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Securities and Exchange Commission

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GIMME SHELTER: REFORM OF REAL ESTATE TAX SHELTERS

Farrell C. Glasser*

Today the majority of publicly traded securities are selling at prices which are at or near an all time low. Interest in this country's equity markets has waned. The speculative wave of the mid-1960's seems a forlorn recollection. Despite the present morass of concern and confusion, one area of public equity financing has emerged from the debacle: the "tax shelter" investment.2

Some statistics may prove helpful in demonstrating the severity of the decline in the stock market from 1967 to 1970:

In May, 1970, a portfolio consisting of one share of every stock listed on the Big Board was worth just about half of what it would have been worth at the start of 1969. The high flyers that had led the market of 1967 and 1968 were precipitously down from their peaks. Nor were they down 25 percent, like the Dow [Jones Industrial Average], but 80, 90, or 95 percent. This was vintage 1929 stuff, and the prospect of another great depression.


2 Adam Smith, a noted Wall Street commentator, has defined tax shelters in this way:

A tax shelter, for the general public, is a business somebody else is in. Somebody who has a good lobby in Washington. Congress writes the tax laws, and Congress in its wisdom and its collective desire to be re-elected has decided that some areas of endeavor are socially more noble than others, they are Good Things, and should be helped along. So, if you are a dentist, you take your dentistry income, not a Good Thing Congresswise, and put it into building an apartment house or drilling an oil well, two Good Things relatively easy to understand, and then you don't have to pay taxes this year. The income is offset by the accounting charges from the Good Things. Some other year, when the Good Thing is sold, you might have to pay a capital gains tax, but that rate is lower than on earned income and maybe you can find another shelter that year.


The Treasury has stated that tax shelters are

[i]nvestment devices by which an individual obtains an immediate
Favorable economic conditions during the past several years and continued high federal and state income taxes have prompted an ever-increasing number of high-income taxpayers to invest in various tax shelter programs. This trend toward tax shelter investments has resulted in a proliferation of publicly and privately offered real estate, timber\(^3\), cattle and farming,\(^4\) oil and gas,\(^5\) cable television, equipment leasing,\(^6\) and various other specialty programs. All of these programs have the specific objective of providing investors with the largest present paper tax loss possible, while at the same time holding out to investors the promise of capital gains tax treatment upon the ultimate disposition of the property.

High tax bracket investors who have been having a difficult time making a profit in the stock market have turned to tax shelter investments. They have been aided in their search for these investment opportunities by a mounting volume of public syndications, featuring investments with a minimum subscription of as low as $1000 to $1500. The National Association of Securities Dealers (NASD), which maintains records on most public syndications, expects the dollar volume of syndication filings in 1973 to at least equal the peak $3.2 billion total filed in 1972. Representing some 539 separate programs, the 1972 total was double the $1.6 billion total of the previous year. If private offerings are included, an estimated $10 billion was invested in tax shelter investments in 1973.\(^7\)

Of the many different kinds of tax shelter investments that are available to high bracket taxpayers, the most commonly encountered device is the real estate tax shelter.\(^8\) This article describes the way a tax shelter operates, from both a business-economic and a tax viewpoint, and examines the real estate tax shelter from the standpoint of possible tax reform to correct the abuses that stem from real estate syndications.

and usually substantial reduction in the amount of tax on income he already has and upon which he would but for obtaining the 'tax shelter' have to pay tax. He thus in effect is investing the government's tax dollars rather than his own money.

The essence of a tax shelter is the deferral or postponement of tax on current income, accomplished by accelerating future deductions into the current taxable year.

U.S. DEP'T OF THE TREASURY, PROPOSALS FOR TAX CHANGE 95 (1973) [hereinafter cited as PROPOSALS FOR TAX CHANGE].

\(^3\) See, e.g., Georges, Timber as a Tax Shelter: What are the Benefits and are There Drawbacks?, 36 J. TAX. 364 (1972).


\(^5\) See, e.g., Romak, Natural Resources Including Oil and Gas: Timber; Who and How, the Economics, the Risks and the 1969 Act, N.Y.U. 29TH INST. ON FED. TAX. 1589 (1971).


\(^8\) The New York State Attorney General's office reports that $2.8 billion of public participations in real estate were filed during the first six months of 1973, compared to $1.9 billion for the same period in 1972 (about a three to two increase). THE MONEY MANAGER, Aug. 27, 1973, at 48.
I. THE OPERATION OF REAL ESTATE TAX SHELTERS

A. General Description

Real estate tax shelter programs utilize primarily apartment houses, office buildings, shopping centers, and other income-producing properties as investment media. Included within these various groups of properties are both new construction, where deductions, risk, and reward are greater, and existing properties, where investment results may be more predictable. Since improved real estate enjoys the advantages of relative safety, afforded by appreciation in value caused by population growth and inflation, and high leverage, apartment houses account for the bulk of private security offerings.  

Real estate has some very distinct advantages as an investment medium. It tends to appreciate in value to an extent at least equal to the rate of inflation, and, if the property is well selected, it often appreciates considerably over a relatively short period of time. Further, by using debt financing, an investor can purchase a valuable real estate asset with an initial investment of only 10 percent of the total purchase price. This financial leverage, of course, has the effect of magnifying both the income and loss on a cash investment.

In addition to the economic advantages of real estate investments, such investments offer significant tax advantages to the investor. Because real estate is an economic commodