognize realized gain where the disposition of the property is involuntary. The law has, however, set up a sort of test to determine whether disposition or destruction of the taxpayers property is really

contrary to their wishes. If the taxpayer, within a reasonable time, reinvests the proceeds derived from the forced sale or destruction of his property in substantially similar property, the realized gain is not recognized. To state the law more precisely: realized gain will be recognized to the extent that the proceeds of involuntary conversion are not reinvested in substantially similar property. Substantially similar property has been defined as property related in service or use to the property involuntarily condemned, or stock constituting control of a corporation owning such property.

With the advent of section 1250, it was obvious that where the proceeds of involuntary conversion were invested in stock of a corporation, no depreciable property was acquired. In these situations the first ceiling or limitation on the general rule with respect to recognition of gain or recapture had to be supplemented. Thus the first ceiling was to be the amount of gain recognized on the transaction (on account of unreinvested proceeds) plus the cost of any stock purchased. To illustrate assume that the taxpayer owned a building held for investment with a basis of $100,000 and a depreciation recapture potential of $25,000. Assume further that the building is destroyed by fire and insurance proceeds of $160,000 are recovered. The taxpayer invests $145,000 in a new building, $10,000 in control of the stock of a corporation having a similar building and keeps $5,000 in cash. His unreinvested proceeds are $5,000 and before enactment of section 1250 this would be the gain recognized. But after 1963, the depreciation recapture is $15,000, the sum of the unreinvested proceeds and the $10,000 value of the stock.

(e) <u>Liquidation of a controlled subsidiary</u> - Section 332 of

the Internal Revenue Code deals with the situation where a parent corporation has 80 percent control of a subsidiary. The parent can bring about a liquidation of the subsidiary resulting in an exchange of the subsidiary's stock for the subsidiary's assets. Gain on such an exchange is not recognized. There is no need to require that depreciation recapture be applied in this situation since, generally, the assets owned by the subsidiary come into the hands of the parent corporation at the same basis they had to the subsidiary. Any potential depreciation recapture will be recognized upon subsequent disposal of the assets.

(f) Transfers to a controlled corporation - The Internal Revenue Code provides that, generally, no gain or loss is to be recognized when property is transferred to a controlled corporation in exchange for stock or securities. Control in this context means that the transferors of the property must possess immediately after the transfer at least 80 percent of the voting power and at least 80 percent of the total number of shares of each other class of stock. Since no gain or loss is to be recognized on this type of exchange, the basis of the transferred property to the transferee corporation is the same as it was in the hands of the transferor. Thus, any potential recapture of depreciation on the transferred property will carry over to the transferee corporation and there is no necessity of recapture at the time of the exchange.

(g) Exchanges in connection with reorganizations - Generally, corporate readjustments in the form of mergers and consolidations do not result in the recognition of gain or loss. Thus, in connection with a corporate acquisition the stock of the acquiring corporation

may be exchanged for stock or assets of the acquired corporation. Of course, if the acquiring corporation keeps the acquired corporation alive in the form of subsidiary, no problem arises with respect to recapture of depreciation. The subsidiary is still a viable corporate entity and any dispositions of assets by it will be subject to the general recapture rules. If a merger takes place through exchange of the stock of the acquiring corporation for stock of the acquired corporation, the assets of the acquired corporation will be assimilated by the acquiring corporation. Hence, again, the general rule is that the assets thus acquired retain their basis in the hands of the acquiring corporation. If the acquired assets are subsequently disposed of, the recapture rules will come into operation at that point.

The same general rules with respect to non-recognition of recapture as are applicable in the corporate reorganizations just described also apply to corporate reorganizations under the bankruptcy act and to railroad reorganizations.

(h) Transfers to a partnership - Under section 721 of the Internal Revenue Code, no gain or loss is recognized on a transfer of property to a partnership in exchange for an interest in the partnership. Under section 721 the basis of such property to the partnership is the same as the basis to the transferor immediately before the transfer. Since this is another situation in which basis is carried over from the transferor to the transferee, recapture is not recognized on the exchange.

The general rule controlling distributions of property by a partnership to a partner is similar to the rule related to contributions of property to the partnership. In general no gain is recognized and

the basis carries over. There is, therefore, no need for imposition of recapture gain.

(i) Disposition of principal residence - The final exception to the general rule requiring recapture of depreciation involved the disposition of a personal residence. This exception provided that the general rule did not apply to a disposition of a principal residence. This was because depreciation of a principal residence was not an allowable deduction for income tax purposes. On the other hand, if an individual sold his principal residence, a portion of which had been subject to an allowance for depreciation in his trade or business, the general rule applied only in respect of the disposition of that portion of the residence.

Method of Depreciation

Major changes have been made in the definition as to what constitutes a reasonable allowance for depreciation. Since the Revenue Act of 1921 businesses have been entitled to deduct: "A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence."[21] This was construed to mean that businesses could depreciate assets by a straight-line method over their useful life. This interpretation remained in effect for over thirty years. Even though straight-line depreciation was the only method specifically permitted by the regulations, the Internal Revenue Service deemed 150 percent declining balance

[21]Statute, Revenue Act of 1921, section 214.

depreciation to be reasonable and thus, an acceptable method of depreciation.[22]

Internal Revenue Code of 1954

In addition to a complete recodification of the 1939 Internal Revenue Code, the Congress in 1954 made several major changes in the statute. One of these provided a new definition of a reasonable allowance for depreciation. Interpretations of the word "reasonable" in this connection had given rise to many controversies between taxpayers and the Internal Revenue Service. Taxpayers argued that the methods of depreciation which were considered reasonable by the Internal Revenue Service were not in agreement with economic reality. This was particularly true in industries which had significant obsolescence. The House Ways and Means Committee stated:

> There is evidence that the present system of depreciation acts as a barrier to investment, particularly with respect to risky commitments in fixed assets. Comparatively slow rates of write-off tend to discourage replacement of obsolete equipment and the installment of modern, up-to-date machinery.[23]

The Committee's bill provided for a liberalization of depreciation by adjusting the estimate of useful life of property and by permitting additional methods of allocating the depreciable cost over the useful life of service. The bill provided, that in addition to straight-line depreciation, the following methods would be considered

[22] Revenue Ruling 57-352, Cumulative Bulletin of the Internal Revenue Service, 1957-2, p. 150.

[23] U.S. Congress, House, Committee on Ways and Means, Internal Revenue Code of 1954, House Report No. 1337, 83rd Congress, 2nd session, 1954, p. 22.

reasonable for new property acquired or constructed after December 31, 1953:

> The declining balance method, using a rate not in excess of twice the straight-line rate . . . Any other method consistently applied so long as the accumulated depreciation allowances for a property at the end of each year do not exceed the allowances which would have resulted from the use of the declining-balance method described above.[24]

In addition, the Committee stated that ". . . any method of depreciation which, under existing law, has been shown to be reasonable for a taxpayer's property regardless of the method of writeoff [sic] used . . ."[25] would still be considered proper. The new depreciation methods were

> . . . to apply to all types of tangible depreciable assets, including farm equipment, machinery, and buildings, rental housing, and industrial and commercial buildings as well as machinery and equipment. They are limited, however, to property new in use and therefore never before subject to depreciation allowances.[26]

The Committee believed that the changes in depreciation policy would have far reaching economic effects. The liberalization of depreciation policy was hoped to assist in the modernization and expansion of American industrial capacity. This, it was believed, would result in economic growth, increased production, and a higher standard of living.

The bill, as passed by the House, was accepted by the Senate with only minor modifications. However, several of the Senate

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[24] *Ibid.*, p. 23.

[25] *Ibid.*, p. 23.

[26] *Ibid.*, p. 23.

amendments affected the real estate provisions. (1) The House bill limited the accumulated depreciation allowance under any other reasonable and consistent method to the allowance which would have resulted from the double-declining balance method. The Senate Finance Committee changed this so that the limitation applied only during the first two-thirds of service life. (2) The Senate allowed taxpayers using the double-declining balance method to switch to straight-line depreciation at any time in the life of the property. (3) The use of the accelerated methods was limited to property with an estimated life of three or more years. (4) The Senate proposed that the entire cost of all property put into service after December 31, 1953 could be depreciated under the new methods. (5) The Senate inserted a provision to specifically allow the sum-of-the-years digits method of depreciation.[27]

The differences between the House and Senate bills were resolved in Conference. The inclusion of the sum-of-the-years digits depreciation method was accepted by the House conferees. Also accepted was the Senate provision for limiting the amount of deductions to less than the amount obtained from using the double-declining balance method during the first two-thirds of a property's life. In addition, the House conferees accepted the Senate amendment for limiting the use of the accelerated methods to property with a life of three or more years. However, the House provision to the effect that only costs incurred after December 31, 1953 were to be subject to the new depreciation methods was retained. Finally, the House accepted the Senate provision

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[27]U.S. Congress, Senate, Internal Revenue Code of 1954, Senate Report No. 1622, 83rd Congress, 2nd session, 1954, pp. 27-29.

for permitting the taxpayer to change from the double-declining balance method to the straight-line method.[28]

These methods of depreciation and types of property eligible for accelerated depreciation remained unchanged until the Tax Reform Act of 1969.

Treasury Study

In the Revenue and Expenditure Control Act of 1968 Congress made a request. It was that: "Not later than December 31, 1968, the President shall submit to the Congress proposals for a comprehensive reform of the Internal Revenue Code of 1954."[29] Pursuant to this request, the Treasury Department, on December 11, 1968, submitted its Tax Reform Studies and Proposals. As part of the supplemental material was a section on the Tax Treatment of Real Estate.[30] The section examined the special provisions and the effect of the preferential tax treatment given real estate investments.

The Treasury Department made an estimate, which it labeled as conservative, that $750 million of revenue concessions could be attributed to accelerated depreciation and another $100 million could be attributed to the favorable treatment given to gains arising from real estate dispositions. This estimate was for 1967. The breakdown of

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[28]U.S. Congress, Conference, Internal Revenue Code of 1954, House Report No. 2543, 83rd Congress, 2nd session, 1954, House Miscellaneous Reports, Volume VII, pp. 28-29.

[29]Revenue and Expenditure Control Act of 1968, Statutes at Large, LXXXII, section 110 (1968).

[30]Treasury, Tax Reform Studies and Proposals, pp. 438-458.

the $750 million was:

1. $500 million to motels, office buildings, shopping centers, and other types of commercial and industrial structures;
2. $100 million to older housing which was undergoing its second, third, or fourth round of write-offs at rates above straight-line;
3. $100 million to construction of semi-luxury and luxury highrise apartments; and
4. $50 million to investors who built low- and moderate-income housing.[31]

Thus, less than seven percent of the benefits from the accelerated depreciation provision accrued to those who increased the supply of low- and moderate-income housing.

The study stated that, using the present state of the economic art, it was virtually impossible to make reliable quantitative estimates of the effects of the preferential tax provisions on construction and the housing supply. The following estimates of broad qualitative effects were, however, presented.

1. Even though it could be presumed that the tax provisions encourage construction, the effect of them cannot be reliably measured in terms of construction of all buildings, all housing, or even low-income housing.
2. The tax stimuli were probably more effective for luxury and moderate-income rental housing than for

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[31] *Ibid.*, p. 442.

low-income housing. The profitability and appreciation prospects relative to risk were given as the causes of this.

3. In addition, it was stated that:

> Capital and other resource demands engendered by the existing tax stimuli probably tend to expand luxury housing, commercial, office, motel, shopping center, and other forms of more glamorous investment, squeezing out lower income housing.
>
> The investor tax stimuli depend on and are sensitive to favorable financial leverage and interest rates relative to rents so that they are turned on and off abruptly with abrupt changes in monetary policy; <u>as a consequence, investors apparently rank loan-term factors high and ahead of taxes in deciding whether to invest.</u>[32] (Emphasis supplied.)

4. Other effects mentioned were the problem of old housing being depreciated more than once and the lack of tax stimuli to improve or remodel existing housing.

The study cited recent Treasury examinations of tax returns of three types of taxpayers who had benefitted from the real estate provisions. The examples were given to illustrate the incompatability of the provisions with an equitable tax system. The three types of taxpayers were real estate operators, passive investors in real estate, and individuals with large capital gains arising from the disposition of real estate.

The Treasury summarized its beliefs thus:

> To sum up on the effects of the present system of accelerated depreciation and related tax treatment of real estate operators and investors--the real estate tax shelter--the system--

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[32] Ibid., p. 443.

is costly and inefficient as a means of getting more housing or other construction;

offers no assurance that construction resources are directed to priority needs; indeed--it may be surmised--it diverts promotional talent, capital, and other resources into forms of building which are less essential than many basic housing needs;

is basically incompatible with the operation of a fair tax system and the important objectives of tax reform; and

is also incompatible with budgetary responsibility since it involves substantial tax-expenditure commitments via the revenue side of the budget which escape the tests and controls of sound modern budgetary procedures.[33]

[33] Ibid., p. 445.

CHAPTER III

EXPLANATION OF THE PROVISIONS OF THE TAX REFORM ACT OF 1969 AFFECTING REAL ESTATE INVESTMENT

In January 1969, the House Ways and Means Committee announced that it would hold hearings on the subject of tax reform. Dates were given when testimony would be taken on specified topics. The hearings lasted from February 18 through April 24, 1969. During this period fifteen volumes of testimony were taken on various topics. One of the topics was: Real Estate Where Accelerated Methods of Depreciation Are Used.[1] Some of the highlights of the statements were presented in Chapter I. The House report on its bill was issued in August, 1969.

Upon completion of House action on the bill, the Senate Finance Committee held its own set of hearings. Some of the highlights of the testimony are given in Chapter I. The Senate completed consideration of the bill in November, 1969. The bill then went to a Conference Committee to iron out the differences between the House and Senate versions. This was accomplished and the bill was signed into law on December 30, 1969 by President Nixon. The provisions affecting investment in real estate are reproduced in Appendix C.

It is the purpose of Chapter III to explain and illustrate the effects of the changes embodied in the Tax Reform Act of 1969 which

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[1]House, Tax Reform, 1969, Hearing, Part VIII.

affected investment in real estate. As previously mentioned, the changes affected four areas of real estate investment. These were: depreciation policy, depreciation recapture, rehabilitation expenditures, and tax free sales of federally assisted housing. Examples will be given illustrating the consequences under the old and the new statute. The basis of comparison between the old and new statute will be the internal rate of return which is generated under each assumption.

The chapter will be divided into three sections. The first section will explain the changes made in depreciation policy and depreciation recapture. Examples will illustrate the effects that the changes made upon the internal rate of return from different types of real estate investment. The second section will explain the changes affecting rehabilitation expenditures and examine the effects. The third section will examine and explain the changes affecting tax free sales of federally assisted housing.

"Typical" Real Estate Investment

At this point it is advisable to present an example of a "typical" real estate investment; the purpose is to illustrate the problems which the Congress attempted to solve.

The following facts are assumed as typical of a real estate investment prior to 1969. Examples based upon these facts are given for various types of real estate on pages 74-90. Other examples under slightly different assumed facts are given on pages 90-110.

1. Cost of Building $1,000,000
2. Rental Income per Year . . . . $ 168,000
3. Operating Expenses per Year . . . . $ 84,000
4. Depreciable Life of Building . . . . . . 40 years
5. Amount Borrowed . . . . $ 900,000
6. Length of Mortgage . . . . 40 years
7. Interest Rate on Mortgage 8%
8. Method of Depreciation . . . 200% Declining Balance
9. Equity Investment . . . . $ 100,000
10. Sales Price . . . . . . $1 over Balance of Mortgage

A one million dollar structure is used in the illustration for purposes of simplicity. It is assumed to have monthly rentals of $14,000 or $168,000 annually. An operating ratio of fifty percent ($84,000) was selected after investigation in trade association publications.[2] During the interviews it was determined that it was common practice to have the mortgage the same length as the depreciable life of the building. Forty years was selected as a conservative figure. It was also determined that an equity contribution of ten percent of the cost of the building was the most common. An interest rate of eight percent was selected as an average cost of money for real estate investment. The two-hundred percent declining balance method of depreciation was utilized in order to get as early a write-off as possible. It is to be assumed that the land on which the building is located is leased. The cost of the lease is included in the operating expenses. Finally, whenever the investment is sold, the sales price will be allocated for this demonstration in such a manner so as to permit the maximum amount of depreciation to be recaptured. This assumption about

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[2]Institute of Real Estate Management Experience Exchange Committee, _A Statistical Compilation and Analysis of Actual 1968 Income and Expenses Experienced in Apartment Building Operations_, (Chicago: Institute of Real Estate Management of the National Association of Real Estate Boards, 1969), pp. 7 and 11.

the sale of the investment causes the poorest possible result to the taxpayer. The effect of the assumptions is that the examples present the most conservative results. With these facts, the investment generates the annual cash flows and taxable incomes illustrated in Table V.

Before these data can be useful, one additional step is necessary. This is the determination of the after-tax cash benefits to the investor. For simplicity, it is assumed that there is one equity investor. For comparison purposes, three marginal tax rates are used: thirty percent, fifty percent, and seventy percent. With these additional assumptions, the investment yields the annual cash benefits to the investor as listed in Table VI.

Proponents for change have criticized the tax statute in that it allows negative taxable incomes and positive cash flows from an investment as illustrated in Tables V and VI. In fact, as shown in Table VI, the highest bracket taxpayer will receive more cash benefits from the same investment than will the lower bracket taxpayers. This will occur as long as the taxable income from the investment is negative. As soon as the investment becomes profitable (after eighteen years), the lowest bracket taxpayer receives more cash benefits than the higher bracket taxpayers.

Since Congress was persuaded to believe that such conditions were unfair, changes were made in the Internal Revenue Code sections affecting investment in real estate. To illustrate the effects of these changes upon different types of real estate investment, the internal rate of return from an investment made before the Tax Reform Act of 1969 will be compared with the internal rate of return from the

TABLE V

Annual Cash Flows and Taxable Incomes of "Typical" Real Estate Investment (Assumes no sale of investment)

Length of Holding Period	Net Cash Flow	Taxable Income
1	$8906	$-37,884
2	8906	-35,118
3	8906	-32,454
4	8906	-29,885
5	8906	-27,404
6	8906	-25,001
7	8906	-22,669
8	8906	-20,402
9	8906	-18,191
10	8906	-16,028
11	8906	-13,906
12	8906	-11,818
13	8906	- 9,756
14	8906	- 7,711
15	8906	- 5,677
16	8906	- 3,644
17	8906	- 1,605
18	8906	449
19	8906	2,528
20	8906	4,640
21	8906	6,795
22	8906	8,108
23	8906	9,5[illegible]9
24	8906	11,069
25	8906	12,736
26	8906	14,542
27	8906	16,497
28	8906	18,615
29	8906	20,908
30	8906	23,392
31	8906	26,082
32	8906	28,995
33	8906	32,150
34	8906	35,567
35	8906	39,268
36	8906	43,276
37	8906	47,616
38	8906	52,317
39	8906	57,407
40	8909	62,921

TABLE VI

Cash Benefits from "Typical" Real Estate Investment
to Taxpayers with Three Different Marginal Tax Rates
(Assumes no sale of Investment)

Length of Holding Period	30% Taxpayer	50% Taxpayer	70% Taxpayer
1	$20,272	$27,848	$35,425
2	19,442	26,465	33,489
3	18,643	25,133	31,624
4	17,872	23,849	29,826
5	17,127	22,608	28,089
6	16,407	21,407	26,407
7	15,707	20,241	24,775
8	15,027	19,107	23,188
9	14,363	18,002	21,640
10	13,715	16,920	20,126
11	13,078	15,859	18,641
12	12,452	14,815	17,179
13	11,833	13,784	15,735
14	11,220	12,762	14,304
15	10,609	11,745	12,880
16	10,000	10,728	11,457
17	9,388	9,709	10,030
18	8,771	8,682	8,592
19	8,148	7,642	7,137
20	7,514	6,586	5,658
21	6,868	5,509	4,150
22	6,474	4,852	3,231
23	6,048	4,142	2,236
24	5,586	3,372	1,158
25	5,086	2,538	-9
26	4,544	1,636	-1,273
27	3,957	658	-2,642
28	3,322	-401	-4,124
29	2,634	1,548	-5,729
30	1,889	-2,790	-7,468
31	1,082	-4,135	-9,351
32	208	-5,591	-11,390
33	-739	-7,169	-13,599
34	-1,764	-8,877	-15,991
35	-2,874	-10,728	-18,581
36	-4,076	-12,731	-21,387
37	-5,378	-14,902	-24,425
38	-6,789	-17,252	-27,715
39	-8,316	-19,797	-31,279
40	-9,968	-22,552	-35,136

same investment as if it were made after the act. Several variations of the assumptions used in the "typical" real estate investment will be utilized. In addition, it is assumed that whenever an investment is sold, it is sold for one dollar over the balance remaining on the mortgage and thus producing a loss of all but one dollar of the investor's equity. With this last assumption, the internal rate of return will be computed for forty different holding periods, i.e., computations will be made as if the investment were sold at the end of each and every year. In this manner, the effect that the holding period has upon the internal rate of return can be examined.

Depreciation Policy and Depreciation Recapture

Changes in Depreciation Policy

Prior to the enactment of the Tax Reform Act of 1969, the following types of depreciation were considered reasonable for the indicated types of buildings. The maximum allowable for new construction was the amount computed under the double declining balance method or the sum-of-the-years digits method. For used structures, the maximum allowable was the amount obtainable using the 150 percent declining balance method. After passage of the 1969 Act the maximum considered reasonable for all new construction is the amount obtained using the 150 percent declining balance method. If, however, certain conditions are met, new residential rental property can be depreciated under the double declining balance method or the sum-of-the-years digits method. Used property is limited to use of the straight-line method unless it is used residential rental property and has a useful life of twenty years or more; if so, the property can be depreciated under the

declining balance method at a rate up to 125 percent. Thus, changes were made as to what constitutes reasonable depreciation for new commercial and industrial buildings and all used real estate. Examples will be given to illustrate the effect of these changes. First, it is necessary to explain the conditions which must be met to qualify real estate as residential rental property.

Residential Rental Property: As just explained, the depreciation methods which are considered reasonable for residential rental property, were not changed by the Tax Reform Act of 1969; however, property will qualify as residential rental property only if it meets certain conditions. A building or structure is:

> . . . considered to be residential rental property for any taxable year only if 80 percent or more of the gross rental income from such building or structure for such year is rental income from dwelling units . . .[3]

If the taxpayer occupies a portion of the structure, its rental value shall be included in determining the gross rental income from the structure. The term "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, motel, inn, or other establishment more than one-half of the units in which are used on a transient basis.[4]

Under this definition, it is possible for a building to qualify as residential rental property for one year and then to not qualify the next year. If this occurs, the taxpayer will be forced to change his

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[3]Prentice-Hall, Internal Revenue Code of 1954, (Englewood Cliffs, N.J.: Prentice-Hall, Inc., 1970) Section 167 (j)(2)(B).

[4]Ibid., Section 167(k)(3)(C).

method of depreciation. The Internal Revenue Code waives the requirement of approval for changing the method of depreciation under these circumstances.[5] The eighty percent occupancy requirement (hereinafter referred to as the eighty percent test) is illustrated in the following example:

Example (1): The taxpayer built a high-rise apartment building. It was completely occupied at the end of 1970. The first five floors of the building were leased to a department store and were occupied by it as of April 1, 1970. During 1970 the department store paid $20,000 in rent and the apartment dwellers paid $15,000 in rent. It 1971 the department store paid $30,000 in rent and the apartment dwellers paid $175,000 in rent. The 80 percent test was not met in 1970, but it was met in 1971. For 1970, neither the double declining balance method nor the sum-of-the-years digits method could be used. In 1971 either of these methods are available. The ability of the taxpayer to utilize the faster methods of depreciation in 1972 and subsequent years depends upon whether or not the 80 percent test is met in each separate year.

Pre-July 25, 1969 Exceptions: The provisions of the Tax Reform Act of 1969 affecting depreciation policy do not apply:

> . . . in the case of property--
> (A) the construction, reconstruction, or erection of which was begun before July 25, 1969, or
> (B) for which a written contract entered into before July 25, 1969, with respect to any part of the construction, reconstruction or erection or for the permanent financing thereof, was on July 25, 1969, and at all times thereafter, binding on the taxpayer.[6]

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[5] Ibid., Section 167(j)(2)(C).

[6] Ibid., Section 167(j)(3).

Under the statutory scheme, whether a contract is binding is determined under the applicable local law. Thus, state law as to the effect of past performance and as to when a seller has accepted an order will apply; the contract can be either written or oral.

In both the House and Senate Reports it is explained that a binding contract exists only with respect to the property which the taxpayer is obligated to accept under the contract. The Senate Report stated that:

> A contract may be considered binding on a taxpayer even though (a) the price of the item to be acquired under the contract is to be determined at a later date, (b) the contract contains conditions the occurrences of which are under the control of a person not a party to the contract, or (c) the taxpayer has the right under the contract to make minor modifications as to the details of the subject matter of the contract.[7]

A contract which is binding on a taxpayer on July 25, 1969 will not be considered binding at all times thereafter if it is substantially modified after that date. A waiver of a right to cancel upon a price change is an example of a substantial modification. In addition,

> A contract under which the taxpayer has an option to acquire property is not a contract that is binding upon the taxpayer for purposes of this provision unless the amount paid for the option is forfeitable (if the taxpayer does not exercise his option), is to be applied against the purchase price of the property (if the taxpayer exercises his option) and then only if the amount paid for the option is not nominal.[8]

<u>Changes in Depreciation Recapture</u>

As explained in Chapter II, the determination of the amount of depreciation recaptured upon the sale or disposition of depreciable

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[7]Senate, <u>Tax Reform Act of 1969</u>, pp. 230-231.

[8]House, <u>Tax Reform Act of 1969</u>, p. 184.

real propety is governed by section 1250 of the Internal Revenue Code. In summary, this determination prior to the Tax Reform Act of 1969, was as follows: (1) Gain on the sale or disposition of section 1250 property during the first twelve months it was held was taxed as ordinary income to the extent of all depreciation previously deducted. (2) If the property was held over twelve full months but less than twenty full months, the excess depreciation, i.e., the amount of depreciation actually deducted in excess of the straight-line depreciation allowable, was recaptured in full. (3) After the property had been held for over twenty full months, the recapture of excess depreciation was reduced from one-hundred percent by one percent for each month the property had been held until the property had been held for one-hundred and twenty full months. After this, there could be no recapture of pre-1970 excess depreciation.[9]

As previously outlined in Chapter I, there are three different recapture rules now in effect for section 1250 property. For certain qualified housing projects the recapture rule will be the same as that existing prior to the Tax Reform Act of 1969. Specifically, these qualified housing projects are Sections 221(d)(3) and 236 National Housing Act programs.[10] For all residential rental property, except qualified housing projects, post-1969 excess depreciation will be recaptured at the rate of one-hundred percent minus one percent for each full month the property is held after one-hundred full months. Accordingly, there will be no recapture on residential rental property after

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[9] Supra., Chapter II, pp. 31-58 for a more complete explanation.

[10] Supra., notes 33 and 34, p. 14.

it is held for sixteen years and eight months. If the property is disposed of during the first twelve full months, all depreciation will be recaptured. If the property is disposed of during the first one-hundred full months, all excess depreciation will be recaptured. For all other types of section 1250 property, the excess depreciation attributable to periods after 1969 will be fully recaptured, i.e., the applicable percentage will always be one-hundred percent.

Left unchanged was the rule that the amount of excess depreciation which can be recaptured will not in any event exceed (1) the gain realized on the sale, exchange, or involuntary conversion, or (2) the fair market value of the property (in the case of any other disposition), over the adjusted basis of the property disposed of. For all section 1250 properties held on July 24, 1969, transitional rules were provided in the new statutes. Under these rules, post-1969 excess depreciation will be subject to recapture prior to pre-1970 excess depreciation. The determination of the amount of depreciation recaptued on disposition after July 24, 1969 can be computed using the following steps:

1. If the property has been held for twelve full months or less, all depreciation will be recaptured;

2. If the property has been held for more than twelve full months but less than twenty full months, all excess depreciation will be recaptured;

3. If the property has been held for more than twenty full months, but less than one-hundred and twenty full months, the post-1969 excess depreciation must be computed first. If such post-1969 excess depreciation exceeds the gain on sale, recapture will be limited

to the applicable percentage of such gain. If, however, the post-1969 excess depreciation is less than the gain on sale the excess depreciation will be multiplied by the applicable percentage for post-1969 recapture. Next, the pre-1970 excess depreciation will be computed. The lesser of this amount or the realized gain minus the post-1969 excess depreciation will be multiplied by the applicable percentage. The amount so determined plus the amount determined as post-1969 excess depreciation recaptured will constitute the amount taxable as ordinary income under the general rule;

4. If the property has been held for more than one-hundred and twenty months, but less than two-hundred months, there will be no pre-1970 excess depreciation recaptured. The lesser of the post-1969 excess depreciation or the realized gain will be multiplied by the applicable percentage. This product will constitute the amount taxable as ordinary income;

5. If the property has been held more than two-hundred months, there will be no recapture of pre-1970 excess depreciation and if the property is residential rental property, there will be no recapture of post-1969 excess depreciation. If it is not, the lesser of the realized gain or all post-1969 excess depreciation will be recaptured.

Effects of Changes

New Commercial and Industrial Property: The type of section 1250 property most affected by the changes is new commercial and industrial property. Applying the same assumptions as those utilized in creating the "typical" real estate investment to a new commercial building acquired in 1968, the internal rate of return, determined at that time

TABLE VII

Pre-Tax Reform Act of 1969:
Internal Rate of Return
for New Section 1250 Property
If Sold at the End of the Indicated Holding Period
by Taxpayers with Three Different Marginal Tax Rates
(Assumes same facts as "typical" real estate investment)

Holding Period (Years)	30% Taxpayer	50% Taxpayer	70% Taxpayer
1 (1968)	*	*	*
2	*	*	*
3	*	*	*
4	*	*	*
5	*	*	3.6%
6	*	*	13.7
7	*	7.2%	19.6
8	2.1%	12.4	23.3
9	5.9	15.6	25.7
10	8.6	17.8	27.2
11	10.2	19.1	28.0
12	11.4	20.0	28.7
13	12.4	20.7	29.1
14	13.1	21.3	29.4
15	13.7	21.7	29.7
16	14.2	22.0	29.9
17	14.6	22.2	30.0
18	14.9	22.4	30.1
19	15.1	22.5	30.1
20	15.3	22.6	30.2
21	15.5	22.7	30.2
22	15.6	22.8	30.3
23	15.7	22.8	30.3
24	15.8	22.9	30.3
25	15.9	22.9	30.3
26	15.9	22.9	30.3
27	16.0	22.9	30.3
28	16.0	23.0	30.3
29	16.0	23.0	30.3
30	16.1	23.0	30.3
31	16.1	23.0	30.3
32	16.1	23.0	30.3
33	16.1	23.0	30.3
34	16.1	23.0	30.3
35	16.1	23.0	30.3
36	16.1	23.0	30.3
37	16.1	23.0	30.3
38	16.1	23.0	30.3
39	16.1	23.0	30.3
40	16.1	23.0	30.3

*The cumulative cash flow after the sale of the investment at the end of these years is negative.

TABLE VIII

Post-Tax Reform Act of 1969:
Internal Rate of Return
for New Commercial and Industrial Property
If Sold at the End of the Indicated Holding Period
by Taxpayers with Three Different Marginal Tax Rates
(Assumes same facts as "typical" real estate investment)

Holding Period (Years)	30% Taxpayer	50% Taxpayer	70% Taxpayer
1 (1973)	*	*	*
2	*	*	*
3	*	*	*
4	*	*	*
5	*	*	*
6	*	*	*
7	*	*	5.4%
8	*	1.0%	9.8
9	*	5.1	12.9
10	2.4%	8.0	15.2
11	4.6	10.2	16.9
12	6.3	11.8	18.2
13	7.7	13.0	19.1
14	8.7	14.0	19.8
15	9.6	14.7	20.4
16	10.2	15.3	20.8
17	10.8	15.7	21.1
18	11.2	16.1	21.3
19	11.6	16.4	21.5
20	11.9	16.6	21.7
21	12.1	16.8	21.8
22	12.3	16.9	21.9
23	12.5	17.0	21.9
24	12.6	17.1	22.0
25	12.7	17.2	22.0
26	12.8	17.3	22.1
27	12.9	17.3	22.1
28	13.0	17.4	22.1
29	13.0	17.4	22.1
30	13.1	17.4	22.1
31	13.1	17.4	22.1
32	13.1	17.4	22.1
33	13.2	17.4	22.1
34	13.2	17.5	22.1
35	13.2	17.5	22.2
36	13.2	17.5	22.2
37	13.2	17.5	22.2
38	13.2	17.5	22.2
39	13.2	17.5	22.2
40	13.2	17.5	22.2

*The cumulative cash flow after the sale of the investment at the end of these years is negative.

for forty different holding periods and for taxpayers with three different marginal tax rates, is given in TABLE VII. TABLE VIII gives the internal rate of return from an investment made in 1973 under the same assumptions. The differences in the internal rates of return are caused by the changes made in the 1969 Tax Reform Act with respect to depreciation policy and depreciation recapture.

The internal rates of return given in Tables VII and VIII for certain holding periods appear in TABLE IX; which provides the data on which the following discusson is based. In this table and other summary tables which follow, it should be noted that there are several blank spaces. This is intentional; only those rates of return which are used for comparison purposes are listed.

TABLE IX

Internal Rate of Return under
Pre '69 Act for New Section 1250 Property and
Post '69 Act for New Commercial and Industrial Property
If Sold at the End of the Indicated Holding Period
by Taxpayers with Three Different Marginal Tax Rates
(Assumes same facts as "typical" real estate investment)

Taxpayer's Tax Bracket	Holding Period	Pre '69 Act	Post '69 Act
30%:	10 years	8.6%	2.4%
	14 "	13.1	
	15 "	13.7	
	33 "	16.1	13.2
	40 "	16.1	13.2
50%:	9 years	15.6%	
	10 "	17.8	8.0%
	40 "	23.0	17.5
70%:	7 years	19.6%	
	8 "	23.3	
	40 "	30.3	22.2%

As a result of the changes, the maximum internal rate of return for a taxpayer with a marginal tax rate of thirty percent declines from 16.1 percent to 13.2 percent. If, under the old statute, the property had been sold at the end of ten years (no recapture of depreciation could occur for this or for any longer holding period), the internal rate of return from the investment would be 8.6 percent. However, under the new statute, the internal rate of return to the taxpayer would only be 2.4 percent if the investment were sold at the end of ten years. In addition, for the taxpayer to obtain the maximum return under the new statute, he would have to hold the property for thirty-three years, whereas under the old statute, he would have had to hold the property only slightly in excess of fourteen years.

The effects of the changes upon a taxpayer with a marginal tax rate of fifty percent are slightly greater. The maximum internal rate of return declines from 23.0 percent to 17.5 percent. This is a decline of 19.6 percent versus a decline of 18.0 percent for the thirty percent bracket taxpayer. If the property is sold at the end of ten years, the statutory changes cause the internal rate of return to decrease more than half, i.e., from 17.8 percent to 8.0 percent. In fact, the internal rate of return obtained under the old statute when the property is sold after ten years is greater than the maximum possible under the new statute. To obtain the maximum under the new statute, the taxpayer would have had to hold the property slightly less than ten years.

The effects of the changes upon the highest bracket taxpayer are even greater. The maximum internal rate of return declines from 30.3 percent to 22.2 percent, a drop of 26.7 percent. For the highest

bracket taxpayer to obtain the maximum internal rate of return under the new statute, he previously would have had to hold the property between seven and eight years. The return obtained under the old rules after holding the property for eight years is greater than is possible for the two other tax brackets under the old statute and for all three tax brackets under the new statute.

New Residential Rental Property: The effect upon investment in property which qualifies as new residential rental property is not nearly as great as the effect upon new commercial and industrial property. For this analysis, assume that the "typical" real estate investment is a new apartment building. The internal rates of return from such an investment, if purchased in 1968 and determined at that time, are shown in TABLE VII. If the property were purchased in 1973, the internal rates of return from the investment are shown in TABLE X. Since the only change that affected new residential rental property was a change in depreciation recapture, the maximum internal rate of return obtainable from an investment in this kind of property does not change. The holding periods for which the internal rate of return is affected will be all periods greater than twenty full months and less than sixteen years and eight months. Those holding periods for which a change in the internal rate of return is identifiable are listed in TABLE XI.

The reason there is no change for holding periods of sixteen years and eight months and longer is easily explained. The phaseout of recapture under the new statute is completed within this period. Prior to this, the applicable percentage will be different for all holding periods longer than twenty months.

TABLE X

Post-Tax Reform Act of 1969:
Internal Rate of Return
for New Residential Rental Property
If Sold at the End of the Indicated Holding Period
by Taxpayers with Three Different Marginal Tax Rates
(Assumes same facts as "typical" real estate investment)

Holding Period (Years)	30% Taxpayer	50% Taxpayer	70% Taxpayer
1 (1973)	*	*	*
2	*	*	*
3	*	*	*
4	*	*	*
5	*	*	*
6	*	*	*
7	*	*	13.3%
8	*	3.4%	19.4
9	0.3%	11.3	23.2
10	5.2	15.3	25.7
11	8.2	17.6	27.2
12	10.3	19.2	28.2
13	11.7	20.3	28.9
14	12.8	21.0	29.3
15	13.5	21.6	29.6
16	14.1	21.9	29.8
17	14.6	22.2	30.0
18	14.9	22.4	30.1
19	15.1	22.5	30.1
20	15.3	22.6	30.2
21	15.5	22.7	30.2
22	15.6	22.8	30.3
23	15.7	22.8	30.3
24	15.8	22.9	30.3
25	15.9	22.9	30.3
26	15.9	22.9	30.3
27	16.0	22.9	30.3
28	16.0	23.0	30.3
29	16.0	23.0	30.3
30	16.1	23.0	30.3
31	16.1	23.0	30.3
32	16.1	23.0	30.3
33	16.1	23.0	30.3
34	16.1	23.0	30.3
35	16.1	23.0	30.3
36	16.1	23.0	30.3
37	16.1	23.0	30.3
38	16.1	23.0	30.3
39	16.1	23.0	30.3
40	16.1	23.0	30.3

*The cumulative cash flow after the sale of the investment at the end of these years is negative.

TABLE XI

Pre- and Post-Tax Reform Act of 1969:
Internal Rate of Return
for New Residential Rental Property
If Sold at the End of the Indicated Holding Period
by Taxpayers with Three Different Marginal Tax Rates
(Assumes same facts as "typical" real estate investment)

Holding Period (Years)	30% Taxpayer		50% Taxpayer		70% Taxpayer	
	Pre	Post	Pre	Post	Pre	Post
4	*	*	*	*	*	*
5	*	*	*	*	3.6%	*
6	*	*	*	*	13.7	*
7	*	*	7.2%	*	19.6	13.3%
8	2.1%	*	12.4	3.4%	23.3	19.4
9	5.9	0.3%	15.6	11.3	25.7	23.2
10	8.6	5.2	17.8	15.3	27.2	25.7
11	10.2	8.2	19.1	17.6	28.0	27.2
12	11.4	10.3	20.0	19.2	28.7	28.2
13	12.4	11.7	20.7	20.3	29.1	28.9
14	13.1	12.8	21.3	21.0	29.4	29.3
15	13.7	13.5	21.7	21.6	29.7	29.6
16	14.2	14.1	22.0	21.9	29.9	29.8
17	14.6	14.6	22.2	22.2	30.0	30.0

*The cumulative cash flow after the sale of the investment at the end of these holding periods is negative.

For the taxpayer in the thirty percent bracket, the difference in the internal rates of return is small. Under the old statute the internal rate of return obtained from holding the property for ten years is 8.6 percent. The internal rate of return from holding the property for ten years determined under the new statutes is 5.2 percent. The effect upon the taxpayer in the fifty percent bracket is smaller. If determined under the old statute, the internal rate of return from holding the property for ten years is 17.8 percent. For the same holding period, the internal rate of return determined under the new statute is 15.3 percent. This is a decline of 14.0 percent as compared with a decline of 39.5 percent for a taxpayer in the thirty percent bracket.

The effect upon the taxpayer in the seventy percent tax bracket is the smallest. The internal rate of return declines from a 27.2 percent determined under the old statute to 25.7 percent determined under the new statute. This is a decrease of only 5.5 percent.

Based upon this analysis, the effect of the Tax Reform Act of 1969 upon investment in new residential rental property is small, with the greatest effect in the lower tax brackets. There is no effect if the property is held longer than sixteen years and eight months. In conclusion, while there is some additional incentive for holding on to new residential rental property for a longer period of time, the overall effect appears to be more psychological than actual.

Used Commercial and Industrial Property: One of the reasons advanced for the changes made by the 1969 Act was "to eliminate the repeated sale and resale of property for the purpose of tax minimization."[11] In its attempt to reduce the frequency of resales of used property, Congress made changes in both depreciation policy and depreciation recapture as applied to used property. It is assumed that a "typical" real estate investment is a used warehouse, purchased in 1968; the internal rates of return, determined at that time, for holding the property for up to forty years are as given in TABLE XII. If this investment were made in 1973, the internal rates of return are given in TABLE XIII. The highlights of TABLE XII and XIII are given in TABLE XIV. They will be the basis of discussion in succeeding paragraphs.

For the taxpayer in the thirty percent tax bracket, the differences in the internal rates of return caused by the changes in the

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[11] House, Tax Reform Act of 1969, p. 167.

TABLE XII

Pre-Tax Reform Act of 1969:
Internal Rate of Return
for Used Section 1250 Property
If Sold at the End of the Indicated Holding Period
by Taxpayers with Three Different Marginal Tax Rates
(Assumes same facts as "typical" real estate investment)

Holding Period (Years)	30% Taxpayer	50% Taxpayer	70% Taxpayer
1 (1968)	*	*	*
2	*	*	*
3	*	*	*
4	*	*	*
5	*	*	*
6	*	*	4.9%
7	*	1.0%	9.6
8	*	5.2	13.0
9	2.2%	8.3	15.4
10	4.6	10.5	17.1
11	6.2	12.0	18.3
12	7.5	13.1	19.1
13	8.6	14.0	19.8
14	9.4	14.6	20.3
15	10.1	15.2	20.7
16	10.6	15.6	21.0
17	11.1	16.0	21.3
18	11.4	16.3	21.5
19	11.7	16.5	21.6
20	12.0	16.7	21.7
21	12.2	16.9	21.8
22	12.4	17.0	21.9
23	12.6	17.1	22.0
24	12.7	17.2	22.0
25	12.8	17.2	22.0
26	12.9	17.3	22.1
27	12.9	17.3	22.1
28	13.0	17.4	22.1
29	13.1	17.4	22.1
30	13.1	17.4	22.1
31	13.1	17.4	22.1
32	13.2	17.4	22.1
33	13.2	17.5	22.1
34	13.2	17.5	22.2
35	13.2	17.5	22.2
36	13.2	17.5	22.2
37	13.2	17.5	22.2
38	13.2	17.5	22.2
39	13.2	17.5	22.2
40	13.2	17.5	22.2

*The cumulative cash flow after the sale of the investment at the end of these years is negative.

TABLE XIII

Post-Tax Reform Act of 1969:
Internal Rate of Return
for Used Section 1250 Property
(excluding Used Residential Rental Property)
If Sold at the End of the Indicated Holding Period
by Taxpayers with Three Different Marginal Tax Rates
(Assumes same facts as "typical" real estate investment)

Holding Period (Years)	30% Taxpayer	50% Taxpayer	70% Taxpayer
1 (1973)	*	*	*
2	*	*	*
3	*	*	*
4	*	*	*
5	*	*	*
6	*	*	*
7	*	*	2.9%
8	*	0.6%	5.4
9	*	3.0	7.3
10	1.8%	4.9	8.8
11	3.4	6.4	10.1
12	4.8	7.7	11.2
13	5.8	8.7	12.0
14	6.7	9.5	12.7
15	7.5	10.2	13.3
16	8.1	10.8	13.8
17	8.6	11.2	14.2
18	9.0	11.6	14.5
19	9.4	12.0	14.8
20	9.7	12.2	15.0
21	9.9	12.5	15.2
22	10.2	12.7	15.4
23	10.3	12.8	15.5
24	10.5	13.0	15.6
25	10.6	13.1	15.7
26	10.7	13.2	15.7
27	10.8	13.2	15.8
28	10.9	13.3	15.8
29	11.0	13.3	15.9
30	11.0	13.4	15.9
31	11.1	13.4	15.9
32	11.1	13.4	15.9
33	11.2	13.5	16.0
34	11.2	13.5	16.0
35	11.2	13.5	16.0
36	11.2	13.5	16.0
37	11.2	13.5	16.0
38	11.2	13.5	16.0
39	11.2	13.5	16.0
40	11.2	13.5	16.0

*The cumulative cash flow after the sale of the investment at the end of these years is negative.

TABLE XIV

Pre- and Post-Tax Reform Act of 1969:
Internal Rate of Return
for Used Section 1250 Property
(excluding Used Residential Rental Property)
If Sold at the End of the Indicated Holding Period
by Taxpayers with Three Different Marginal Tax Rates
(Assumes same facts as "typical" real estate investment)

Taxpayer's Tax Bracket	Holding Period	Pre '69 Act	Post '69 Act
30%:	15 years	10.1%	
	17 "	11.1	
	18 "	11.4	
	21 "		9.9%
	22 "		10.2
	33 "	13.2	11.2
50%:	10 years	10.5%	
	12 "	13.1	
	13 "	14.0	
	15 "		10.2%
	16 "		10.8
	40 "	17.5	13.5
70%:	9 years	15.4%	
	10 "	17.1	
	22 "		15.4%
	40 "	22.2	16.0

statute are of some magnitude. The maximum internal rate of return from such an investment declined from 13.2 percent to 11.2 percent—a decrease of 15.1 percent. The taxpayer could obtain the maximum return under the new statute only if he held the property for thirty-three years, whereas, under the old statute, he would have had to hold the property between seventeen and eighteen years. The holding period has to be almost doubled in order to obtain the same internal rate of return from the investment. To further illustrate the changes in holding periods required, assume the taxpayer has as his goal an internal rate of return of ten percent. To obtain this under the old statute, he would have had to hold the property for approximately fifteen years.

The taxpayer would have to own the property almost twenty-two years to obtain this same return under the new statute, thus the holding period required under the new statute is almost one and one-half times as long as that necessary under the old statute.

The changes made were more detrimental to a taxpayer in the fifty percent tax bracket. The maximum internal rate of return from the investment declined from 17.5 percent under the old statute to 13.5 percent under the new statute. This is a decrease of 22.8 percent. For this taxpayer to obtain the maximum return under the new statute, he previously would have had to hold the property approximately twelve and one-half years. To receive the return obtained under the old statute from holding the property for ten years, the taxpayer would, under the new statute, have to hold the property between fifteen and sixteen years. Again, the holding period is lengthened about one and one-half times.

The effect on the taxpayer in the seventy percent tax bracket is greater than that on taxpayers in the two lower brackets. The maximum internal rate of return which he could receive under the old statute was 22.2 percent. Under the new statute, he can receive no greater than 16.0 percent--a decrease of 27.9 percent. The taxpayer would have had to hold the property between nine and ten years under the old statute in order to obtain the maximum rate obtainable under the new statute. To obtain the return determined under the old statute from holding the property nine years, the taxpayer would, under the new statute, have to hold the property for twenty-two years.

In conclusion, the changes made in the statutes which affected used commercial and industrial property have caused a lengthening of the holding period necessary to obtain a stated internal rate of return.

TABLE XV

Post-Tax Reform Act of 1969:
Internal Rate of Return
for Used Residential Rental Property
(With a Depreciable Life Greater than Twenty Years)
If Sold at the End of the Indicated Holding Period
by Taxpayers with Three Different Marginal Tax Rates
(Assumes same facts as "typical" real estate investment)

Holding Period (Years)	30% Taxpayer	50% Taxpayer	70% Taxpayer
1 (1973)	*	*	*
2	*	*	*
3	*	*	*
4	*	*	*
5	*	*	*
6	*	*	*
7	*	*	3.7%
8	*	0.7%	6.9
9	*	3.8	9.3
10	2.1%	6.1	11.3
11	4.0	7.9	12.8
12	5.5	9.3	13.9
13	6.7	10.4	14.9
14	7.6	11.3	15.6
15	8.4	12.0	16.1
16	9.0	12.6	16.6
17	9.5	13.0	16.9
18	9.9	13.4	17.2
19	10.2	13.7	17.4
20	10.5	13.9	17.6
21	10.8	14.1	17.7
22	11.0	14.3	17.9
23	11.1	14.4	18.0
24	11.3	14.5	18.0
25	11.4	14.6	18.1
26	11.5	14.7	18.1
27	11.6	14.8	18.2
28	11.7	14.8	18.2
29	11.7	14.8	18.2
30	11.8	14.9	18.3
31	11.8	14.9	18.3
32	11.9	14.9	18.3
33	11.9	14.9	18.3
34	11.9	14.9	18.3
35	11.9	15.0	18.3
36	11.9	15.0	18.3
37	11.9	15.0	18.3
38	12.0	15.0	18.3
39	12.0	15.0	18.3
40	12.0	15.0	18.3

*The cumulative cash flow after the sale of the investment at the end of these years is negative.

Used Residential Rental Property: The changes affecting used residential rental property are not as significant as those affecting other used property. A "typical" real estate investment of this type would be a used apartment building with a depreciable life of forty years. The internal rates of return to be obtained from the purchase of this investment in 1968 and holding it from one to forty years are given in TABLE XII. Internal rates of return if the purchase were made in 1973 are listed in TABLE XV. TABLE XVI contains selected internal rates of return which will be used in examining the effects caused by the Reform Act.

TABLE XVI

Pre- and Post-Tax Reform Act of 1969:
Internal Rate of Return
for Used Residential Rental Property
(With a Depreciable Life Greater than Twenty Years)
If Sold at the End of the Indicated Holding Period
by Taxpayers with Three Different Marginal Tax Rates
(Assumes same facts as "typical" real estate investment)

Taxpayer's Tax Bracket	Holding Period	Pre '69 Act	Post '69 Act
30%:	15 years	10.1%	
	18 "		9.9%
	19 "		10.2
	20 "	12.0	
	32 "	13.2	
	38 "		12.0
50%:	10 years	10.5%	
	14 "	14.6	
	15 "	15.2	
	33 "	17.5	
	35 "		15.0%
70%:	11 "	18.3%	
	30 "		18.3%
	34 "	22.2	

The changes included in the Tax Reform Act of 1969 affecting used residential rental property have a small effect upon a taxpayer in the thirty percent tax bracket. Under the new provision, the internal rate of return from the investment is 12.0 percent. This is a decrease of 9.1 percent from the return obtainable under the old statute. The new maximum return could have been obtained under the old statute if the property had been held for twenty years. The taxpayer will, therefore, have to hold the property eighteen years longer or almost double the former holding period in order to obtain the same rate of return. If an internal rate of return of ten percent is again used as a goal for the thirty percent taxpayer, this can be attained under the old statute by holding the property for fifteen years. Under the new statute, the same property would have to be held between eighteen and nineteen years. While this is a longer holding period by three or four years, the increase in length is not nearly as great as that for used commercial and industrial property.

The changes made by the Tax Reform Act of 1969 affecting investment in used residential rental property have a greater impact upon the taxpayer in the fifty percent tax bracket. He previously could have obtained the maximum internal rate of return of 17.5 percent by holding the property for thirty-three years. Under the new provisions, he must hold the property for thirty-five years to obtain the maximum internal rate of return of 15.0 percent--a decrease of 14.3 percent. The new maximum return could have been obtained under the old statute if the property had been held between fourteen and fifteen years. Thus, the holding period required to obtain the same return is increased by two and one-half times.

For the taxpayer in the seventy percent tax bracket, the effect was greater than that of the two lower tax bracket taxpayers. The previous maximum (22.2 percent) was obtained by holding the property for thirty-four years. The maximum possible internal rate of return under the new statute obtained by holding the property for thirty years is 18.3 percent--a decrease of 17.6 percent. If the property had been held for eleven years, the internal rate of return determined under the old statute would have been 18.3 percent. Thus, the holding period to obtain this internal rate of return is almost tripled, i.e., from eleven years to thirty years.

Effects of Changes - Different Assumptions

Following analysis of the material in the foregoing part of this chapter, it was decided that additional insights could be obtained if several of the assumptions were varied. Accordingly, the length of the mortgage was shortened to thirty years; the land was considered to be purchased for $100,000 rather than leased; and the equity investment was increased to two hundred thousand dollars. The effects caused alternatively by a higher (9%) and a lower (7%) interest rate will also be examined. Additional analysis will show the effects of reducing the operating ratio from fifty percent to forty percent and of shortening the depreciable life of the new building from forty to thirty-five years. Finally, an analysis of the effects on investment in used real property will be made by assuming a mortgage length of twenty-five years and a depreciable life of twenty-five years.

New Commercial and Industrial Property: All examples involving the purchase of new real estate will assume a thirty year mortgage. If, under

TABLE XVII

Pre '69 Act: Internal Rate of Return
for New Section 1250 Property
Sold at the End of the Year Indicated
by Taxpayers with Three Different Marginal Tax Rates
(Assumes facts of "typical" investment with a 30 year Mortgage)

Holding Period	30% Taxpayer	50% Taxpayer	70% Taxpayer
1 (1968)	*	*	*
2	*	*	*
3	*	*	*
4	*	*	*
5	*	*	*
6	*	*	2.0%
7	*	*	9.8
8	*	*	14.5
9	*	5.2%	17.5
10	*	8.4	19.5
11	*	10.0	20.5
12	0.7%	11.2	21.2
13	2.0	12.1	21.8
14	3.1	12.8	22.2
15	3.9	13.4	22.5
16	4.6	13.8	22.7
17	5.1	14.1	22.8
18	5.5	14.3	22.9
19	5.8	14.4	23.0
20	6.0	14.5	23.1
21	6.2	14.6	23.1
22	6.3	14.6	23.1
23	6.3	14.7	23.1
24	6.3	14.6	23.1
25	6.3	14.6	23.1
26	6.2	14.6	23.1
27	6.2	14.6	23.1
28	6.3	14.6	23.1
29	6.4	14.5	23.1
30	6.4	14.5	23.1
31	7.7	14.6	23.1
32	8.5	14.7	23.1
33	9.0	14.8	23.1
34	9.3	14.9	23.1
35	9.6	14.9	23.1
36	9.9	15.0	23.1
37	10.1	15.0	23.1
38	10.2	15.0	23.1
39	10.4	15.1	23.1
40	10.5	15.1	23.1

*The cumulative cash flow after the sale of the investment at the end of these years is negative.

these assumptions, the investor purchased a new office building in 1968, the rates of return which would be generated are shown in TABLE XVII. The rates of return generated with a thirty year mortgage are compared for selected periods with the returns from an identical investment financed with a forty year mortgage in TABLE XVIII.

TABLE XVIII

Pre '69 Act:
Selected Internal Rates of Return
for Comparing Effects of Different
Mortgage Terms Upon New Section 1250 Property

Taxpayer's Tax Bracket	Holding Period	TABLE VII (40 yr. M.)	TABLE XVII (30 yr. M.)
30%:	11 years	10.2%	*
	12 "	11.4	
	30 "	16.1	
	40 "		10.5%
50%:	8 years	12.4%	
	9 "	15.6	
	27 "	22.9	
	39 "		15.1%
70%:	7 years	19.6%	
	8 "	23.3	
	20 "		23.1%
	22 "	30.3	

*The cumulative cash flow after the sale of the investment at the end of this year is negative.

Based upon the rates of return generated from a typical real estate investment, it appears more advantageous to obtain a mortgage for forty years rather than for thirty years. The rates of return shown in the tables also support the contention of the interviewees that financing arrangements are very important. As a result of the

change in mortgage terms, the maximum internal rate of return, for a taxpayer with a marginal tax rate of thirty percent, declines from 16.1 percent to 10.5 percent. If, with a forty year mortgage, the property had been sold at the end of eleven years, the internal rate of return from the investment would be 10.2 percent. With a thirty year mortgage and a sale at the end of eleven years, the investor would not have recovered his equity investment. In addition, if the taxpayer is to obtain the maximum return with a thirty year mortgage, he would have to hold the property for forty years; whereas to obtain the same return with a forty year mortgage, he would have to hold the property slightly in excess of eleven years.

The effects of the change in mortgage terms are slightly greater in the case of a taxpayer with a marginal tax rate of fifty percent. The maximum internal rate of return declines from 22.9 percent to 15.1 percent. To obtain the maximum return with a thirty year mortgage, the taxpayer would have to hold the property for thirty-nine years; whereas to obtain the same return with a forty year mortgage, the taxpayer would have to hold the property between eight and nine years. With the forty year mortgage, the maximum return is obtained if the property is sold after holding it for twenty-seven years.

The effects of the change in mortgage terms upon the taxpayer in the seventy percent tax bracket are about the same as those in the case of the fifty percent taxpayer. With a forty year mortgage, the maximum return (30.3 percent) is obtained by holding the property for twenty-two years. With a thirty year mortgage the maximum return (23.1 percent) is obtained by holding the property for twenty years. To obtain this return with a forty year mortgage, the property would

only have to be held for between seven and eight years.

For all remaining examples involving the purchase of either new or used real property, it will be assumed that land is purchased at a cost of one-hundred thousand dollars. The equity investment of the investor is accordingly increased to two-hundred thousand dollars. The assumptions now comprising the typical real estate investment ($200,000 equity investment, thirty year mortgage, and all other assumptions remaining the same) shall be hereafter referred to as the modified typical real estate investment.

For this analysis, assume that the typical real estate investment is a new office building. The internal rates of return from such an investment, if purchased in 1968 and determined at that time, are shown in TABLE XIX. If the property were purchased in 1973, the internal rates of return from the investment are shown in TABLE XX. The differences in the internal rates of return are caused by the changes in the 1969 Tax Reform Act with respect to depreciation policy and depreciation recapture.

The internal rates of return given in Tables XIX and XX for certain holding periods appear in TABLE XXI; which provides the data on which the following discussion is based.

For the taxpayer in the thirty percent bracket, the difference in the internal rates of return is small. Under the old statute the internal rate of return obtained from holding the property for forty years is 5.3 percent. The internal rate of return from holding the property for forty years determined under the new statute is 4.9 percent. The effect upon the taxpayer in the fifty percent bracket is greater. If determined under the old statute, the internal rate of

TABLE XIX

Pre '69 Act: Internal Rate of Return
for New Section 1250 Property
Sold at the End of the Year Indicated
by Taxpayers with Three Different Marginal Tax Returns
(Assumes facts of modified "typical" real estate investment)

Holding Period	30% Taxpayer	50% Taxpayer	70% Taxpayer
1 (1968)	*	*	*
2	*	*	*
3	*	*	*
4	*	*	*
5	*	*	*
6	*	*	*
7	*	*	*
8	*	*	*
9	*	*	*
10	*	*	*
11	*	*	*
12	*	*	*
13	*	*	*
14	*	*	*
15	*	*	*
16	*	*	*
17	*	*	*
18	*	*	*
19	*	*	*
20	*	*	*
21	*	*	*
22	*	*	*
23	*	*	*
24	*	*	*
25	*	*	*
26	*	*	*
27	*	*	*
28	*	*	*
29	*	*	*
30	*	*	*
31	0.6%	0.6%	0.6%
32	1.9	1.9	1.8
33	2.8	2.7	2.6
34	3.4	3.3	3.1
35	3.9	3.8	3.6
36	4.3	4.1	3.9
37	4.6	4.5	4.2
38	4.8	4.7	4.4
39	5.1	4.9	4.6
40	5.3	5.1	4.8

*The cumulative cash flow after the sale of the investment at the end of these years is negative.

TABLE XX

Post '69 Act: Internal Rate of Return
for New Commercial and Industrial Property
Sold at the End of the Year Indicated
by Taxpayers with Three Different Marginal Tax Rates
(Assumes facts of modified "typical" real estate investment)

Holding Period	30% Taxpayer	50% Taxpayer	70% Taxpayer
1 (1973)	*	*	*
2	*	*	*
3	*	*	*
4	*	*	*
5	*	*	*
6	*	*	*
7	*	*	*
8	*	*	*
9	*	*	*
10	*	*	*
11	*	*	*
12	*	*	*
13	*	*	*
14	*	*	*
15	*	*	*
16	*	*	*
17	*	*	*
18	*	*	*
19	*	*	*
20	*	*	*
21	*	*	*
22	*	*	*
23	*	*	*
24	*	*	*
25	*	*	*
26	*	*	*
27	*	*	*
28	*	*	*
29	*	*	*
30	*	*	*
31	0.5%	0.4%	0.3%
32	1.7	1.4	1.0
33	2.4	2.1	1.5
34	3.0	2.6	1.9
35	3.5	3.0	2.3
36	3.9	3.4	2.6
37	4.2	3.7	2.8
38	4.5	3.9	3.0
39	4.7	4.1	3.2
40	4.9	4.3	3.4

*The cumulative cash flow after the sale of the investment at the end of these years is negative.

TABLE XXI

Pre- and Post-Tax Reform Act of 1969:
Internal Rate of Return
for New Commercial and Industrial Property
If Sold at the End of the Indicated Holding Period
by Taxpayers with Three Different Marginal Tax Rates
(Assumes facts of modified "typical" real estate investment)

Holding Period (Years)	30% Taxpayer		50% Taxpayer		70% Taxpayer	
	Pre	Post	Pre	Post	Pre	Post
30	*	*	*	*	*	*
31	0.6%	0.5%	0.6%	0.4%	0.6%	0.3%
32	1.9	1.7	1.9	1.4	1.8	1.0
33	2.8	2.4	2.7	2.1	2.6	1.5
34	3.4	3.0	3.3	2.6	3.1	1.9
35	3.9	3.5	3.8	3.0	3.6	2.3
36	4.3	3.9	4.1	3.4	3.9	2.6
37	4.6	4.2	4.5	3.7	4.2	2.8
38	4.8	4.5	4.7	3.9	4.4	3.0
39	5.1	4.7	4.9	4.1	4.6	3.2
40	5.3	4.9	5.1	4.3	4.8	3.4

*The cumulative cash flow after the sale of the investment at the end of these holding periods is negative.

return from holding the property for forty years is 5.1 percent. For the same holding period, the internal rate of return determined under the new statute is 4.3 percent. The decline in the internal rate of return for the taxpayer in the fifty percent tax bracket is about sixteen percent; whereas, the decline for the taxpayer in the thirty percent tax bracket is about eight percent. The effect upon the taxpayer in the seventy percent tax bracket is greater. The internal rate of return declines from a 4.8 percent determined under the old statute to 3.4 percent determined under the new statute. This is a decrease of twenty-nine percent.

Based upon this analysis, the effect of the Tax Reform Act of 1969 upon investment in new commercial and industrial property is

small, with the greatest effect in the upper tax brackets. Under the previously employed set of facts, the overall effect was small, but the effect was greatest upon those in the lower tax brackets. Since the mortgage is for thirty years, the money normally utilized to pay off the mortgage becomes available to the investor during the last ten years of the project. This large increase in cash flow is the primary reason why the rate of return becomes positive after holding the property for thirty-one years.

In the previous section describing the effect of the changes in depreciation and depreciation recapture upon new residential rental property, it was explained that these changes would only affect holding periods of from twenty to two hundred months. Since the rate of return does not become positive until after the property has been held for thirty-one years, the changes will have no effect upon the rate of return, assuming that the modified typical real estate investment is an apartment complex.

New Low-Income Housing: In this section three of the assumptions comprising the modified typical real estate investment will be varied. Their effect upon an investment in low-income housing will be examined. The purpose is to attempt to provide additional information about the relative importance of certain factors. Assumptions to be varied are the interest rate, the operating ratio, and the depreciable life of the building.

Two additional interest rates will be used to illustrate the effect the interest rate can have upon an investment in low-income housing. It is assumed that the modified typical real estate investment is a low-income housing project purchased in 1973 and financed

with a nine percent mortgage. The internal rates of return generated by the investment for forty holding periods are shown in TABLE XXII. The rates of return from an identical investment financed with a seven percent mortgage and purchased in 1973 are shown in TABLE XXIII. TABLE XXIV contains the rates of return for selected holding periods for the three different interest rates. These data form the basis for the following discussion.

As would be expected, the rate of return from the investment is greatest with a seven percent mortgage. The degree of difference in the rates of return varies among the three tax brackets. For discussion purposes the return of taxpayers in only the thirty and seventy percent tax brackets have been shown in TABLE XXIV.

For the taxpayer in the thirty percent tax bracket, the investment, when financed with a seven percent mortgage, provides a positive return if sold after fifteen years. It obtains a maximum return of 7.4 percent if the property is sold after forty years. With an eight percent mortgage, the investment provides a positive return after holding it for thirty-one years and attains a maximum return of 5.3 percent after holding it for forty years. With a nine percent mortgage, the investment provides a thirty percent bracket taxpayer with a positive return if sold after thirty-four years. The maximum internal rate of return of 3.4 percent is attained if property is sold after forty years. Based upon these assumptions, an increase in the interest rate of from seven to eight percent decreases the maximum return from 7.4 percent to 5.3 percent. A further increase in the interest rate to nine percent reduces the maximum return to 3.4 percent. This further increase in the interest rate causes the return to

TABLE XXII

Post '69 Act: Internal Rate of Return
for New Low-Income Housing
Sold at the End of the Year Indicated
by Taxpayers with Three Different Marginal Tax Rates
(Assumes 9% Mortgage and other facts of modified "typical"
real estate investment)

Holding Period	30% Taxpayer	50% Taxpayer	70% Taxpayer
1 (1973)	*	*	*
2	*	*	*
3	*	*	*
4	*	*	*
5	*	*	*
6	*	*	*
7	*	*	*
8	*	*	*
9	*	*	*
10	*	*	*
11	*	*	*
12	*	*	*
13	*	*	*
14	*	*	*
15	*	*	*
16	*	*	*
17	*	*	*
18	*	*	*
19	*	*	*
20	*	*	*
21	*	*	*
22	*	*	*
23	*	*	*
24	*	*	*
25	*	*	*
26	*	*	*
27	*	*	*
28	*	*	*
29	*	*	*
30	*	*	*
31	*	*	*
32	*	*	*
33	*	*	*
34	0.6%	0.6%	0.5%
35	1.3	1.3	1.1
36	1.9	1.9	1.8
37	2.4	2.4	2.3
38	2.8	2.7	2.6
39	3.1	3.1	3.0
40	3.4	3.3	3.2

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*The cumulative cash flow after the sale of the investment at the end of these years is negative.

TABLE XXIII

Post '69 Act: Internal Rate of Return
for New Low-Income Housing
Sold at the End of the Year Indicated
by Taxpayers with Three Different Marginal Tax Rates
(Assumes 7% Mortgage and other facts of modified "typical"
real estate investment)

Holding Period	30% Taxpayer	50% Taxpayer	70% Taxpayer
1 (1973)	*	*	*
2	*	*	*
3	*	*	*
4	*	*	*
5	*	*	*
6	*	*	*
7	*	*	*
8	*	*	*
9	*	*	*
10	*	*	0.9%
11	*	*	1.9
12	*	*	2.6
13	*	0.4%	3.2
14	*	1.1	3.6
15	0.2%	1.7	4.0
16	0.9	2.1	4.2
17	1.4	2.5	4.4
18	1.9	2.8	4.5
19	2.2	3.0	4.5
20	2.5	3.1	4.5
21	2.8	3.2	4.3
22	3.0	3.3	4.0
23	3.2	3.4	3.7
24	3.5	3.6	3.9
25	3.7	3.8	4.0
26	3.9	3.9	4.1
27	4.0	4.1	4.1
28	4.2	4.1	4.1
29	4.3	4.2	4.0
30	4.4	4.2	3.9
31	5.1	4.8	4.4
32	5.6	5.3	4.8
33	6.0	5.7	5.1
34	6.3	6.0	5.3
35	6.6	6.2	5.5
36	6.8	6.4	5.7
37	7.0	6.6	5.9
38	7.1	6.8	6.0
39	7.3	6.9	6.1
40	7.4	7.0	6.3

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*The cumulative cash flow after the sale of the investment at the end of these years is negative.

TABLE XXIV

Post '69 Act:
Selected Internal Rates of Return
for Comparing Effects of Different
Interest Rates Upon Investment in Low-Income Housing

Holding Period (Years)	30% Taxpayer 7%**	30% Taxpayer 8%#	30% Taxpayer 9%##	70% Taxpayer 7%**	70% Taxpayer 8%#	70% Taxpayer 9%##
9	*	*	*	*	*	*
10	*	*	*	0.9%	*	*
11	*	*	*	1.9	*	*
12	*	*	*	2.6	*	*
13	*	*	*	3.2	*	*
14	*	*	*	3.6	*	*
15	0.2%	*	*	4.0	*	*
30	4.4	*	*	3.9	*	*
31	5.1	0.6%	*	4.4	0.6%	*
32	5.6	1.9	*	4.8	1.8	*
33	6.0	2.8	*	5.1	2.6	*
34	6.3	3.4	0.6%	5.3	3.1	0.5%
35	6.6	3.9	1.3	5.5	3.6	1.1
36	6.8	4.3	1.9	5.7	3.9	1.8
37	7.0	4.6	2.4	5.9	4.2	2.3
38	7.1	4.8	2.8	6.0	4.4	2.6
39	7.3	5.1	3.1	6.1	4.6	3.0
40	7.4	5.3	3.4	6.3	4.8	3.2

*The cumulative cash flow after the sale of the investment at the end of these years is negative.

**From TABLE XXIII

#From TABLE XIX

##From TABLE XXII

be less than half that obtainable with a seven percent mortgage.

The differences in the maximum internal rate of return obtainable by a seventy percent taxpayer caused by the three interest rates are not as great. The investment, when financed with a seven percent mortgage, provides the seventy percent taxpayer with a small return if it is sold after ten years. If the property is sold after holding it for forty years, the investment provides a maximum return of 6.3 percent. With an eight percent mortgage, the investment does not provide a positive return until the property is held for at least thirty-one years. The maximum return (4.8 percent) is obtained by holding the property for forty years. When the investment is financed with a nine percent mortgage, a positive return is not obtained until the property has been held for thirty-four years. The maximum return of 3.2 percent is obtained if the property is sold after forty years. An increase in the interest rate from seven percent to eight percent to nine percent causes the maximum internal rate of return obtainable by a seventy percent taxpayer to be reduced from 6.3 percent to 4.8 percent to 3.2 percent, respectively. Thus, an increase in the interest rate from seven percent to nine percent causes the return to be reduced by almost one-half.

For this analysis it is assumed that the modified typical real estate investment is a low-income apartment complex purchased in 1973 and financed with an eight percent mortgage. The operating ratio will be reduced from fifty to forty percent. In addition, the depreciable life of the building will be reduced to thirty-five years. The effects to the internal rate of return caused by these changes will be examined for each change separately and for the effects on the return

if both changes are combined in one example. The rates of return from the assumed investment with an operating ratio of forty percent are shown in TABLE XXV. The return from the investment when a depreciable life of thirty-five years is utilized is shown in TABLE XXVI. TAVLE XXVII contains the rates of return obtained from the assumed investment when an operating ratio of forty percent and a depreciable life of thirty-five years are utilized. The highlights of TABLES XIX, XXV, XXVI, and XXVII are given in TABLE XXVIII. They will be the basis of discussion in succeeding paragraphs.

To the taxpayer in the thirty percent tax bracket, the effects caused by shortening the depreciable life from forty years to thirty-five years are small. The maximum return obtainable from the investment is only increased from 5.3 percent to 5.6 percent. For the taxpayer in the seventy percent tax bracket, the effect is greater. The maximum return obtainable by a seventy percent taxpayer is increased from 4.8 percent to 6.6 percent. The investment does not provide a positive return to either taxpayer until it is held for thirty-one years. It should also be noted that the shortening of the depreciable life causes the maximum return to be greater to the seventy percent taxpayer. Previously, the maximum return was greater for the thirty percent taxpayer.

The effect of the reduction in the operating ratio from fifty percent to forty percent upon a thirty percent taxpayer is significant. The change causes a positive return to be provided if the property is sold after nine years. The maximum return is more than doubled as a result of the change. For the taxpayer in the seventy percent tax bracket, the effect caused by the change is of the same magnitude. The

TABLE XXV

Post '69 Act: Internal Rate of Return
for New Low-Income Housing
Sold at the End of the Year Indicated
by Taxpayers with Three Different Marginal Tax Rates
(Assumes 40% operating ratio and other facts of modified
"typical" real estate investment)

Holding Period	30% Taxpayer	50% Taxpayer	70% Taxpayer
1	*	*	*
2	*	*	*
3	*	*	*
4	*	*	*
5	*	*	*
6	*	*	*
7	*	*	*
8	*	*	0.3%
9	0.5%	1.5%	3.2
10	2.6	3.6	5.1
11	4.1	4.8	6.1
12	5.2	5.8	6.9
13	6.1	6.6	7.5
14	6.8	7.2	8.0
15	7.4	7.7	8.4
16	7.9	8.2	8.7
17	8.2	8.5	8.9
18	8.6	8.7	9.1
19	8.8	9.0	9.2
20	9.0	9.1	9.3
21	9.2	9.2	9.3
22	9.4	9.3	9.3
23	9.5	9.4	9.3
24	9.6	9.4	9.2
25	9.7	9.5	9.3
26	9.8	9.6	9.3
27	9.8	9.6	9.3
28	9.9	9.7	9.3
29	9.9	9.7	9.3
30	10.0	9.7	9.2
31	10.2	9.8	9.3
32	10.4	10.0	9.4
33	10.5	10.1	9.4
34	10.6	10.2	9.5
35	10.7	10.3	9.6
36	10.8	10.4	9.6
37	10.9	10.5	9.7
38	11.0	10.5	9.7
39	11.0	10.6	9.8
40	11.1	10.6	9.8

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*The cumulative cash flow after the sale of the investment at the end of these years is negative.

TABLE XXVI

Post '69 Act: Internal Rate of Return
for New Low-Income Housing
Sold at the End of the Year Indicated
by Taxpayers with Three Different Marginal Tax Rates
(Assumes 35 year depreciable life and other facts of modified "typical" real estate investment)

Holding Period	30% Taxpayer	50% Taxpayer	70% Taxpayer
1	*	*	*
2	*	*	*
3	*	*	*
4	*	*	*
5	*	*	*
6	*	*	*
7	*	*	*
8	*	*	*
9	*	*	*
10	*	*	1.0%
11	*	*	2.0
12	*	*	2.8
13	*	*	3.5
14	*	*	4.0
15	*	*	4.4
16	*	*	4.7
17	*	*	4.9
18	*	*	5.0
19	*	*	5.0
20	*	*	4.9
21	*	*	4.7
22	*	*	4.4
23	*	*	3.9
24	*	*	*
25	*	*	*
26	*	*	*
27	*	*	*
28	*	*	*
29	*	*	*
30	*	*	*
31	0.7%	0.9%	2.3
32	2.1	2.5	3.9
33	3.0	3.4	4.7
34	3.7	4.0	5.2
35	4.2	4.5	5.6
36	4.6	4.9	5.9
37	4.9	5.2	6.1
38	5.2	5.5	6.3
39	5.4	5.7	6.5
40	5.6	5.9	6.6

*The cumulative cash flow after the sale of the investment at the end of these years is negative.

TABLE XXVII

Post '69 Act: Internal Rate of Return
for New Low-Income Housing
Sold at the End of the Year Indicated
by Taxpayers with Three Different Marginal Tax Rates
(Assumes 40% operating ratio, a 35 year depreciable life, and
other facts of modified "typical" real estate investment)

Holding Period	30% Taxpayer	50% Taxpayer	70% Taxpayer
1	*	*	*
2	*	*	*
3	*	*	*
4	*	*	*
5	*	*	*
6	*	*	*
7	*	*	*
8	*	0.2%	3.0%
9	1.3%	3.0	5.6
10	3.5	5.1	7.5
11	4.9	6.4	8.5
12	6.0	7.4	9.3
13	6.9	8.2	10.0
14	7.6	8.8	10.5
15	8.2	9.3	10.9
16	8.7	9.7	11.2
17	9.0	10.0	11.4
18	9.3	10.3	11.6
19	9.6	10.5	11.7
20	9.8	10.6	11.8
21	10.0	10.8	11.9
22	10.1	10.9	11.9
23	10.2	10.9	11.9
24	10.3	11.0	11.9
25	10.4	11.0	11.9
26	10.5	11.0	11.9
27	10.6	11.1	11.9
28	10.6	11.1	11.9
29	10.7	11.1	11.9
30	10.7	11.1	11.9
31	10.9	11.3	11.9
32	11.0	11.4	12.0
33	11.2	11.5	12.0
34	11.3	11.6	12.0
35	11.4	11.6	12.1
36	11.5	11.7	12.1
37	11.5	11.8	12.1
38	11.6	11.8	12.2
39	11.6	11.9	12.2
40	11.7	11.9	12.2

*The cumulative cash flow after the sale of the investment at the end of these years is negative.

TABLE XXVIII

Selected Internal Rates of Return for Comparing Effects of Lower Operating Ratios and Shorter Depreciable Lives Upon Investment in Low-Income Housing

Holding Period (Years)	30% Taxpayer				70% Taxpayer			
	Table XIX[1]	35 yr. DL[2]	40% OR[3]	35 & 40[4]	Table XIX[1]	35 yr. DL[2]	40% OR[3]	35 & 40[4]
7	*	*	*	*	*	*	*	*
8	*	*	*	*	*	*	0.3%	3.0%
9	*	*	0.5%	1.3%	*	*	3.2	5.6
10	*	*	2.6	3.5	*	*	5.1	7.5
18	*	*	8.6	9.3	*	*	9.1	11.6
23	*	*	9.5	10.2	*	*	9.3	11.9
24	*	*	9.6	10.3	*	*	9.2	11.9
30	*	*	10.0	10.7	*	*	9.2	11.9
31	0.6%	0.7%	10.2	10.9	0.6%	2.3%	9.3	11.9
33	2.8	3.0	10.5	11.2	2.6	4.7	9.4	12.0
35	3.9	4.2	10.7	11.4	3.6	5.6	9.6	12.1
37	4.6	4.9	10.9	11.5	4.2	6.1	9.7	12.1
39	5.1	5.4	11.0	11.6	4.6	6.5	9.8	12.2
40	5.3	5.6	11.1	11.7	4.8	6.6	9.8	12.2

*The cumulative cash flow after the sale of the investment at the end of these years is negative.

[1]The modified typical real estate investment with no changes.

[2]The modified typical real estate investment with a 35 yr. depreciable life (TABLE XXVI).

[3]The modified typical real estate investment with a 40% operating ratio (TABLE XXV).

[4]The modified typical real estate investment with a 35 yr. depreciable life and a 40% operating ratio (TABLE XXVII).

investment provides a positive return if sold at the end of eight years. The maximum return is increased to 9.8 percent. This is more than double the return obtainable with a fifty percent operating ratio. The return obtainable by a thirty percent taxpayer remains greater than that obtainable by a taxpayer in the seventy percent tax bracket.

When both the forty percent operating ratio and the thirty-five year depreciable life are combined in one example, the effect is greatest upon the highest tax brackets. For the taxpayer in the seventy percent tax bracket, the investment provides a positive return if it is sold after eight years. The maximum return from the investment of 12.2 percent is obtained if the property is held for forty years. For the taxpayer in the thirty percent tax bracket, the investment provides a positive return if it is sold after nine years. The maximum return of 11.7 percent is obtained if the property is sold after forty years. As a result of both changes, the taxpayer in the seventy percent tax bracket obtains a greater return than does the taxpayer in the thirty percent tax bracket.

Based upon these low-income housing examples, it appears that a reduction in the operating ratio from fifty percent to forty percent is more effective in increasing the profitability of an investment in low-income housing than a shortening of the depreciable life from forty years to thirty-five years and a decrease in the interest rate from eight percent to seven percent. This applies to taxpayers in all tax brackets. For the taxpayer in the thirty percent tax bracket, a decrease in the interest rate from eight to seven percent is more effective in increasing the return from an investment in low-income housing than a shortening of the depreciable life by five years to thirty-five

years. This does not hold true, however, for the seventy percent taxpayer. The shortening of the depreciable life causes the investment to provide a greater maximum return than does the interest rate decrease. Finally, it should be noted that the shortening of the depreciable life causes the investment to provide a greater return to the upper bracket taxpayers; whereas, the reduction in the operating ratio and the decrease in the interest rate cause the investment to remain more profitable to investors in the lower tax brackets.

Used Real Property: Two of the assumptions were changed for investment in used property. It was assumed that the typical real estate investment was a used building financed with an eight percent, twenty-five year mortgage. The depreciable life of the building was shortened to twenty-five years. Analyses were made of the effects of the changes in depreciation and depreciation recapture upon investment in used property. Under this fact situation, the rate of return for an investment made in 1968 and determined at that time was negative for all holding periods from one year to twenty-five years. The rate of return was also negative when the effects of the changes in depreciation and depreciation recapture were considered. Since all of the rates of return were negative, no further analysis is attempted to determine the effect of the changes in depreciation and depreciation recapture upon used real property.

Rehabilitation Expenditures

Both the Douglas and Kaiser Commission Reports emphasized the tendency of then existing tax incentives to encourage turnover in older properties in order to take advantage of repeated allowances of 150

percent declining balance depreciation. This tendency allegedly acted as a disincentive to proper maintenance and upkeep.[12] In an attempt to encourage rehabilitation of buildings for low-cost rental housing, the House Ways and Means Committee and the Senate Finance Committee inserted a provision in the Tax Reform Act providing an incentive for the rehabilitation of buildings for occupancy by low-income tenants. The Finance Committee noted that:

> . . . the present tax provisions provide no special incentive for improvements or remodeling of existing housing. In fact, the requirement of capitalization of costs of this nature, and tax recovery over an extended period, to some extent discourages such activity. This misallocation is especially unfortunate since it appears that remodeling of low-income projects faces special difficulties in obtaining conventional financing.[13]

The new provision (section 167(k) of the Internal Revenue Code) permits a taxpayer to elect with respect to "rehabilitation expenditures" incurred for low-income rental housing after July 24, 1969 and before 1975, to depreciate the same under the straight-line method, using a useful life of sixty months and no salvage value. This method may be used in lieu of any other write-off being treated as accelerated depreciation.

To qualify as a "rehabilitation expenditure" the expenditures must total $3,000 per dwelling unit over a period of two consecutive years. In addition, no more than $15,000 per dwelling unit can qualify. These limits are designed to assure that the rehabilitation is a substantial one, not just a painting and general fix-up. The ceiling is

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[12]House, Building the American City (Douglas Commission Report), pp. 403-04; Committee on Urban Housing, A Decent Home, pp. 99-100.

[13]Senate, Tax Reform Act of 1969, p. 213.

intended to deny the benefit beyond the amount needed for adequate rehabilitation. Both limits are based on the general experience of the Federal Housing Administration with respect to costs of rehabilitation.[14] To illustrate, assume a situation where, with respect to one dwelling unit, the taxpayer makes rehabilitation expenditures of $500 in 1970, $1,700 in 1971, and $17,000 in 1972. No election will be available to the taxpayer in 1970. Neither would the election be available in 1971, because the total for 1970 and 1971 is only $2,200. However, the election would be available in 1972 for both 1972 and 1971. In 1972, both the $1,700 spent in 1971 and $13,300 of the $17,000 spent in 1972 would be eligible for the special election. The remainder of the 1972 expenditures ($3,700) would be capitalized and written off over the remaining life of the building. It is assumed that the taxpayer is able to file an amended return for 1971 claiming the special election for the $1,700.

The term "rehabilitation expenditures" is defined as the amounts chargeable to capital account and incurred for property or additions or improvements to property with a useful life of five years or more, in connection with the rehabilitation of an existing building for low-income rental housing. This term does not include the cost of acquisition of the building or any interest therein. If any expenditure does not qualify because the $3,000 test is not met or because more than $15,000 is spent on any one unit, the disallowed amount is added to the taxpayer's basis in the dwelling unit.

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[14] Supra., Committee on Urban Housing, A Decent Home, p. 101, indicating an average range of rehabilitation costs of from $4,173 to $13,636 in various regions of the nation.

The term "low-income rental housing" is defined as any building in which the dwelling units are held for occupancy on a rental basis by families and individuals of low- or moderate-income. The determination of what constitutes low- or moderate-income is to be made in a manner consistent with policies of the Housing and Urban Development Act of 1968.

A report prepared by the staff of the Joint Committee on Internal Revenue Taxation estimated that the rehabilitation incentive would cost the Treasury over $400 million during its initial five year term. In addition, if retained in the law after 1974, it was estimated that the incentive would result in annual revenue losses of some $330 million per year.[15] By comparison, the President recommended a rehabilitation loan fund of $84 million for fiscal 1970,[16] $50 million for fiscal 1971,[17] and $50 million for the first half of fiscal 1972.[18] Thus, the new provision is apparently to become a major instrument of government policy designed to preserve existing housing and to increase the housing available to persons of low- and moderate-income.

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[15]U.S., Congress, Senate, Finance Committee, Revenue Estimates Relating to the House, Senate, and Conference Versions on H.R. 13270 - Tax Reform Act of 1969, Prepared for the Use of the Senate Committee on Finance and the House Committee on Ways and Means by the Staff of the Joint Committee on Internal Revenue Taxation, 91st Congress, 1st session, 1969.

[16]The Budget of the United States Government, (Fiscal 1970), p. 312.

[17]The Budget of the United States Government, (Fiscal 1971), p. 336.

[18]The Budget of the United States Government, (Fiscal 1972), p. 334.

Tax Free Sales of Federally Assisted Housing

The Tax Reform Act of 1969 added a new section to the Internal Revenue Code (Section 1039). This section creates new rules for certain sales of low-income housing projects. The complete text of section 1039 begins on page 201 of Appendix C.

In general, the new provision follows the approach of the Internal Revenue Code provision (Section 1033) which defers gain on an involuntary conversion to the extent the taxpayer makes a timely reinvestment in replacement property.[19] The new provision is complex and very technical, a fact which may inhibit its practical application. In summary, the new section provides that:

> If a qualified housing project is disposed of, after October 9, 1969, in an approved disposition, and if, within the reinvestment period, the seller constructs or acquires another qualified housing project, then, if the seller so elects (as prescribed by Regulation), gain from the approved disposition will be recognized only to the extent that the net amount realized exceeds the cost of the replacement qualified housing project.[20]

Four key terms appearing in the above quotation require definition.

The term "qualified housing project" means a project to provide rental or co-operative housing for low-income families, the mortgage on which is insured under Sections 221(d)(3) and 236 of the National Housing Act.[21] Under these programs, the owner is limited as to the

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[19]Supra., page 25 in Chapter II for a more complete explanation of the provision affecting involuntary conversions.

[20]John J. Sexton, "Working with the new tax deferral provision on low-income housing," Journal of Taxation, XXXII (June, 1970), pp. 370-373.

[21]Supra., notes 33 and 34, p. 14.

rate of return on investment in the project and is limited with respect to rentals or occupancy charges for units in the project. The term "approved disposition" means a disposition to tenants or occupants, or to a co-operative or other non-profit organization for the benefit of such tenants or occupants. The disposition must be approved by the Secretary of the Department of Housing and Urban Development under Sections 221(d)(3) or 236 of the National Housing Act. The "reinvestment period" is the period beginning one year before the date of the approved disposition and ending one year after the close of the first taxable year in which any part of the gain from the approved disposition is realized. Finally, "net amount realized" is the amount realized reduced by expenses directly connected with the approved disposition and by the amount of taxes (other than income taxes) attributable to the approved disposition.

The main purpose of the new provision is to encourage sales of low-income housing projects to the occupants of the projects. The Kaiser Commission Report had recommended the deferral of taxable gain on sale of low-income housing projects to occupants as a means of encouraging such sales, reducing the price which the occupants would have to pay, and encouraging investment in such projects by increasing the net effective yield. Under the Housing and Urban Development Act of 1968, the amount received by the owner upon sale of a qualified housing project cannot exceed his original equity investment plus an amount equal to the capital gains and recapture taxes and the outstanding mortgage. This control was intended to permit the tenants of a project to purchase the investment from the original owners at a price which did not give the owner a profit beyond that attributable to the rents

which had been collected. It was believed that the deferral of tax on the sale of a qualified housing project would further encourage sales to tenant and co-operative groups.[22]

The effectiveness of the new provision depends upon whether the tax advantages offered under the new provision outweigh the disadvantages. For purposes of determining the holding period for the recapture rules, the period the new property is considered to be held includes the holding period of the property sold to the tenant group. The taxpayer does not have to include the gain normally recognized from such a sale in his taxable income; it may be deferred to some future date. Furthermore, there is always the possibility of ultimately passing the property at death without the gain ever being taxed. Moreover, the tax saving may result in a lower sales price which the tenant group would be more likely to be able to afford.

The principal disadvantage of the new provision is the lower basis for depreciation on the new project. If the owner can sell the original property for the maximum sales price the Federal Housing Administration allows, he probably will not elect to sell to a tenant group. If the property is sold at a gain, the seller must pay the federal income taxes on the gain, and those taxes can be included in the determination of the maximum sales price as set by the Federal Housing Administration. The buyer thus pays the federal income taxes on the sale. If the seller chooses to invest the proceeds in another low-income housing project, he does not have to reduce his basis for

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[22]Senate, Tax Reform Act of 1969, p. 292.

depreciation by the amount of the unrecognized or non-taxed gain. It is possible, though, when the project is sold for less than the maximum, the new provision may be beneficial and create more sales to tenant groups.

CHAPTER IV

PRESENTATION OF RESEARCH FINDINGS

Investment decisions are, in the last analysis, made by people--directors, officers, and individuals charged with the responsibility of investment of funds. It follows that a critical intermediate point between the adoption of a tax device for controlling and channeling real estate investment and the realization of the desired impact lies in the investment decision making process. If those who invest funds react to tax devices in the way in which it is intended they should, the adoption of the tax device may be said to have accomplished, at least to this extent, that which was intended. On the other hand, if, at the critical point of investor decision, the desired reaction is not brought about, or the intended stimuli are impotent, or induce an attitude of indecision, the tax device has not brought about the desired result.

It is very important to realize that many factors - other than tax considerations - enter into the real estate investment decision making process. If tax considerations are relatively unimportant, the reason for this needs to be determined; similarly, the factors which are important should be identified. Taxes do exist, and it is important to know the specific investment sectors in which they actually cause significant effects on investment.

Major business organizations are, to a considerable extent,

operated through well-established internal management procedures. In most firms there is a well defined procedure for originating, reviewing, and implementing real estate investment decisions. While these procedures vary from firm to firm, it seems clear that nearly all have the basic components of initiating proposals, provision for one or more reviews, and, finally, managerial mechanisms for implementation.

The real estate investment sector is made up of many different areas; expertise in one area is not totally transferable to another. Many firms and individuals specialize in building in a single area or perhaps in two or more related areas. Examples of building specialization are: single-family dwellings and garden-type apartments; high-rise apartments and high-rise office buildings; shopping centers and medical office complexes. Similarly, there is specialization in real estate financing. Specialization has led to the development of tax incentives designed to affect specific areas of the real estate sector.

As explained in Chapter I, requests for interviews were sent to forty companies and individuals. Accompanying the requests was a brochure (Appendix A) which explained the purpose of this study. Thirty-seven of the firms and individuals consented to participate in the study. The statements, comments, and opinions of the interviewees are given in this chapter.

The chapter is divided into four sections. The first section contains a discussion of the "locked-in effect" and the "battle of earnings-per-share versus cash flow." The second presents the reactions of the interviewees to the changes in depreciation policy and depreciation recapture made by the tax laws. The responses of those interviewed will be analyzed in an attempt to determine the effect the

changes in depreciation and recapture have had upon specific areas of real estate investment. The third section presents the reactions of the interviewees with respect to the effect on real estate investment of rehabilitation expenditures and tax free sales of federally assisted housing. A summary of the comments given by the interviewees concerning the role of federal income taxation as a means of implementing policy in the real estate investment area is contained in the fourth section.

Discussion of Two Problems

Some of the observations received from those interviewed were applicable to specific areas and problems in real estate investment. Two, in particular, were noted repeatedly. Of these two, the most frequently mentioned was a concept which will be referred to as the "locked-in effect." Few individuals are willing to switch from their area of specialization to another area of real estate investment and development, or from real estate investment to other types of investment. Reasons given for this reluctance to change are:

1. The necessity of learning new skills;
2. Reluctance to incur expenses associated with acquiring the requisite expertise in a new field;
3. Forfeiture of the advantage of contacts already acquired in a particular field. Some said they felt "at home" in their particular specialization, but in another they would be like a "fish out of water."

As a result of this unwillingness to change, many investors indicated they were willing to accept a lower rate of return from investments in

their own area than might possibly be obtained in other investment lines.

Another aspect of the "locked-in effect" relates to patterns of operation. Since investors tend to stay with those type of investments with which they have become familiar, they usually use the same developer; the developer, in turn, usually employs the same construction company; the construction company hires the same men. This leads to a situation in which it is difficult for a new developer or construction company to get started and for new workers to break into construction employment. This is particularly true with respect to minority workers.

The second general comment related to a situation which will be referred to as the "battle of earnings-per-share versus cash flow." Cursory observation would seem to indicate that the methods of accounting used to determine reported financial results and the results obtained by cash flow analysis for a specific period should give similar results; such is not the case. In order to show high earnings under an acceptable method of accounting, non-cash deductions are estimated at the lowest possible amount. On the other hand, the greatest cash flow will be shown by reducing the federal tax liability through taking the largest possible non-cash tax deductions. The following illustration emphasizes the point.

Assume that an individual builds an apartment building and that all revenue and expenses are identical for financial reporting purposes and federal income tax purposes with the exception of depreciation. The individual is undecided as to whether to use an accelerated depreciation method (e.g., the 200 percent declining balance

method) or the straight-line method. The results of the two alternatives in the first year are:

		For Books (S.L. Depr.)	For Taxes (Acc. Depr.)
Income		$1,000	$1,000
Expenses (except for depreciation)		500	500
Net		500	500
Straight-Line Depreciation		100	
Accelerated Depreciation			200
Net Income/Taxable Income		400	300
Less:			
Current Taxes (50% Taxable Income)	150		150
Deferred Taxes	50	200	
After Tax Net Income		$ 200	$ 150
Cash Flow:			
Income		$1,000	$1,000
Less:			
Expenses		500	500
Federal Income Taxes		200	150
Net Cash Flow		$ 300	$ 350

If an accelerated depreciation method is used, the net income in the earlier years will be lower than it would have been if the straight-line method had been used. Since the net income is smaller, the federal tax liability is smaller. Since less tax is owed, the cash flow is greater if an accelerated method is used. The individual must therefore decide now at the inception of the project which is more

important to him, the larger cash flows or larger reported earnings. Since the situation will be reversed toward the end of the life of the building, the investor must decide at the inception which is the more important to him during the life of the project.

This decision becomes highly significant when a developer is attempting to determine if he should secure funds by selling stock to the general public. Several of the developers and Certified Public Accountants who were interviewed indicated that an almost total lack of understanding of the concept of cash flow exists among financial analysts. The analysts are primarily concerned with the concept of earnings-per-share. Since most developers work in terms of cash flow, they have found it impossible to offer stock to the public at a satisfactory price. Since the developer is thus almost precluded from seeking equity financing, he is forced to form joint ventures and limited partnerships for each separate project in which he is involved. These methods of financing are the only ones available to him. This is one of the factors which has caused the construction industry to develop in its highly complex and fragmented form.

An additional element was added to the conflict on March 24, 1971. On this date the Treasury Department published proposed amendments to the Income Tax Regulations dealing with accounting for long-term contracts.[1] Prior to this time, the regulations had permitted the use of either the percentage of completion or completed contract method of accounting for long-term contracts. The percentage of completion method permits income to be reported in the ratio of cost actually

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[1]Proposed Regulations 1.451-3, Federal Register, Volume 36, pp. 5509-5510.

incurred during a period to total estimated costs to be incurred on the project. This method purports to result in a better matching of revenue and expenses and in a more level flow of income from the project. The completed contract method permits all income from the project and all costs to be reported in total in the year in which the project is completed. This results in an uneven flow of income. Under the earnings-per-share concept, a level flow of income is more desirable than a widely fluctuating flow. The interviewees stated that construction companies whose stock was publicly held tended to use the percentage of completion method for financial reporting purposes and the completed contract method for federal income tax purposes. This usually resulted in a lower reported level flow of income and a delayed tax liability.

The proposed amendments should have restricted future use of the completed contract method to those taxpayers who use it for financial reporting purposes. After holding hearings on these amendments, the Treasury Department in December, 1971 withdrew the proposed regulations and issued new proposed regulations.[2] In April, 1972 these regulations were withdrawn for further study and reconsideration.[3] At the present time, therefore, it is still permissible to use different methods for financial reporting and for federal income tax purposes.[4]

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[2]Reproposed Regulations 1.451-3, Federal Register, Volume 36, pp. 23805-23809.

[3]Technical Information Release 1168, Federal Taxes, Prentice Hall, Volume 5, p. 54963.

[4]Proposed Regulations 1.451-3, Federal Taxes, Prentice Hall, Volume 7, pp. 65511-65512.5.

The effect of the proposed regulations would have been almost entirely on publicly held firms, since small developers generally do not make public their financial statements.

The position taken in the proposed regulations by the Treasury Department may have been a trial balloon testing the reaction of the business community to the requirement of uniformity in financial and tax reporting. If this requirement is made, future tax incentives may not have much impact on the decisions of large developers because their financial reports will be on an earnings-per-share basis. Smaller developers and those whose stock is closely held will be able to avail themselves of tax incentives because they will still be operating on a cash flow basis. It appears that the construction industry will continue to be made up of many small and specialized firms.

One of the Certified Public Accountants interviewed mentioned an interesting result of the Tax Reform Act. He stated that, due to the publicity given to the elimination of loopholes in the Tax Reform Act of 1969, he had been frequently contacted for tax advice. He believed that many tax shelters still existed. In fact, one of the best tax shelters available, in his opinion, was investment in a section 221(d)(3) or section 236 National Housing Act Program. He believed, that more people became interested in and invested in tax shelters <u>because</u> of the Tax Reform Act of 1969 than were deterred from doing so.

Depreciation Policy and Depreciation Recapture

As previously explained in Chapter II, the Congress in 1954 approved the use of accelerated depreciation methods. Since then the Treasury Department has been calling to the attention of Congress the

abuses which have resulted from the use of these methods. In 1962 the Congress attempted to reduce future abuses arising from the use of accelerated depreciation methods in connection with tangible personal property.[5] In 1964, a similar attempt was made to eliminate abuses arising from the use of accelerated depreciation on tangible real property.[6] As previously explained and illustrated in Chapter III, the Tax Reform Act of 1969 was designed to further reduce the benefits arising from the use of accelerated depreciation on certain types of tangible real property.

New Real Property

Whether or not the reforms will achieve their purpose has as yet to be determined. From the responses of those interviewed, it can be inferred that the effect, if any, will be small. A summary of the responses of the interviewees as to the effect upon their own investment decisions caused by the changes in depreciation policy is contained in Table XXIX.

The responses under the "no comment" heading are of two types. Some persons did not know what the effect would be upon their firm. In other cases the interviewee was in a specific area of real estate investment and the question did not apply to him, e.g., an investor in warehouses would have no comment on the effect of the changes on investment in conventional and low-income apartments. A breakdown of

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[5] Internal Revenue Code, section 1245.

[6] Internal Revenue Code, section 1250.

TABLE XXIX

The Responses of the Interviewees
as to the
Effect of the Changes in Depreciation
upon Various Types of Real Estate Investment

Type of Real Estate	No Effect	Slight or Small Effect	Definite Effect	No Comment	Total
Commercial and industrial property	14	7	9	7	37
Conventional Apartments	14	7	8	8	37
Low-income Apartments	15	7	9	6	37

the responses by different types of investors is given in Table XXX. The Others type of interviewee listed in Table XXX includes all of the remaining types not specifically listed.

The most noticeable response is that all ten insurance companies agree that the change in depreciation will have no effect upon their decisions as to whether or not to invest in any type of real estate. Nine of the thirty-seven interviewees stated that the changes in depreciation will have a definite effect upon their decisions to invest in commercial and industrial property. Of the thirty interviewees who commented upon the effect, over one-half of them (sixteen) felt that the changes in depreciation will have at least a small effect upon their decisions to invest in commercial and industrial property.

The responses of the interviewees as to the effect of the changes in depreciation upon investment in conventional apartments were almost identical to those just discussed. Of the twenty-nine interviewees who commented upon the effect, slightly more than one-fourth (eight) stated that the changes will have a definite effect

TABLE XXX

The Responses of Specific Types of Interviewees
as to the
Effect of the Changes in Depreciation
upon Various Types of Real Estate Investment

Type of Interviewee	No Effect	Slight or Small Effect	Definite Effect	No Comment	Total
Commercial and Industrial Property:					
CPA	1	4	1	0	6
Developer	2	3	1	1	7
Federal	0	0	2	2	4
Insurance	10	0	0	0	10
Others	1	0	5	4	10
Total	14	7	9	7	37
Conventional Apartments:					
CPA	1	4	1	0	6
Developer	1	3	1	2	7
Federal	0	0	2	2	4
Insurance	10	0	0	0	10
Others	2	0	4	4	10
Total	14	7	8	8	37
Low-income Apartments:					
CPA	1	4	1	0	6
Developer	1	3	1	2	7
Federal	0	0	2	2	4
Insurance	10	0	0	0	10
Others	3	0	5	2	10
Total	15	7	9	6	37

upon their investment decisions. More than half (fifteen) stated that the changes will have at least some effect upon their decision to invest in conventional apartments.

With respect to low-income apartments, nine interviewees stated that the changes will have a definite effect, while fifteen

thought the changes would have no effect upon their decision to invest in this type of real estate. Thus, of the thirty-one who commented, over one-half believed the changes will have at least some effect.

A summary of the responses of the interviewees as to the effect upon their investment decisions caused by the changes in depreciation recapture policy are contained in Table XXXI. If this summary is compared with the one in Table XXIX, it can be inferred that the interviewees believe that the changes in depreciation recapture will

TABLE XXXI

The Responses of the Interviewees
as to the
Effect of the Changes in Depreciation Recapture
upon Various Types of Real Estate Investment

Type of Real Estate	No Effect	Slight or Small Effect	Definite Effect	No Comment	Total
Commercial and industrial property	12	8	10	7	37
Conventional apartments	12	8	9	8	37
Low-income apartments	13	8	10	6	37

have more effect than the changes in depreciation. An analysis of the responses by different types of interviewees as to the effect of the changes upon different types of real estate investment is contained in Table XXXII.

TABLE XXXII

The Responses of Specific Types of Interviewees as to the Effect of the Changes in Depreciation Recapture upon Various Types of Real Estate Investment

Type of Interviewee	No Effect	Slight or Small Effect	Definite Effect	No Comment	Total
Commercial and Industrial Property:					
CPA	0	4	2	0	6
Developer	1	3	2	1	7
Federal	0	0	2	2	4
Insurance	10	0	0	0	10
Others	1	1	4	4	10
Total	12	8	10	7	37
Conventional Apartments:					
CPA	0	4	2	0	6
Developer	1	3	1	2	7
Federal	0	0	2	2	4
Insurance	10	0	0	0	10
Others	1	1	4	4	10
Total	12	8	9	8	37
Low-income Apartments:					
CPA	0	4	2	0	6
Developer	1	3	1	2	7
Federal	0	0	2	2	4
Insurance	10	0	0	0	10
Others	2	1	5	2	10
Total	13	8	10	6	37

All ten of the insurance companies stated that the changes in depreciation recapture will have no effect upon their real estate investment decisions. The responses of the six Certified Public Accountants and the four federal officials interviewed did not vary as to different types of real estate. One federal official stated that the

Tax Reform Act of 1969 had established a set of priorities as to the types of real estate investment which the government believed should be encouraged. He stated that his comment pertained especially to the new recapture provisions.

If the responses summarized in Table XXXII are compared with those summarized in Table XXX, the following conclusions appear significant. The changes in depreciation recapture will have a slightly greater effect upon all forms of real estate investment than the changes in depreciation policy. The effect caused by both changes will not, however, be of great significance. At least forty percent of all interviewees who expressed an opinion stated that both changes will not, however, be of great significance. At least forty percent of all interviewees who expressed an opinion stated that both changes would have no effect upon their investment decisions, and these opinions covered all types of real estate investment. Considering all three types of real estate, the number of interviewees who stated that the changes in depreciation policy would have no effect is two more than the number who stated that the changes in depreciation recapture will have no effect.

Regardless of the effects of the changes upon their own decisions, most of the interviewees stated that the investor affected the most was the one who had already made his investment. These investments were made under the recapture rules in effect prior to 1969 and, as illustrated by the examples in Chapter III, the rate of return is materially changed by the new rules. Furthermore, these investors will have to abide by the new rules. New investors, though, know about the new rules beforehand. They will be able to structure the investment

so as to receive the return they previously received. This point was frequently cited by those who believed the changes would cause little or no effect in their investment decisions.

Based upon the responses summarized in Table XXX and in Table XXXII, it can be inferred that there is a divergency of opinion as to the effect the changes will have upon real estate investment decisions. One of the primary reasons given as to why the new provisions will have no effect, or at most a small effect (except for the insurance companies), was the existence of the previously discussed "locked-in effect." Those who stated the changes will have a definite effect acknowledged the existence of such a condition. They believed, however, that the tax incentives were strong enough to cause the movement of funds into and within the real estate sector. Whether or not tax incentives are indeed this strong can only be determined by future developments.

Those interviewed in the insurance industry all agreed that the changes in depreciation methods and recapture of depreciation will have no effect upon their real estate investment decisions. The primary reason given for this is that federal income taxes have little or no effect upon their decisions to invest in real estate. The principal concern to the insurance companies is the yield which the investments will provide. The insurance companies provide the mortgage money which, in addition to the equity money, pay for the cost of the project. Some of the insurance companies are now requiring that in addition to the mortgage money, they be permitted to contribute some of the equity funds. In this manner they are able to share in the profits from the investment. Even those firms that are now requiring this "piece of

the action" stated that the tax incentives do not affect their investment decisions.

After the riots in the ghettos of the mid-sixties, the insurance companies voluntarily began a program known as the Billion Dollar Program. Each insurance company agreed to put a specific dollar amount of mortgage commitments into inner city projects. Most, if not all, of these projects were ones which, under normal circumstances, would have been denied mortgage money. Some of the insurance companies put up the mortgage money for single-family dwellings; others invested in multi-family dwellings, commercial developments, and industrial projects.

All ten of the insurance companies had two common complaints when asked about their experience in this program. All had had to make too many foreclosures, and many of the mortgages were delinquent. Even though the Billion Dollar Program appeared socially desirable, most of the interviewees stated that they wished that their firm had decided not to participate. The benefits which were being derived from the program just were not worth the costs involved, they believed. The costs involved were the time and money expended by the insurance company and the time, effort, and unfulfilled hopes of those to whom the mortgage money was loaned.

When asked how such a program could succeed, they stated that it could only succeed if a mass educational program were begun in the inner cities. The residents do not understand the principles of ownership of property. If they miss a rent payment, quite often it is just forgotten. They are unable to understand that they still owe the interest on the mortgage, i.e., it is not just forgotten when they

don't make the payment. In addition, they are accustomed to having a landlord. The property and all of its problems are his. The individuals are incapable of solving problems themselves. They have always had someone else do it for them. If what the interviewees stated is actually true, this country has a long way to go before it can solve the housing problems in its large cities by resident ownership.

The only manner in which the federal government could induce the insurance companies to invest in specific types of projects would be through incentives affecting the interest rate. All of the companies, however, agreed that they did not want the federal government to provide such an incentive. None of them wanted the government influencing the interest rate any more than it does at present. In addition, they did not like the present Federal Housing Administration program which provides mortgage money at below market interest rates. In conclusion, the only manner in which insurance companies could be influenced by federal government incentives is through incentives affecting interest rates, and all of the insurance companies agreed that they would be against an interest rate provision if it came before Congress. It seems reasonable to conclude that no present or future federal government program will affect the investment decisions of insurance companies.

Used Real Property

A summary of the responses given by different types of interviewees as to the effect of the changes in depreciation and recapture of depreciation upon investment in used real property is given in Table XXXIII. Although, almost two-thirds of the interviewees did not comment upon the effect of the changes on used real property, the

comments of some of those who did respond were quite forceful. Three stated the changes would have no effect, five that they would have slight or small effect, and six that they would have a definite effect upon their investment decisions. These six felt that the changes have caused an almost complete halt to the turnover of used property.

TABLE XXXIII

Responses of Different Types of Interviewees as to the Effect of the Changes in Depreciation and Depreciation Recapture Upon Investment in Used Real Property

Type of Interviewee	No Effect	Slight or Small Effect	Definite Effect	No Comment	Total
CPA	0	2	2	2	6
Developer	0	2	1	4	7
Federal	0	0	0	4	4
Insurance	2	1	0	7	10
Others	1	0	3	6	10
Total	3	5	6	23	37

With the exception of those used residential rental properties which qualify for the 125 percent declining balance method of depreciation, tax shelters are no longer available in used real property. Because of this, investors who acquire used real property after the Act must intend to operate it at a profit each year. If a building cannot be operated at a profit, there will be no buyer for it when it is offered for sale as used real property. This point was repeatedly referred to as causing an end to turnover of used property. Previously, the equity investor in used real property obtained a major portion of his return from the tax shelter it provided. Since accelerated depreciation is no longer generally available, the only return obtainable

from the ownership of used real property is in the form of a positive earnings flow from the building. Present owners of property will now have to demonstrate that the property can generate a positive flow of earnings for a substantial length of time in order to interest prospective buyers. This requirement of profitability may provide the necessary incentive for proper maintenance of the building. A lack of just such an incentive was frequently mentioned as one of the prime factors in causing the present deplorable conditions of America's inner cities.

One of the developers who stated that the changes will have a slight or small effect believed that corporations will begin to acquire used real property. They will take the place of individuals or limited partnerships composed of individuals in high tax brackets. The primary reason for this attitude was his belief that used property will be able to generate a positive flow of earnings. These earnings, he believed, could increase the earnings-per-share of the company. In addition, many investors view ownership of real estate as a type of hedge against inflation. Due to these factors, i.e., the possibility of positive earnings and an inflation hedge, he believed that used real property will become an attractive investment for some corporations.

In conclusion, although many of the investors did not comment about the effect of the changes upon used real property, a large majority of those who did believed that the changes would have some effect upon investment decisions. One individual went so far as to say that the effect was so detrimental that Congress would have to amend the provision in order to breathe some life into the used real property market. He did not believe that Congress had intended to

cause an almost complete halt in sales of used realty. Whether the entering of corporations into the used realty market, or some other development may improve the used real estate market is difficult to forecast. It will be interesting to observe what actually does take place.

Provisions Affecting Low-Income Housing

The responses of the interviewees as to the effect of the two provisions affecting low-income housing, that is, rehabilitation expenditures and tax-free sales will be summarized by type of investor. Comments and opinions of the interviewees about the probable effectiveness or lack of effectiveness of the two provisions will be considered. In addition, several comments of the interviewees about the low-income housing problem will be noted.

Rehabilitation Expenditures

The responses of the interviewees as to the effect of the new provision for rehabilitation expenditures are given in Table XXXIV.

TABLE XXXIV

Responses of Different Types of Interviewees as to the Effect of the New Provision for Rehabilitation Expenditures

Type of Interviewee	No Effect	Slight or Small Effect	Definite Effect	No Comment	Total
CPA	1	5	0	0	6
Developer	2	1	0	4	7
Federal	0	1	0	3	4
Insurance	4	2	0	4	10
Other	1	6	0	3	10
Total	8	15	0	14	37

Of the thirty-seven respondents, fourteen did not comment upon the effect of this provision. Of the remaining twenty-three, eight believed that it would have no effect and fifteen believed that it would have a slight or small effect. It is interesting to note that none of the interviewees believed that the provision would have a definite effect upon rehabilitations. They thought few additional rehabilitation projects would be attempted.

Almost all of those who stated that the provision would have a slight or small effect believed that it would have no effect in the center of America's large cities. Most, if not all, rehabilitations which will be attributable to this provision will be located on the edges or fringes of the slum areas. Several of the interviewees mentioned that the two most important requisites for a successful rehabilitation project are location of the project and the attitude and character of the people who will occupy the building. These comments seem to indicate that the new provision will not stimulate many rehabilitation projects in the inner city. If the Congress intended that this provision should cause substantial rehabilitation of inner city housing, the evidence seems to indicate it will not succeed and some other stimulus needs to be found.

A number of the interviewees did not like the form of the incentive. As passed by Congress, the excess of the fast write-off permitted over normal straight-line depreciation is considered a tax preference item. If a taxpayer has a certain dollar amount of tax preference items, he can be assessed an additional tax called a "minimum tax."[7] In addition, the excess of the deductions over normal

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[7] Ibid., section 56.

straight-line depreciation can be recaptured if the building is sold at a gain. When these two adverse factors are added to the high risk inherent in any rehabilitation project, the interviewees believed that the prospects of the incentive succeeding are very dim.

Other reservations about the rehabilitation incentive were expressed. Rehabilitation projects, unless prefabricated units or housing modules are installed, have very high labor costs. Due to the relatively high wages paid to construction workers, a couple of the developers stated that they could use their men more profitably on other projects. One of the Certified Public Accountants believed that the provision would be of some benefit to those developers who were already engaged in rehabilitation work. He felt, however, that the incentive was not sufficient to attract new developers to this activity.

One last point: it is extremely difficult to obtain mortgage financing for a rehabilitation project from a source other than the federal government. This is caused by the high risk factor. The federal government provides a limited amount of mortgage money through the Federal Housing Administration at below market interest rates. However, in the federal budget for fiscal year 1973, this program was eliminated and the funds transferred to a proposed revenue sharing program.[8] Nevertheless, the Congress did not follow the President's suggestion and appropriated seventy million dollars for a rehabilitation

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[8]The Budget of the United States Government (Fiscal Year 1973), p. 318.

loan fund.[9]

Tax Free Sales of Federally Assisted Housing

The responses of the interviewees as to the effect of the new provision allowing tax free sales of federally assisted housing were even less encouraging than those concerning the rehabilitation expenditure provision. A summary of the responses by type of interviewee is given in Table XXXV. Over one-half of those who did respond with

TABLE XXXV

Responses of Different Types of Interviewees
as to the
Effect of the New Provision
for Tax Free Sales of Federally Assisted Housing

Type of Interviewee	No Effect	Slight or Small Effect	Definite Effect	No Comment	Total
CPA	2	2	0	2	6
Developer	1	0	0	6	7
Federal	0	0	0	4	4
Insurance	3	0	0	7	10
Other	1	2	2	5	10
Total	7	4	2	24	37

comments (seven out of thirteen) believed that the provision would have no effect. Four believed that the provision would have a slight or small effect, and two thought the provision would have a definite effect. The primary reason given by those who did not comment (twenty-four out of thirty-seven interviewees) was that the Treasury Department had not published any regulations for this new provision at the time of the interviews. The Treasury Department subsequently did publish these

[9]Department of HUD and other Agencies - Appropriations, Public Law 92-383, U.S. Code, 92nd Congress, 2nd session.

regulations in June, 1972.[10] They are very complex and it may still be some time before all of the implications of this provision are understood.

One comment raised doubts as to whether the provision will accomplish its objective even if the regulations are deemed favorable. The interviewees believed that the provision offered no incentive to the equity investor. Even though the taxation of the gain was postponed until some future date, this was more than offset by the reduction in basis which the postponement causes.

Some of the interviewees believed that the provision offered some incentive to the developer. They explained that the developer obtains his profit from constructing buildings. When one low-income project is sold, a new one must be constructed using the funds received from the sale if the tax incentive is to be utilized. The developer, therefore, has a reason for trying to convince the equity investors to sell and invest in a new development. As one of the Certified Public Accountants explained, the developers are really salesmen of new real estate. Because of their selling ability, he believed that some of the developers will succeed in persuading equity investors to undertake non-taxable sales. Since the developer will have an incentive to sell, it is possible that more low-income housing projects will become owned by the tenants.

One developer pointed out that the Section 236 National Housing Act program was enacted in 1968. Assuming that it would take half

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[10]Regulations 1.1039-1, Standard Federal Tax Reports, Commerce Clearing House, pp. 53158-53164.

of a year for approval and a full year for construction, it would be late 1970 or early 1971 before any of these projects were completed. In addition, he believed that it would be another three or four years before the residents would be ready to want to buy the project. Hence, it will be at least late 1973 and possibly later, before any effects of this incentive will be apparent.

The Section 221(d)(3) National Housing Act program was phased out as of June 30, 1970. The developer believed that the Federal Housing Administration would not permit any of these projects to be sold through a tax free sale. If one were sold tax free, an additional appropriation of funds would be necessary, and for this reason, he believed no approval would be given to attempts to sell Section 221(d)(3) projects under this new provision.

Other Comments Concerning Low-Income Housing

Almost all low-income housing constructed in this country is built with the approval of the Federal Housing Administration. Many of the interviewees complained of Federal Housing Administration bureaucratic inefficiency. The difficulty involved in getting an application for a Federal Housing Administration program approved was said to cause many headaches. Several developers admitted that they do not consider Federal Housing Administration programs because of the many frustrations involved. In addition, the time from initiation of the project to completion becomes so long in many instances that cost estimates of materials and labor are outdated. Construction labor contract rates have increased on the average from eight to ten percent annually (before the imposition of wage and price controls). This point was cited more than once as one of the major contributing causes

of price overruns on Federal Housing Administration approved low-income housing projects.

One of the interviewees did attempt to justify the necessity of the Federal Housing Administration bureaucracy. He stated that the agency paid such low wages that it was necessary to hire one or two additional persons to check the work of an initial clerk. He believed that the level of competency of employees of this agency precluded accurate work. He believed that the agency is prevented from hiring employees at salaries sufficient to attract competent personnel.

One of the other problems mentioned was the problem of obtaining sufficient land on which to build low-income housing. One developer gave an example of land costs for a project in the inner city being ten times the cost per square foot of land in the suburbs. He believed that because of this cost disparity it was necessary for some governmental agency to subsidize land acquisition costs. Unless this subsidization did occur, he could not foresee how low-income persons could afford to occupy new housing in the inner city.

Another point raised by several of the interviewees was that they believed that low-income projects should no longer consist of high-rise apartments; but should be garden-type apartments. These require more ground space and this explains why more and more low-income projects were being constructed in the suburbs. However, as evidenced by the battle which has been going on for over two years in the Chicago courts, many suburban residents oppose location of low-income projects in their community.[11]

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[11] Chicago Sun Times, July 2, 1969, pp. 1, 5; July 3, 1969, p. 4; July 11, 1969, p. 4; June 20, 1972, pp. 5, 20; August 8, 1972, pp. 1, 26.

One individual went so far as to state that it would be necessary for the Federal government to provide a property tax subsidy for low-income projects constructed in the inner city. The property taxes on these buildings are so high that they cause rents to rise above the level affordable by a low-income person. He stated that his state already has a program to reimburse the cities for a specified percentage of the property taxes imposed upon low-income projects. He believed that in the future the federal government will have to adopt such a program.

An additional point was mentioned by an individual with many years experience in managing low-income projects. He maintained that residents of slum areas generally refuse to move to different cities and in some instances even to a different location within the same city. Even though their residences are dilapidated and the area has a high crime rate, they refuse to move to a different residence. Even if a job is offered in connection with the move, they still refuse. The individuals are "at home" in their present surroundings and are not willing to accept the challenge of attempting something different. In many instances, he stated, the individuals involved are low-income blacks. They prefer living with other blacks and do not want to put up with the hassle involved in moving to a previously all-white area. He believed that the present slums will have to be torn down and new buildings will have to be constructed in their place. This can only succeed, though, if the tearing down and rebuilding encompasses a large area. He stated that if the demolition and rebuilding process is carried out, one building at a time, the attempt will fail. It would only be a short time before one new building would acclimate itself to

the surroundings and itself become a part of the slums.

One last point mentioned by almost everyone interested in low-income housing was the lack of congressional funding of the National Housing Act programs which provided housing for low-income individuals and families. Presently, when an appropriation is made it is possible to determine the number of units of new housing which has been made possible by the legislation. In none of the past appropriations has the number of units made possible approached the number required to attain the National Housing Goals.[12] Hence, if the Congress is going to attempt to attain the goal which it set, it will have to begin to appropriate more funds. At the present time, it appears that the Congress is not going to make such an attempt.

Comments on Tax Policy

In addition to asking what effects the Tax Reform Act of 1969 has had upon their real estate investment decisions, the interviewees were asked several questions concerning federal income tax policy. The interviewees were asked to rate three factors as to their importance in investment decisions. These factors were: (1) federal income tax considerations; (2) demand for the structure; (3) the financing arrangements for the project. Almost all of the interviewees stated that demand was the foremost consideration when a project was being evaluated. The financing arrangements were the second; and federal income taxes were a far distant third. In fact, in some cases, as exemplified by the

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[12] Supra, Table I, p. 5.

insurance companies, federal income taxes are not a factor at all in the investment decision making process. Those interviewees who did not believe demand to be the most important factor preferred to assign primary importance to a factor different than the given three. They believed that economic conditions were the key investment factors.

It was believed that given a strong demand for buildings, they would be built, barring, of course, the most adverse of financing arrangements and federal income tax considerations. An example of demand overcoming adverse financing arrangements was the commercial building boom occurring in Chicago's Loop area in 1969 when interest rates were at their highest.

While the depreciation deductions allowed have an immediate effect, it was pointed out by one of the Certified Public Accountants that the recapture of depreciation is in the future and happens only if the investment is sold at a gain. Since the effect of future occurrences are discounted, recapture is a small consideration in making the actual investment decision. Federal income taxes do affect, though, the manner in which the investment is structured, i.e., the form in which each investor receives his annual return (cash or depreciation deductions) and the percentage of proceeds each investor receives upon disposition of the investment.

The interviewees believed that the federal government affected all three factors to some extent. Through the use of its fiscal and monetary policies, the federal government influences general business conditions, and general business conditions have a substantial effect upon demand for new structures. The monetary policy of the federal government directly affects the available financing arrangements.

Finally, it is obvious that the federal government has an effect upon the federal income tax provisions which affect real estate investment.

Based upon the observation that the interviewees believed federal income taxes to be the least important of the three factors, the following question was asked: Why do real estate investors consider the current federal income tax provisions so important? A large majority of the interviewees gave several reasons. The most common answer was that the present tax structure is needed to keep real estate investments competitive with other forms of investment. Under current federal tax statutes, an investor is able to determine with reasonable certainty the return obtainable from a specific type of investment. If the return obtainable from a specific type of investment is altered because of federal tax changes, the alterations may place that type of investment in an advantageous or a disadvantageous position vis-a-vis other types. Hence, whenever an attempt is made to lessen the advantages of investing in real estate, real estate investors are vociferous in their opposition. If the return from all types of investments could be reduced by the same degree by changes in the federal tax statutes, the objections from real estate investors would be muted. Investors might not like the changes, but they could offer no real objection. All forms of investment would still be in the same competitive position. Since a change in the tax laws having precisely the same effect on all types of investments appears impossible, investors in each sector will always object when changes are suggested which adversely affect their competitive position.

Another frequent response was a request for a stable investment climate. Several of the interviewees stated that as soon as they

understood how to utilize a tax incentive Congress was changing it. They cited the Revenue Acts of 1962 and 1964 and the 1969 Act as examples. The interviewees believed that the changes, which they labeled as frequent, had a detrimental effect upon attracting new investments in real estate.

A minority of the interviewees did express several opinions as to why the income tax provisions are not vital. Their primary objection was that tax incentives were being utilized by investors who did not require them in order to make an adequate profit from an investment. The availability of the tax incentives to all investors is a situation which the minority would like to have eliminated. They would prefer that only those investors who need the incentives in order to obtain an adequate return should receive them. It would seem nearly impossible to draft such a law, let alone administer it.

The next question asked was: "What form of tax incentive do you favor in the real estate investment sector?" The different forms of incentives, it was explained, are determined by who receives the incentive. Possibilities as recipients are the developer, the equity investor, the long-term debt financier, and the occupant of the building. Currently, there are tax provisions which act as incentives for developers, e.g., deduction of construction expenses and accelerated depreciation; and for the equity investor in real estate, e.g., accelerated depreciation and limited recapture of additional depreciation. There are, however, no tax incentives for the long-term debt financier. The only incentive available to occupants of buildings are those available to occupants of low-income housing projects.

Several of the interviewees stated that if the developer is

given sufficient incentives, the project will be built. It was believed that the developer would be able to convince equity investors and long-term financiers to put up the necessary funds. The incentives available under the section 236 National Housing Act program were frequently given as an example. The interviewees stated that there is no lack of developers wishing to build this type of project. The question comes down to the point of whether the federal government should provide a general type of incentive for all developers, i.e., the federal income tax incentives, or should the government find an alternative form of incentive to assist only those developers who would be unable to obtain an adequate profit from a specific project without government assistance.

The interviewees connected with the federal government explained a point which becomes relevant whenever new tax incentives are suggested. The federal government was beginning to prefer the usage of direct subsidies over tax incentives. The main reason for this was the then current interest in cost-benefit analysis. In a direct subsidy program, the cost to the federal government can be determined. In addition, the individuals who receive the benefits can be identified and an attempt can be made to measure the benefits which they receive. When a tax incentive, is used, it is not possible to make an accurate estimate of the cost to the federal government. Similarly, it is impossible to measure the benefit which has been derived and to identify those who have received the benefits. For these reasons, the Treasury Department is beginning to prefer the usage of direct subsidies rather than new tax incentives.

The interviewees next were asked their opinions concerning

alternative forms of assistance to enable low-income individuals to obtain housing. The question was: If current tax incentives to build low-income housing were removed, what form of assistance, if any, would you prefer to assist low-income persons in obtaining adequate housing? A program similar to the current food stamp program was frequently mentioned as a possible alternative. Under this program, the government would issue stamps which could be used with money to rent housing in conventional apartments. The stamps would be given to the apartment owner as part of the rent payment. The apartment owner would turn the stamps in to the federal government and receive cash. Another possible alternative mentioned was a rent supplement program. Under this program, a low-income individual would locate suitable housing. He would then pay from twenty to twenty-five percent of his income as rent. The federal government would pay the remaining balance of the monthly rental. Several of the interviewees within the insurance industry were very much in favor of either of these two alternatives. They believed that such programs would probably cause the elimination of the Federal Housing Administration program under which below market interest rate mortgages are made. This, they believed, would tend to reduce federal government interference with long-term interest rates.

One developer posed a question which has implications for both of the proposed alternatives. He asked: "Should a developer volunteer a certain number of units of his project, or should he be required to make available a certain percentage of units for occupancy by low-income individuals?" He outlined the voluntary program as working along these lines. The developer would designate so many units as being available for low-income occupants. These units could be

either concentrated in one area of the project or scattered throughout the project. The developer would notify an appropriate federal agency of the availability of these units. The federal agency would then list them in a manner such as homes are listed for sale. Under the non-voluntary program, a specified percentage of all new units would be required to be listed as eligible for occupancy by low-income occupants. The developer indicated a preference for the voluntary program. He agreed, though, that if the voluntary program did not provide sufficient units, the non-voluntary program might have to be instituted.

One of the mortgage bankers gave an example of why he is against the present programs and might be persuaded to support one of the two alternatives. A new low-income housing project was under construction in his city. Individuals with incomes below a certain level were eligible to apply as occupants. He knew of an individual who asked for a pay cut so that he could qualify for the new building. The reduction in rental payments was more than the requested cut in pay; so, the individual came out ahead by asking for a reduction in pay. The banker stated that if either of these two alternatives could eliminate such occurrences he would support it.

One of the developers opposed the rent supplement plan. He believed that since the plan required low-income individuals to spend from twenty to twenty-five percent of their income on housing, it was a bad plan. He stated that such a plan took a spending decision away from the individual and <u>forced</u> him to spend a specific percentage of income on housing. He believed that a citizen of this country should be free to spend his money as he pleases, as much or as little as he wished on housing. The forcing of low-income individuals to spend a

certain percentage of their income on housing, he believed was not the American way of doing things.

Finally, one of the interviewees stated that he believed the current emphasis on building housing for low-income individuals was misdirected. He believed that more emphasis should be placed upon obtaining jobs for these individuals rather than upon the construction of housing for them. If these individuals could obtain job training and then a job, they would no longer be classified as low-income individuals. They would then need no assistance in obtaining adequate housing. Thus, he believed, that more emphasis should be placed upon job training and the creation of new jobs, i.e., more federal funding of such programs, than upon building housing for occupancy only by low-income individuals.

CHAPTER V

CONCLUSIONS AND RECOMMENDATIONS

Introduction

The purpose of this dissertation has been to determine the effect of the Tax Reform Act of 1969 upon investment in real estate. To accomplish this, interviews were conducted with individual investors, executives of firms investing in real estate, and several other real estate investment experts. The responses of the interviewees are summarized in Chapter IV. Examples were constructed to illustrate the effect of the Act's changes which affected real estate investment. The purpose of the examples was to lend support to and show at least some of the reasoning behind the replies of the interviewees. These examples are given in Chapter III. The interviewees' responses and the examples are the bases of the conclusions in this chapter.

The first part of the chapter will discuss the conclusions which can be drawn from the responses of the interviewees and from the examples. The conclusions are to be considered as judgments and not objective facts. In the second part, recommendations will be made concerning possible future interaction between federal income taxes and real estate investment. The third and concluding section of the chapter contains suggestions for further research.

Conclusions

Depreciation Policy and Recapture of Depreciation

As illustrated by the examples in Chapter III, one of the areas most affected by the changes in depreciation and depreciation recapture was investment in new commercial and industrial property. Even though this appears to be so, over two-thirds of the interviewees commenting upon the effects of these changes stated that the effect upon their decisions would be slight or nonexistent. It can be concluded, therefore, that construction of new commercial and industrial property is based more upon demand and financing considerations than upon tax stimuli. Federal income taxes were not a significant factor in the investment decision before the Tax Reform Act of 1969, and will become even less significant because of the moderation of tax incentives brought about by the Act. In addition, due to the "locked-in effect," the same investors will continue to invest in commercial and industrial structures. They will accept the lower return for the reasons previously explained [page 120]. It can be concluded, therefore, that the present incentives are sufficient for investment in new commercial and industrial properties.

An effective tax shelter is still available to those who invest in new convential apartments. This fact was recognized by all of the interviewees [TABLES XXX and XXXII]. Not one stated that the changes in depreciation and depreciation recapture would have an unfavorable effect upon investment in this type of structure. Construction of new buildings will still be closely correlated with demand and financing considerations. It can be concluded, therefore, that if the Act affects construction of new conventional apartments, it will be in

a favorable manner.

None of the favorable tax incentives previously available to investment in low-income housing were removed by the Act. Thus investment in low-income housing is the best tax shelter available in the real estate field. Because of the risk involved in investing in this area, it was the intention of Congress to provide a relatively better return for investment in low-income housing than for investment in other types of real estate. When the fact that no changes were made affecting new low-income housing is considered with the changes made affecting used residential rental property, it can be concluded that Congress is putting more emphasis upon investment in new property. As was frequently pointed out by the interviewees [page 145], almost all new low-income housing construction is based upon government funding.[1]

As was indicated in both the House and Senate reports on the 1969 Act, the Congress did not intend to support the used real property market at the expense of new construction. It would appear, therefore, that the reduced level of turnover of used real property which has occurred was a result intended by Congress. Both of these reports

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[1]It should be noted that in January, 1973, Mr. George Romney, Secretary of the Housing and Urban Development Department, announced that the Nixon Administration would accept no more applications for certain housing programs. One of these programs was the section 236 National Housing Act program, the primary means of constructing low-income housing in this country. Secretary Romney pointed out, though, that it will take about one year before the cutoff is completely felt. When this time period elapses, almost no low-income housing will be constructed in this country. Thus, the Nixon Administration has unilaterally declared that this country will no longer attempt to attain the National Housing Goal of construction of 6,000,000 units for low-income persons. "Aid for Housing and Communities Frozen by Nixon," <u>Wall Street Journal</u>, January 9, 1973, p. 3.

indicated that too much revenue was being lost because of tax induced investment in used property.[2] As illustrated by the examples in Chapter III, the ownership of used real property will definitely not be as profitable. The Congress also anticipated that the reduction in allowable depreciation on used real property would cause increased expenditures for maintenance and improvements. It is still too early to determine if this result will occur.

Provisions Affecting Low-Income Housing

Based upon the responses of the interviewees, it is concluded that the new rehabilitation expenditure provision will not bring about the intended result. A provision similar to the one passed by Congress was thoroughly examined in a technical report which accompanied the report of the Douglas Commission.[3] As was pointed out in the report, such a provision would have a high revenue loss effect per dollar of incentive effect. The provision would benefit high bracket taxpayers rather than cause a marked increase in rehabilitations. It is concluded, therefore, that the rehabilitation expenditure provision is an inefficient means to accomplish a socially desirable goal.

The mortgage loans which finance the rehabilitation projects come primarily from a government rehabilitation loan fund. Almost all rehabilitations completed in this country are financed by this fund.

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[2]House, Tax Reform Act of 1969, p. 166; Senate, Tax Reform Act of 1969, p. 212.

[3]Richard E. Slitor, The Federal Income Tax in Relation to Housing, Research Report No. 5 - Prepared for the Consideration of THE NATIONAL COMMISSION ON URBAN PROBLEMS, (Government Printing Office: Washington, D.C., 1968), pp. 81-84.

As was noted in Chapter IV, the Nixon Administration has attempted for the past two fiscal years to eliminate this loan fund from the federal budget. It would appear, therefore, that the present administration is against the use of federal government loans to facilitate the rehabilitation of low-income housing in this country. Furthermore, no announcement of a substitute program has been made. Finally, it is believed that the administration will again suggest the elimination of this loan fund in the federal government budget for fiscal year 1974.

The provision to encourage sales of low-income projects to the occupants may succeed. It will be at least the latter half of 1973 or even early in 1974 before the first sales occur. Some time after this, a determination of the attainment, or lack of attainment, of this objective can be made. Based upon the few comments and explanations obtained from the interviewees [pages 140-142], it is concluded that the objective will be achieved in limited degree. Since the provision causes only a deferral of revenue and not an absolute loss of it, it is concluded that the provision be retained.

Tax Policy

Based upon the comments and opinions of the interviewees [pages 145-152], it can be concluded that demand and financing considerations and/or general economic conditions are the most important factors in real estate investment decisions. The interviewees believed that as long as these factors were favorable projects could be built and operated at a profit. While tax incentives were considered necessary, they were not considered as being of great importance in actual investment decisions. The belief in the necessity of the existence of the tax incentives was due to competitive factors. It can be concluded

that removal of tax incentives from real estate investment would bring about a distinct competitive disadvantage with other types of investment.

When the interviewees were asked to suggest other means which could be used as incentives, many of them expressed their preferences hesitantly. They answered the question only after expressing the opinion that, "this is not what we advocate; but if all tax incentives were removed, the following is what we would prefer to occur . . ." It can be concluded, therefore, that the interviewees prefer the use of the tax system to achieve socially desirable goals in the real estate field. They are generally familiar with this type of incentive and would prefer not to have to deal with a new type of program.

Recommendations

The responses of the interviewees, the examples, and the conclusions are the bases for the following recommendations.

1. Since the tax incentives after the changes brought about by the 1969 Act are sufficient for new commercial and industrial property, no additional changes should be made affecting this type of property. This would apply to both depreciation policy and recapture of depreciation. This recommendation is in line with the interviewees' request for a stable investment climate [page 147].

2. Maintain the present order of effectiveness of tax incentives in the real estate sector. The tax incentives are best for new low-income housing, then

for new conventional apartments, next for new commercial and industrial property, and finally for used real estate. This is based upon the belief that a greater return to the investor is needed to compensate for the additional risk of investing in low-income housing. This belief is supported by the Senate report on the Act[4] and by a statement of one of the interviewed federal officials [page 130].

3. Continue to allow only straight-line depreciation on used property (except for the exception permitting 125 percent declining balance depreciation on used residential rental property). This should continue to prevent the repeated turnover of used properties [a result intended by Congress].[5] It may also help to create more interest in making improvements and maintaining used residential rental property.

4. Some new provision should be enacted to assist in rehabilitation of low-income housing [See pages 137-140]. This is one of the areas where further research is needed.

5. In the future only low-rise buildings and garden-type apartments should be constructed to house

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[4]Senate, Tax Reform Act of 1969, p. 212.

[5]Supra, note 2, Chapter V.

low-income families. The only exception to this would be apartment complexes for senior citizens. Buildings intended to house families with children should, under no circumstances, be high-rise buildings [See page 143].

Future Research

In 1962 Congress passed a recapture provision affecting depreciable personal property. Under this provision all depreciation was recaptured upon the disposition of the property if the realized gain exceeded the total depreciation deductions. Shortly after this provision was enacted, the Treasury Department issued liberalized guideline lives for depreciable personal property. No such changes were made for depreciable real property after the Revenue Act of 1964 and the Tax Reform Act of 1969. The recapture provisions, the Treasury stated, were not sufficient to prevent abuses if the guideline lives for real property were liberalized. One area for possible future research would be an examination of the effects that would be brought about if all depreciation were recaptured on real property. As part of this change, the guideline lives on depreciable real property would be liberalized. Especial liberalization should be made for low-income housing. More than one interviewee stated that for certain low-income projects a life of twenty years was optimistic.

In light of the Nixon Administration's freeze upon applications for low-income housing subsidies, further research is needed to find additional means of obtaining housing for the poor. Ideas such as the rent stamp program and others should be thoroughly examined and

evaluated.

Finally, a third area for research is to determine what is a feasible method to use in assisting rehabilitation of low-income housing. It has already been concluded that the present provision will not succeed. Several other possibilities need to be examined. These should be explored in great depth with especial attention given to their acceptance by those affected by the provisions. This will become especially true if a Nixon Administration proposal is enacted. This proposal provides for the elimination of the rehabilitation loan fund from the federal budget and the transfer of the monies to a community development revenue sharing fund. Under this plan, most rehabilitations would need local community approval.

Prior to the announcement by Secretary Romney [See note 1, Chapter V], the determination of a feasible means of assisting rehabilitation of low-income housing was the area most urgently requiring additional research. It appears now, though, that the paramount need is for finding alternative means of housing the poor.

APPENDIX A

ARE REAL ESTATE INVESTMENT INCENTIVES ADEQUATE?

What are they?
Do they have significant acceptance?
What impact do they have?

A study of the impact of the
Tax Reform Act of 1969 upon
investment in real estate

A Research Project of
THE GRADUATE SCHOOL OF BUSINESS, INDIANA UNIVERSITY

ARE REAL ESTATE INVESTMENT INCENTIVES EFFECTIVE?

The Tax Reform Act of 1969 has received a mixed reaction. It has been lauded for its "loophole closing" provisions. Conversely, it has been condemned as being too complex. One of the areas affected was real estate investment. In fact. one author characterized the legislation as affecting real estate investment more adversely than any other investment area. The purpose of this study is to determine what impact this legislation has had upon real estate investment.

The Background

In 1949 the Congress established a national objective, expressed as the "realization as soon as possible of the goal of a decent home and a suitable living environment for every American family." In 1968, the Congress reaffirmed this goal, while admitting that the accomplishments thus far attained had "fallen far short of today's needs."

For more than twenty years, the Congress has tried to create incentives for real estate investment. It has enacted legislation guaranteeing mortgages, providing for rental subsidies, for government insured mortgages, for government housing for low- and moderate-income families, and for the rehabilitation of existing structures. Yet in 1968, the Congress was forced to admit that its efforts had not attained the objective.

In most, if not all, instances real estate investment incentives have been born on the "drafting boards" of economists. All of them have at least one thing in common: They depend primarily on the assumption that investors--making the investment decision--will react in the manner anticipated by the proponents of the particular scheme. But this may not be so. First, because the investor is not a guinea pig in a laboratory and he may not react in the anticipated manner; second, because the difficulty of trying to anticipate the next governmental proposal may create

such uncertainty and frustration as to rob any incentive of its anticipated efficacy.

An Attempt to Evaluate

The entrance of the federal government into the real estate investment sector is a relatively new federal venture. The success of the devices thus far used as incentives has depended upon the reactions of investors to these devices. In addition, there has been a wide divergence of opinion about their effectiveness. Grover A. Cleveland, a doctoral student of the Graduate School of Business at Indiana University, with faculty assistance, has undertaken this research project to evaluate investors' reactions to the government's devices. Specifically, we are trying to find out what effect the provisions of the Tax Reform Act of 1969 concerning accelerated depreciation, recapture of depreciation, and rehabilitation expenditures have actually had with respect to investors' thinking and action. In addition, we are interested in the impact the provisions have had on specific and concrete decisions about the investment of funds--particularly in low-income housing.

Plan of Attack

Our plan of attack on this problem is to talk to business and investment executives who actually formulate investment policy for their companies and to talk to selected individual investors. In addition, tax experts in real estate investment will be contacted with regard to the investment decisions of their clients. We would like to know what they think and how they have reacted.

The following is a brief resume of the current controversy surrounding

real estate investment incentives, including comments by proponents and opponents of increased use of federal income tax incentives for real estate investment.

THE CONTROVERSY

Douglas Commission

Two recent Presidential Commissions have had some pointed remarks to make about real estate investment incentives. The National Commission on Urban Problems, chaired by former Senator Paul Douglas of Illinois, (hereinafter referred to as the Douglas Commission) made extensive studies on all urban problems including housing. As part of its conclusions it made specific recommendations concerning tax policy as it relates to housing. The commission summarized its beliefs thus:

> "(1) That special tax preferences should not be relied upon as the sole or even the primary instrument to deal with urban housing problems;
>
> (2) That some changes in federal income tax laws and regulations should be made as soon as possible; and
>
> (3) That there should be vigorous official exploration of certain other potentially significant changes that might improve the tax climate for urban housing."

The Douglas Commission made three recommendations:

> (1) The Treasury department should make analyses and submit findings and recommendations as to how best to change the tax law to provide materially more favorable treatment for investment in new residential construction (including major rehabilitation) than in other forms of real estate investment; in other words, how to prefer investment in residential construction over other types;
>
> (2) ". . . prompt revision of the Federal income tax laws to provide increased incentives for investment in low- and moderate-income housing, relative to other real estate investment, where such housing is governmentally subsidized and involves a legal limit upon the allowable return on investors' equity capital."

(3) That "the Internal Revenue Code be amended to provide specific incentives for adequate maintenance and rehabilitation of rental residential property by allowing, within appropriate limits, for especially generous tax treatment of investor-owners' expenditures for these purposes with respect to structures of more than some specified age, ..."

Kaiser Commission

The President's Commission on Urban Housing chaired by Edward F. Kaiser (hereinafter referred to as the Kaiser Commission) submitted its final report on December 11, 1968. From June of 1967 until December of 1968 it had submitted interim reports and recommendations. A portion of its recommendations were incorporated in the Housing and Urban Development Act of 1968. The recommendations of this commission relied heavily upon the use of tax incentives to stimulate construction of low-income and moderate-income housing. The Kaiser Commission concluded that many existing tax rules do act as incentives for investment in this type of construction, and that some of the rules arbitrarily discourage such investment.

Housing and Urban Development Act

The Housing and Urban Development Act of 1968 was considered "one of the most comprehensive and forward-looking bills in the field of housing and urban development ever proposed." In it, Congress reaffirmed the national housing goal established by the Housing Act of 1949. The Congress determined that the national housing goal could be "substantially achieved within the next decade by the construction or rehabilitation of twenty-six million housing units, six million of

these for low and moderate income families." "In addition, the bill continues the emphasis of recent years of increased reliance on private sponsorship under our housing programs and participation by private enterprises in the financing and production of housing." One year later, however, Jerrard Gross, Chairman of the Legislative Committee of the National Apartment Association, pointed out in prepared testimony before the House Ways and Means Committee that only 1,500,000 housing units were constructed in 1968 and it was estimated that not more than 1,700,000 units would be constructed in 1969. Thus, actual production of housing units was falling behind schedule at the rate of one million units each year. In other words, actual production was only 60% of the national goal.

Treasury Study

On February 5, 1969, the Treasury Department submitted its Tax Reform Studies and Proposals. This study was not designed to deal primarily with the housing problem, rather it was a proposal for overall federal tax reform. A major thrust of the study was toward the elimination of what were considered "tax loopholes" without regard to the ramifications the suggested reforms might have upon real estate investment and upon national social problems such as low-income housing. The Study did note that the Treasury considered it impossible to make reliable quantitative estimates of the effect of tax provisions on construction and on the supply of housing. No attempt was made to determine the effect of the then current tax provisions upon the housing supply. While the Treasury Study appeared to take an attitude of indifference toward the housing problem, being primarily concerned with tax reform, the Douglas and Kaiser Commissions, and Congress in the Housing and Urban Development Act of 1968, had been primarily interested in this social problem.

Not only did the Treasury Study fail to endorse the positive effects of existing tax provisions on real estate investment, it emphasized the preferential nature of the tax treatment. It pointed out examples of taxpayers who offset income from other sources by tax losses from real estate investments. These investments or "real estate tax shelters" derived their preferential treatment from more than one provision. The Treasury cited the use of accelerated depreciation, thin equity financing, and limited recapture of prior over-depreciation as the major causes of tax losses. These losses existed even though there was an economic profit from the investment. Thus, the import of the examples was that the provisions affecting real estate were being abused by certain taxpayers to avoid taxation or to greatly reduce their taxes.

Proponents of Real Estate Investment Incentives

A number of representatives of real estate associations appeared before the Ways and Means Committee to protest the inference given by the Treasury Study. Mr. Wallace R. Woodbury, Chairman of the National Association of Real Estate Boards Subcommittee on Federal Taxation began his testimony by stating:

> A cutback in accelerated methods of depreciation, with its resulting sharp reduction in yield to equity investors, would substantially reduce the sources of risk capital in the construction industry.

Mr. Louis R. Barba, First Vice President of the National Association of Home Builders, stated that:

> Withdrawal of depreciation benefits presently extended to income-producing real estate would constitute a disastrous blow to that attempt [To attain the national housing goal].
> This is so for the simple fundamental reason that the yield --considered over the years--from the operation of residential income properties is so low and uncertain and subject to such

high risks that, absent favorable depreciation treatment, there is simply little incentive for a builder to invest in the equity of a rental property his skill and experience, a year or more of his time, and possible large sums of limited capital. Compared to other available investments, even under the most favorable circumstances, residential real estate is just not attractive to a builder or a real estate investor if the return is solely from the net rental proceeds of the property after payment of taxes, operating expenses and mortgage interest and amortization.

We say categorically that should accelerated depreciation for real estate be eliminated, the construction of income-producing real estate--particularly multifamily housing--would drop to a fraction of its present level--to a negligible amount compared with the need for it during the next 10 years. (Emphasis supplied)

Jerrard M. Gross, Chairman of the Legislative Committee of the National Apartment Association asserted:

Given the serious disadvantages which real estate has in raising capital as compared to other forms of capital investment, if these rules were changed adversely to real estate, it would be even more difficult to obtain capital, and fewer units would be built, which is going to cause more urban problems, which is going to cause higher rents, which is going to cause greater dislocation.

In addition, it was argued that to give incentives for low- and moderate-income housing but not for other types of structures would not succeed. Robert H. Pease, Vice-President of the Mortgage Bankers Association of America, testified before the Ways and Means Committee that:

I hope you would not fall into the trap of giving accelerated depreciation to low-income housing or moderate-income housing alone. This I think would be the death knell of American cities. We cannot afford a policy which forecloses out all but low-income new construction in our American cities. All types are necessary.

Opponents of Real Estate Investment Incentives

Just as there were those in favor of retaining the investment incentives, a number of individuals opposed it. Their opposition centered around the concept of "equity." The main argument against these incentives was expressed by Arnold Fisher, formerly of the Treasury, as:

> The principal tax inequity of the depreciation shelter is the manner in which it enables persons in the higher income brackets to use real estate as an artificial means of converting their ordinary income into capital gains.

A similar argument was given by George Meany, President American Federation of Labor and Congress of Industrial Organizations, in his written statement. He stated:

> A host of special tax-forgiveness provisions apply to real estate. Taken by themselves, these privileges are hardly justifiable but, when manipulated and combined, they result in unconscionable tax-avoidance opportunities for wealthy real-estate operators, investors, and speculators.

Dan Throop Smith, Professor of Finance Harvard Business School and Stanford Business School, expressed a slightly different concern when he said:

> It is unquestionably true that the effect of this differential treatment [Section 1245 recapture versus Section 1250 recapture] has encouraged investment in real estate but the economic results are of questionable social value and in any case hardly seem to justify the inequities available to one group of investors.

Rehabilitation Expenditures

One of the recommendations of the Douglas Commission was for the adoption of federal income tax incentives for rehabilitation expenditures. With almost no opposition, the House of Representatives in 1969 enacted a provision to permit amortization of qualified rehabilitation expenditures over a sixty-month period. In its report to the House, the Ways and Means Committee stated that it recognized "the importance of encouraging rehabilitation of buildings for low-cost rental housing." The Senate Finance Committee made only one addition to the provision. The expenditures must be made prior to January 1, 1975 to qualify for the rapid amortization. The Senate Finance Committee's reason for this addition was: "This will provide time for the Congress to evaluate the effectiveness and the cost of this new incentive."

The Problems

The Congress faces three different types of problems when considering real estate investment incentives:

1. Are federal income tax provisions a proper and acceptable means of creating real estate investment incentives designed to attain the national housing goal?

2. To what extent does the use of this relatively new method of stimulating investment in real estate have acceptance in the business community?

3. What impact have the kinds of tax devices thus far used to stimulate investment and to channel investment funds into real estate had on investor decisions?

It is vital to know how investors have reacted and how they think they will react in the future to the use of tax incentives for investment in real estate.

The purpose of this study is to try to determine by a comprehensive program of interviews with investors their reactions to the above problems. We would like to ask you face to face such questions, among others, as:

1. To what extent are federal income tax considerations a factor in your investment decision process?

2. Has the Tax Reform Act of 1969 caused you to reevaluate your present holdings?

3. Has the Tax Reform Act of 1969 increased your propensity to invest in tax favored projects?

4. Has the Tax Reform Act of 1969 increased your inclination to invest in low-income housing?

APPENDIX B

REVENUE ACT OF 1964

GAIN FROM DISPOSITIONS OF CERTAIN DEPRECIABLE REALTY

"SEC. 1250. GAIN FROM DISPOSITIONS OF CERTAIN DEPRECIABLE REALTY.

"(a) GENERAL RULE.---

"(1) ORDINARY INCOME.---Except as otherwise provided in this section, if section 1250 property is disposed of after December 31, 1963, the applicable percentage of the lower of---

"(A) the additional depreciation (as defined in subsection (b) (1)) in respect of the property, or

"(B) the excess of---

"(i) the amount realized (in the case of a sale, exchange, or involuntary conversion), or the fair market value of such property (in the case of any other disposition), over

"(ii) the adjusted basis of such property,

shall be treated as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231. Such gain shall be recognized notwithstanding any other provision of this subtitle.

"(2) APPLICABLE PERCENTAGE.---For purposes of paragraph (1), the term 'applicable percentage' means 100 percent minus one percentage point for each full month the property was held after the date on which the property was held 20 full months.

"(b) ADDITIONAL DEPRECIATION DEFINED.---For purposes of this section---

"(1) IN GENERAL.---The term 'additional depreciation' means, in the case of any property, the depreciation adjustments in respect of such property; except that, in the case of property held more than one year, it means such adjustments only to the extent that they exceed the amount of the depreciation adjustments which would have resulted if such adjustments had been determined for each taxable year under the straight line method of adjustment. For purposes of the preceding sentence, if a useful life (or salvage value) was used to determining the amount allowed as a deduction for any taxable year, such life (or value) shall be used in determining the depreciation adjustments which would have resulted for such year under the straight line method.

"(2) PROPERTY HELD BY LESSEE.---In the case of a lessee, in determining the depreciation adjustments which would have resulted in respect of any building erected (or other improvement made) on the leased property, or in respect of any cost of acquiring the lease, the lease period shall be treated as including all renewal periods. For purposes of the preceding sentence---

"(A) the term 'renewal period' means any period for which the lease may be renewed, extended, or continued pursuant to an option exercisable by the lessee, but

"(B) the inclusion of renewal periods shall not extend the period taken into account by more than 2/3 of the period on the basis of which the depreciation adjustments were allowed.

"(3) DEPRECIATION ADJUSTMENTS.---The term 'depreciation adjustments' means, in respect of any property, all adjustments attributable to periods after December 31, 1963, reflected in the adjusted basis of such property on account of deductions (whether in respect of the same or other property) allowed or allowable to the taxpayer or to any other person for exhaustion, wear and tear, obsolescence, or amortization (other than amortization under section 168). For purposes of the preceding sentence, if the taxpayer can establish by adequate records or other sufficient evidence that the amount allowed as a deduction for any period was less than the amount allowable, the amount taken into account for such period shall be the amount allowed.

"(c) SECTION 1250 PROPERTY.---For purposes of this section, the term 'section 1250 property' means any real property (other than section 1245 property, as defined in section 1245(a)(3)) which is or has been property of a character subject to the allowance for depreciation provided in section 167.

"(d) EXCEPTIONS AND LIMITATIONS.---

"(1) GIFTS.---Subsection (a) shall not apply to a disposition by gift.

"(2) TRANSFERS AT DEATH.---Except as provided in section 691 (relating to income in respect of a decedent), subsection (a) shall not apply to a transfer at death.

"(3) CERTAIN TAX-FREE TRANSACTIONS.---If the basis of property in the hands of a transferee is determined by reference to its basis in the hands of the transferor by reason of the application of section 332, 351, 361, 371(a), 374(a), 721, or 731,

then the amount of gain taken into account by the transferor under subsection (a)(1) shall not exceed the amount of gain recognized to the transferor on the transfer of such property (determined without regard to this section). This paragraph shall not apply to a disposition to an organization (other than a cooperative described in section 521) which is exempt from the tax imposed by this chapter.

"(4) LIKE KIND EXCHANGES: INVOLUNTARY CONVERSIONS, ETC.---

"(A) RECOGNITION LIMIT.---If property is disposed of and gain (determined without regard to this section) is not recognized in whole or in part under section 1031 or 1033, then the amount of gain taken into account by the transferor under subsection (a)(1) shall not exceed the greater of the following:

"(i) the amount of gain recognized on the disposition (determined without regard to this section), increased as provided in subparagraph (B), or

"(ii) the amount determined under subparagraph (C).

"(B) INCREASE FOR CERTAIN STOCK.---With respect to any transaction, the increase provided by this subparagraph is the amount equal to the fair market value of any stock purchased in a corporation which (but for this paragraph) would result in nonrecognition of gain under section 1033 (a)(3)(A).

"(C) ADJUSTMENT WHERE INSUFFICIENT SECTION 1250 PROPERTY IS ACQUIRED.---With respect to any transaction, the amount determined under this subparagraph shall be the excess of ---

"(i) the amount of gain which would (but for this paragraph) be taken into account under subsection (a)(1), over

"(ii) the fair market value (or cost in the case of a transaction described in section 1033(a)(3)) of the section 1250 property acquired in the transaction.

"(D) BASIS OF PROPERTY ACQUIRED.---In the case of property purchased by the taxpayer in a transaction described in section 1033(a)(3), in applying the last sentence of section 1033(c), such sentence shall be applied---

"(i) first solely to section 1250 properties and to the amount of gain not taken into account under subsection (a)(1) by reason of this paragraph, and

"(ii) then to all purchased properties to which such sentence applies and to the remaining gain not recognized on the transaction as if the cost of the section 1250 properties were the basis of such properties computed under clause (i).

In the case of property acquired in any other transaction to which this paragraph applies, rules consistent with the preceding sentence shall be applied under regulations prescribed by the Secretary or his delegate.

"(E) ADDITIONAL DEPRECIATION WITH RESPECT TO PROPERTY DISPOSED OF.---In the case of any transaction described in section 1031 or 1033, the additional depreciation in respect of the section 1250 property acquired which is attributable to the section 1250 property disposed of shall be an amount

equal to the amount of the gain which was not taken into account under subsection (a)(1) by reason of the application of this paragraph.

"(5) SECTION 1071 AND 1081 TRANSACTIONS.---Under regulations prescribed by the Secretary or his delegate, rules consistent with paragraphs (3) and (4) of this subsection and with subsections (e) and (f) shall apply in the case of transactions described in section 1071 (relating to gain from sale or exchange to effectuate policies of FCC) or section 1081 (relating to exchanges in obedience to SEC orders).

"(6) PROPERTY DISTRIBUTED BY A PARTNERSHIP TO A PARTNER.---

"(A) IN GENERAL.---For purposes of this section, the basis of section 1250 property distributed by a partnership to a partner shall be deemed to be determined by reference to the adjusted basis of such property to the partnership.

"(B) ADDITIONAL DEPRECIATION.---In respect of any property described in subparagraph (A), the additional depreciation attributable to periods before the distribution by the partnership shall be---

"(i) the amount of the gain to which subsection (a) would have applied if such property had been sold by the partnership immediately before the distribution at its fair market value at such time and the applicable percentage for the property had been 100 percent, reduced by

"(ii) if section 751(b) applied to any part of such gain, the amount of such gain to which section 751(b)

would have applied if the applicable percentage for the property had been 100 percent.

"(7) DISPOSITION OF PRINCIPAL RESIDENCE.---Subsection (a) shall not apply to a disposition of---

"(A) property to the extent used by the taxpayer as his principal residence (within the meaning of section 1034, relating to sale or exchange of residence), and

"(B) property in respect of which the taxpayer meets the age and ownership requirements of section 121 (relating to gains from sale or exchange of residence of individual who has attained the age of 65) but only to the extent that he meets the use requirements of such section in respect of such property.

"(e) HOLDING PERIOD.---For purposes of determining the applicable percentage under this section, the provisions of section 1223 shall not apply, and the holding period of section 1250 property shall be determined under the following rules:

"(1) BEGINNING OF HOLDING PERIOD.---The holding period of section 1250 property shall be deemed to begin---

"(A) in the case of property acquired by the taxpayer, on the day after the date of acquisition, or

"(B) in the case of property constructed, reconstructed, or erected by the taxpayer, on the first day of the month during which property is placed in service.

"(2) PROPERTY WITH TRANSFERRED BASIS.---If the basis of property acquired in a transaction described in paragraph (1), (2), (3), or (5) of subsection (d) is determined by reference to its basis

in the hands of the transferor, then the holding period of the property in the hands of the transferee shall include the holding period of the property in the hands of the transferor.

"(3) PRINCIPAL RESIDENCE.---If the basis of property acquired in a transaction described in paragraph (7) of subsection (d) is determined by reference to the basis in the hands of the taxpayer of other property, then the holding period of the property acquired shall include the holding period of such other property.

"(f) SPECIAL RULES FOR PROPERTY WHICH IS SUBSTANTIALLY IMPROVED.---

"(1) AMOUNT TREATED AS ORDINARY INCOME.---If, in the case of a disposition of section 1250 property, the property is treated as consisting of more than one element by reason of paragraph (3), then the amount taken into account under subsection (a)(1) in respect of such section 1250 property as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231 shall be the sum of the amounts determined under paragraph (2).

"(2) ORDINARY INCOME ATTRIBUTABLE TO AN ELEMENT.---For purposes of paragraph (1), the amount taken into account for any element shall be the amount determined by multiplying---

"(A) the amount which bears the same ratio to the lower of the amounts specified in subparagraph (A) or (B) of subsection (a)(1) for the section 1250 property as the additional depreciation for such element bears to the sum of the additional depreciation for all elements, by

"(B) the applicable percentage for such element.

For purposes of this paragraph, determinations with respect to

any element shall be made as if it were a separate property.

"(3) PROPERTY CONSISTING OF MORE THAN ONE ELEMENT.---In applying this subsection in the case of any section 1250 property, there shall be treated as a separate element---

"(A) each separate improvement,

"(B) if, before completion of section 1250 property, units thereof (as distinguished from improvements) were placed in service, each such unit of section 1250 property, and

"(C) the remaining property which is not taken into account under subparagraphs (A) and (B).

"(4) PROPERTY WHICH IS SUBSTANTIALLY IMPROVED.---For purposes of this subsection---

"(A) IN GENERAL.---The term 'separate improvement' means each improvement added during the 36-month period ending on the last day of any taxable year to the capital account for the property, but only if the sum of the amounts added to such account during such period exceeds the greatest of---

"(i) 25 percent of the adjusted basis of the property,

"(ii) 10 percent of the adjusted basis of the property, determined without regard to the adjustments provided in paragraphs (2) and (3) of section 1016(a), or

"(iii) $5,000.

For purposes of clauses (i) and (ii), the adjusted basis of the property shall be determined as of the beginning of the first day of such 36-month period, or of the holding period of the property (within the meaning of subsection (e)), whichever is the later.

"(B) EXCEPTION.---Improvements in any taxable year shall be taken into account for purposes of subparagraph (A) only if the sum of the amounts added to the capital account for the property for such taxable year exceeds the greater of---

"(i) $2,000, or

"(ii) one percent of the adjusted basis referred to in subparagraph (A) (ii), determined, however, as of the beginning of such taxable year.

For purposes of this section, if the amount added to the capital account for any separate improvement does not exceed the greater of clause (i) or (ii), such improvement shall be treated as placed in service on the first day, of a calendar month, which is closest to the middle of the taxable year.

"(C) IMPROVEMENT.---The term 'improvement' means, in the case of any section 1250 property, any addition to capital account for such property after the initial acquisition or after completion of the property.

"(g) ADJUSTMENTS TO BASIS.---The Secretary or his delegate shall prescribe such regulations as he may deem necessary to provide for adjustments to the basis of property to reflect gain recognized under subsection (a).

"(h) APPLICATION OF SECTION.---This section shall apply notwithstanding any other provision of this subtitle."

(b) TECHNICAL AMENDMENTS.---

(1) SPECIAL RULE FOR CHARITABLE CONTRIBUTIONS.---

(A) The heading of section 170(e) (relating to special rule for charitable contributions of section 1245 property)

is amended by striking out "SECTION 1245 PROPERTY" and inserting in lieu thereof "CERTAIN PROPERTY".

(B) The text of such section 170(e) is amended by striking out "section 1245(a)" and inserting in lieu thereof "section 1245(a) or 1250(a)".

(2) CORPORATE DISTRIBUTIONS OF PROPERTY.---Subsections (b) and (d) of section 301 (relating to amount distributed) are each amended by striking out "under section 1245(a)" and inserting in lieu thereof "under section 1245(a) or 1250(a)".

(3) EFFECT ON EARNINGS AND PROFITS.---Paragraph (3) of section 312(c) (relating to adjustments of earnings and profits) is amended by striking out "or under section 1245(a)" and inserting in lieu thereof "or under section 1245(a) or 1250(a)".

(4) COLLAPSIBLE CORPORATIONS.---Paragraph (12) of section 341(e) (relating to collapsible corporations) is amended by striking out "section 1245(a)" and inserting in lieu thereof "sections 1245(a) and 1250(a)".

(5) INSTALLMENT OBLIGATIONS IN CERTAIN LIQUIDATIONS.---Subparagraphs (A) and (B) of section 453(d)(4) (relating to distribution of installment obligations in certain corporate liquidations) are each amended by striking out "section 1245(a)" and inserting in lieu thereof "section 1245(a) or 1250(a)".

(6) SPECIAL RULE FOR PARTNERSHIPS.---Section 751(c) (relating to definition of "unrealized receivables" for purposes of subchapter K) is amended by striking out "(as defined in section 1245(a)(3))" and inserting in lieu thereof "(as defined in section 1245(a)(3)) and section 1250 property (as defined in section 1250(c))"

and by striking out "to which section 1245(a)" and inserting in lieu thereof "to which section 1245(a) or 1250(a)".

(7) The table of sections for part IV of subchapter P of chapter 1 is amended by adding at the end thereof the following:

"Sec. 1250. Gain from dispositions of certain depreciable realty."

(c) EFFECTIVE DATE.---The amendments made by this section shall apply to dispositions after December 31, 1963, in taxable years ending after such date.

APPENDIX C

TAX REFORM ACT OF 1969

PROVISIONS AFFECTING REAL ESTATE INVESTMENT

SUBTITLE C-REAL ESTATE DEPRECIATION

SEC. 521. DEPRECIATION OF REAL ESTATE.

(a) Section 1250 Property and Rehabilitation Property.- Section 167 (relating to depreciation) is amended by redesignating subsection (j) as subsection (m), and by inserting after subsection (i) the following new subsections:

"(j) Special Rules for Section 1250 Property.-

"(1) General Rule.-Except as provided in paragraphs (2) and (3), in the case of section 1250 property, subsection (b) shall not apply and the term 'reasonable allowance' as used in subsection (a) shall include an allowance computed in accordance with regulations prescribed by the Secretary or his delegate, under any of the following methods:

"(A) the straight line method,

"(B) the declining balance method, using a rate not exceeding 150 percent of the rate which would have been used had the annual allowance been computed under the method described in subparagraph (A), or

"(C) any other consistent method productive of an annual allowance which, when added to all allowances for the period commencing with the taxpayer's use of the property and including the taxable year, does not, during the first two-thirds of the useful life of the property, exceed the total of such allowances which would have been used had such allowances been computed under the method described in subparagraph (B).

Nothing in this paragraph shall be construed to limit or reduce an allowance otherwise allowable under subsection (a) except where allowable solely by reason of paragraph (2), (3), or (4) of subsection (b).

"(2) Residential Rental Property.-

"(A) In General.-Paragraph (1) of this subsection shall not apply, and subsection (b) shall apply in any taxable year, to a building or structure-

"(i) which is residential rental property located within the United States or any of its possessions, or located within a foreign country if a method of depreciation for such property comparable to the method provided in subsection (b) (2) or (3) is provided by the laws of such country, and

"(ii) the original use of which commences with the taxpayer.

In the case of residential rental property located within a foreign country, the original use of which commences with the taxpayer, if the allowance for depreciation provided under the laws of such country for such property is greater than that provided under paragraph (1) of this subsection, but less than that provided under subsection (b), the allowance for depreciation under subsection (b) shall be limited to the amount provided under the laws of such country.

"(B) Definition.-For purposes of subparagraph (A), a building or structure shall be considered to be residential rental property for any taxable year only if 80 percent or more of the gross rental income from such building or structure for such year is rental income from dwelling units (within the meaning of subsection (k)(3)(C). For purposes of the preceding sentence, if any portion of such building or structure is occupied by the taxpayer, the gross rental income from such building or structure shall include the rental value of the portion so occupied.

"(C) Change in Method of Depreciation.-Any change in the computation of the allowance for depreciation for any taxable year, permitted or required by reason of the application of subparagraph (A), shall not be considered a change in a method of accounting.

'(3) Property constructed, etc., before July 25, 1969.-Paragraph (1) of this subsection shall not apply, and subsection (b) shall apply, in the case of property-

"(A) the construction, reconstruction, or erection of which was begun before July 25, 1969, or

"(B) for which a written contract entered into before July 25, 1969, with respect to any part of the construction, reconstruction, or erection or for the permanent financing thereof, was on July 25, 1969, and at all times thereafter, binding on the taxpayer.

"(4) Used section 1250 property.-Except as provided in paragraph (5), in the case of section 1250 property acquired after July 24, 1969, the original use of which does not commence with the taxpayer, the allowance for depreciation under this section shall be limited to an amount computed under-

"(A) the straight line method, or

"(B) any other method determined by the Secretary or his delegate to result in a reasonable allowance under subsection (a), not including-

"(i) any declining balance method,

"(ii) the sum of the years-digits method, or

"(iii) any other method allowable solely by reason of the application of subsection (b)(4) or paragraph (1)

(C) of this subsection.

"(5) Used residential rental property.-In the case of section 1250 property which is residential rental property (as defined in paragraph (2)(B) acquired after July 24, 1969, having a useful life of 20 years or more, the original use of which does not commence with the taxpayer, the allowance for depreciation under this section shall be limited to an amount computed under-

"(A) the straight line method,

"(B) the declining balance method, using a rate not exceeding 125 percent of the rate which would have been used had the annual allowance been computed under the method described

in subparagraph (A), or

"(C) any other method determined by the Secretary or his delegate to result in a reasonable allowance under subsection (a), not including-

"(i) the sum of the years-digits method,

"(ii) any declining balance method using a rate in excess of the rate permitted under subparagraph (B), or

"(iii) any other method allowable solely by reason of the application of subsection (b)(4) or paragraph (1)(C) of this subsection.

"(6) Special Rules.-

"(A) Under regulations prescribed by the Secretary or his delegate, rules similar to the rules provided in paragraphs (5), (9), (10), and (13) of section 48(h) shall be applied for purposes of paragraphs (3), (4), and (5) of this subsection.

"(B) For purposes of paragraphs (2), (4), and (5), if section 1250 property which is not property described in subsection (a) when its original use commences, becomes property described in subsection (a) after July 24, 1969, such property shall not be treated as property the original use of which commences with the taxpayer.

"(C) Paragraphs (4) and (5) shall not apply in the case of section 1250 property acquired after July 24, 1969, pursuant to a written contract for the acquisition of such property or for the permanent financing thereof, which was, on July 24, 1969, and at all times thereafter, binding on the taxpayer.

"(k) Depreciation of Expenditures to Rehabilitate Low-Income Rental Housing.-

"(1) 60-month rule.-The taxpayer may elect, in accordance with regulations prescribed by the Secretary or his delegate, to compute the depreciation deduction provided by subsection (a) attributable to rehabilitation expenditures incurred with respect to low-income rental housing after July 24, 1969, and before January 1, 1975, under the straight line method using a useful life of 60 months and no salvage value. Such method shall be in lieu of any other method of computing the depreciation deduction under subsection (a), and in lieu of any deduction for amortization, for such expenditures.

"(2) Limitations.-

"(A) The aggregate amount of rehabilitation expenditures paid or incurred by the taxpayer with respect to any dwelling unit in any low-income rental housing which may be taken into account under paragraph (1) shall not exceed $15,000.

"(B) Rehabilitation expenditures paid or incurred by the taxpayer in any taxable year with respect to any dwelling unit in any low-income rental housing shall be taken into account under paragraph (1) only if over a period of two consecutive years, including the taxable year, the aggregate amount of such expenditures exceeds $3,000.

"(3) Definitions.-For purposes of this subsection-

"(A) Rehabilitation expenditures.-The term 'rehabilitation expenditures' means amounts chargeable to capital

account and incurred for property or additions or improvements to property (or related facilities) with a useful life of 5 years or more, in connection with the rehabilitation of an existing building for low-income rental housing; but such term does not include the cost of acquisition of such building or any interest therein.

"(B) Low-income rental housing.-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.

"(C) Dwelling unit.-The term 'dwelling unit' means a house or an apartment used to provide living accommodations in a building or structure, but does not include a unit in a hotel, motel, inn, or other establishment more than one-half of the units in which are used on a transient basis."

(b) Recapture of Additional Depreciation.-Section 1250(a) (relating to gain from dispositions of certain depreciable realty) is amended to read as follows:

"(a) General Rule.-Except as otherwise provided in this section-

"(1) Additional depreciation after December 31, 1969.-If section 1250 property is disposed of after December 31, 1969, the applicable percentage of the lower of-

"(A) that portion of the additional depreciation (as defined in subsection (b) (1) or (4) attributable to periods after December 31, 1969, in respect of the property, or

"(B) the excess of-

"(i) the amount realized (in the case of a sale, exchange, or involuntary conversion), or the fair market value of such property (in the case of any other disposition), over

"(ii) the adjusted basis of such property,

shall be treated as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231. Such gain shall be recognized notwithstanding any other provision of this subtitle.

"(C) Applicable percentage.-For purposes of paragraph (1), the term 'applicable percentage' means-

"(i) in the case of section 1250 property disposed of pursuant to a written contract which was, on July 24, 1969, and at all times thereafter, binding on the owner of the property, 100 percent minus 1 percentage point for each full month the property was held after the date the property was held 20 full months;

"(ii) in the case of section 1250 property constructed, reconstructed, or acquired by the taxpayer before January 1, 1975, with respect to which a mortgage is insured under

section 221(d)(3) or 236 of the National Housing Act, or housing is financed or assisted by direct loan or tax abatement under similar provisions of State or local laws, and with respect to which the owner is subject to the restrictions described in section 1039(b)(1)(B), 100 percent minus one percentage point for each full month the property was held after the date the property was held 20 full months;

"(iii) in the case of residential rental property (as defined in section 167(j)(2)(B)) other than that covered by clauses (i) and (ii), 100 percent minus 1 percentage point for each full month the property was held after the date the property was held 100 full months;

"(iv) in the case of section 1250 property with respect to which a depreciation deduction for rehabilitation expenditures was allowed under section 167(k), 100 percent minus 1 percentage point for each full month in excess of 100 full months after the date on which such property was placed in service; and

"(v) in the case of all other section 1250 property, 100 percent.

Clauses (i), (ii), and (iii) shall not apply with respect to the additional depreciation described in subsection (b)(4).

"(2) Additional depreciation before January 1, 1970.-

"(A) In general.-If section 1250 property is disposed of after December 31, 1963, and the amount determined under

paragraph (1)(B) exceeds the amount determined under paragraph (1)(A), then the applicable percentage of the lower of-

"(i) that portion of the additional depreciation attributable to periods before January 1, 1970, in respect of the property, or

"(ii) the excess of the amount determined under paragraph (1)(B) over the amount determined under paragraph (1)(A),

shall also be treated as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231. Such gain shall be recognized notwithstanding any other provision of this subtitle.

"(B) Applicable percentage.-For purposes of subparagraph (A) the term 'applicable percentage' means 100 percent minus 1 percentage point for each full month the property was held after the date on which the property was held for 20 full months."

(c) Additional Depreciation.-Section 1250(b) (relating to definition of additional depreciation) is amended by adding at the end thereof the following new paragraph:

"(4) Additional depreciation attributable to rehabilitation expenditures.-The term 'additional depreciation' also means, in the case of section 1250 property with respect to which a depreciation deduction for rehabilitation expenditures was allowed under section 167(k), the depreciation adjustments allowed under such section to the extent attributable to such

property, except that, in the case of such property held for more than one year after the rehabilitation expenditures so allowed were incurred, it means such adjustments only to the extent that they exceed the amount of the depreciation adjustments which would have resulted if such adjustments had been determined under the straight line method of adjustment without regard to the useful life permitted under section 167(k)."

(d) Change in Method of Computing Depreciation.-Section 167(e) (relating to depreciation) is amended by adding at the end thereof the following new paragraph:

"(3) Change with respect to section 1250 property.-A taxpayer may, on or before the last day prescribed by law (including extensions thereof) for filing his return for his first taxable year beginning after July 24, 1969, and in such manner as the Secretary or his delegate shall be regulation prescribe, elect to change his method of depreciation in respect of section 1250 property (as defined in section 1250(c) from any declining balance or sum of the years-digits method to the straight line method. An election may be made under this paragraph notwithstanding any provision to the contrary in an agreement under subsection (d)."

(e) Technical and Conforming Changes.-

(1) Subsection (d) of section 1250 is amended by striking out "subsection (a)(1)" wherever it appears and inserting in lieu thereof "subsection (a)".

(2) Subsection (f) of section 1250 is amended-

(A) by striking out "subsection (a)(1)" in paragraph (1) and inserting in lieu thereof "subsection (a)", and

(B) by striking out paragraph (2) thereof and inserting in lieu thereof the following:

"(2) Ordinary income attributable to an element.-For purposes of paragraph (1), the amount taken into account for any element shall be the sum of-

"(A) the amount (if any) determined by multiplying-

"(i) the amount which bears the same ratio to the lower of the amounts specified in subparagraph (A) or (B) of subsection (a)(1) for the section 1250 property as the additional depreciation for such element attributable to periods after December 31, 1969, bears to the sum of the additional depreciation for all elements attributable to periods after December 31, 1969, by

"(ii) the applicable percentage for such element, and

"(B) the amount (if any) determined by multiplying-

"(i) the amount which bears the same ratio to the lower of the amounts specified in subsection (a)(2)(A)(i) or (ii) for the section 1250 property as the additional depreciation for such element attributable to periods before January 1, 1970, bears to the sum of the additional depreciation for all elements attributable to periods before January 1, 1970, by

"(ii) the applicable percentage for such element.

For purposes of this paragraph, determinations with respect to any element shall be made as if it were a separate property."

(f) Carryovers in Certain Corporate Acquisitions.-Section 381(c)(6) (relating to method of computing depreciation allowance) is amended to read as follows:

(6) Method of computing depreciation allowance.-The acquiring corporation shall be treated as the distributor or transferor corporation for purposes of computing the depreciation allowance under subsections (b), (j), and (k) of section 167 on property acquired in a distribution or transfer with respect to so much of the basis in the hands of the acquiring corporation as does not exceed the adjusted basis in the hands of the distributor or transferor corporation."

(g) Effective Date.-The amendments made by this section shall apply with respect to taxable years ending after July 24, 1969.

SEC. 910. SALES OF CERTAIN LOW-INCOME HOUSING PROJECTS.

(a) Nonrecognition of Gain in Case of Approved Dispositions.- Part III of subchapter O of chapter 1 (relating to common nontaxable exchanges) is amended by adding at the end thereof the following new section:

"SEC. 1039. CERTAIN SALES OF LOW-INCOME HOUSING PROJECTS.

"(a) Nonrecognition of Gain.-If-

"(1) a qualified housing project is sold or disposed of by the taxpayer in an approved disposition, and

"(2) within the reinvestment period the taxpayer constructs, reconstructs, or acquires another qualified housing project,

then, at the election of the taxpayer, gain from such approved disposition shall be recognized only to the extent that the net amount realized on such approved disposition exceeds the cost of such other qualified housing project. An election under this subsection shall be made at such time and in such manner as the Secretary or his delegate prescribes by regulations.

"(b) Definitions.-For purposes of this section-

"(1) Qualified housing project.-The term 'qualified housing project' means a project to provide rental or cooperative housing for lower income families-

"(A) with respect to which a mortgage is insured under section 221(d)(3) or 236 of the National Housing Act, and

"(B) with respect to which the owner is, under such sections or regulations issued thereunder-

"(i) limited as to the rate of return on his investment in the project, and

"(ii) limited as to rentals or occupancy charges for units in the project.

"(2) Approved disposition.-The term 'approved disposition' means a sale or other disposition of a qualified housing project to the tenants or occupants of units in such project, or to a cooperative or other nonprofit organization formed solely for the benefit of such tenants or occupants, which sale or disposition is approved by the Secretary of Housing and Urban Development under section 221(d)(3) or 236 of the National Housing Act or regulations issued under such sections.

"(3) Reinvestment period.-The reinvestment period, with respect to an approved disposition of a qualified housing project, is the period beginning one year before the date of such approved disposition and ending-

"(A) one year after the close of the first taxable year in which any part of the gain from such approved disposition is realized, or

"(B) subject to such terms and conditions as may be specified by the Secretary or his delegate, at the close of such later date as the Secretary or his delegate may designate on application by the taxpayer. Such application shall be made at such time and in such manner as the Secretary or his delegate prescribes by regulations.

"(4) Net amount realized.-The net amount realized on an approved disposition of a qualified housing project is the amount realized reduced by-

"(A) the expenses paid or incurred which are directly connected with such approved disposition, and

"(B) the amount of taxes (other than income taxes) paid or incurred which are attributable to such approved disposition.

"(c) Special Rules.-For purposes of applying subsection (a)(2) with respect to an approved disposition-

"(1) no property acquired by the taxpayer before the date of the approved disposition shall be taken into account unless such property is held by the taxpayer on such date, and

"(2) no property acquired by the taxpayer shall be taken into account unless, except as provided in subsection (d), the unadjusted basis of such property is its cost within the meaning of section 1012.

"(d) Basis of Other Qualified Housing Project.-If the taxpayer makes an election under subsection (a) with respect to an approved disposition, the basis of the qualified housing project described in subsection (a)(2) shall be its cost reduced by an amount equal to the amount of gain not recognized by reason of the application of subsection (a).

"(e) Assessment of Deficiencies.-

"(1) Deficiency attributable to gain.-If the taxpayer has made an election under subsection (a) with respect to an approved disposition-

"(A) the statutory period for the assessment of any deficiency, for any taxable year in which any part of the

gain on such approved disposition is realized, attributable to the gain on such approved disposition shall not expire prior to the expiration of 3 years from the date the Secretary or his delegate is notified by the taxpayer (in such manner as the Secretary or his delegate may by regulations prescribe) of the construction, reconstruction, or acquisition of another qualified housing project or of the failure to construct, reconstruct, or acquire another qualified housing project, and

"(B) such deficiency may be assessed before the expiration of such 3-year period notwithstanding the provisions of section 6212(c) or the provision of any other law or rule of law which would otherwise prevent such assessment.

"(2) Time for assessment of other deficiencies attributable to election.-If a taxpayer has made an election under subsection (a) with respect to an approved disposition and another qualiifed housing project is constructed, reconstructed, or acquired before the beginning of the last taxable year in which any part of the gain upon such approved disposition is realized, any deficiency, to the extent resulting from such election, for any taxable year ending before such last taxable year may be assessed (notwithstanding the provisions of section 6212(c) or 6501 or the provisions of any other law or rule of law which would otherwise prevent such assessment) at any time before the expiration of the period within which a deficiency for such last taxable year may be assessed."

(b) Amendments to Section 1250.-

(1) Section 1250(d) (relating to exceptions and limitations) is amended by adding at the end thereof the following new paragraph:

"(8) Disposition of qualified low-income housing.-If section 1250 property is disposed of an gain (determined without regard to this section) is not recognized in whole or in part under section 1039, then-

"(A) Recognition limit.-The amount of gain recognized by the transferor under subsection (a) shall not exceed the greater of-

"(i) the amount of gain recognized on the disposition (determined without regard to this section), or

"(ii) the amount determined under subparagraph (B).

"(B) Adjustment where insufficient section 1250 property is acquired.-With respect to any transaction, the amount determined under this subparagraph shall be the excess of-

"(i) the amount of gain which would (but for this paragraph) be taken into account under subsection (a), over

"(ii) the cost of the section 1250 property acquired in the transaction.

"(C) Basis of property acquired.-The basis of property acquired by the taxpayer, determined under section 1039(d), shall be allocated-

"(i) first to the section 1250 property described in subparagraph (E)(i), in the amount determined under such subparagraph, reduced by the amount of gain not recognized attributable to the section 1250 property disposed of,

"(ii) then to any property (other than section 1250 property) to which section 1039 applies, in the amount of its cost, reduced by the amount of gain not recognized except to the extent taken into account under clause (i), and

"(iii) then to the section 1250 property described in subparagraph (E)(ii), in the amount determined thereunder, reduced by the amount of gain not recognized except to the extent taken into account under clauses (i) and (ii).

"(D) Additional depreciation with respect to property disposed of.-The additional depreciation with respect to any property acquired shall include the additional depreciation with respect to the corresponding section 1250 property disposed of, reduced by the amount of gain recognized attributable to such property.

"(E) Property consisting of more than one element.-There shall be treated as a separate element of section 1250 property-

"(i) that portion of the section 1250 property acquired the cost of which does not exceed the net amount

realized (as defined in section 1039(b) attributable to the section 1250 property disposed of, reduced by the amount of gain recognized (if any) attributable to such property, and

"(ii) that portion of the section 1250 property acquired the cost of which exceeds the net amount realized (as defined in section 1039(b)) attributable to the section 1250 property disposed of.

"(F) Allocation rules.-For purposes of this paragraph-

"(i) the amount of gain recognized attributable to the section 1250 property disposed of shall be the net amount realized with respect to such property, reduced by the greater of the adjusted basis of the section 1250 property disposed of or the cost of the section 1250 property acquired, but shall not exceed the gain recognized in the transaction, and

"(ii) if any section 1250 property is treated as consisting of more than one element by reason of the application of subparagraph (E) to a prior transaction, then the amount of gain recognized, the net amount realized, and the additional depreciation, with respect to each such element shall be allocated in accordance with regulations prescribed by the Secretary or his delegate."

(2) Section 1250(e) (relating to holding period) is amended by adding at the end thereof the following new paragraph:

"(4) Qualified low-income housing.-The holding period of any section 1250 property acquired which is described in subsection (d)(8)(E)(i) shall include the holding period of the corresponding element of section 1250 property disposed of."

(3) Section 1250 (relating to gain from dispositions of certain depreciable realty) is amended by redesignating subsections (g) and (h) as subsections (h) and (i) and by inserting after subsection (f) the following new subsection:

"(g) Special Rules for Qualified Low-Income Housing.-

"(1) Amount treated as ordinary income.-If, in the case of a disposition of section 1250 property, the property is treated as consisting of more than one element by reason of the application of subsection (d)(8)(E), and gain is recognized in whole or in part, then the amount taken into account under subsection (a) as gain from the sale or exchange of property which is neither a capital asset nor property described in section 1231 shall be the sum of the amounts determined under paragraph (2).

"(2) Ordinary income attributable to an element.-For purposes of paragraph (1), the amount taken into account for any element shall be the amount determined by multiplying-

"(A) the amount which bears the same ratio to the lower of the additional depreciation or the gain recognized for the section 1250 property disposed of as the additional depreciation for such element bears to the sum of the additional depreciation for all elements disposed of, by

"(B) the applicable percentage for such element.

For purposes of this paragraph, determinations with respect to any element shall be made as if it were a separate property."

(c) Clerical Amendment.-The table of sections for part III of subchapter O of chapter 1 is amended by adding at the end thereof the following new item:

"Sec. 1039. Certain sales of low-income housing projects."

(d) Effective Date.-The amendments made by this section shall apply to approved dispositions of qualifed housing projects (within the meaning of section 1039 of the Internal Revenue Code of 1954, as added by subsection (a)) after October 9, 1969.

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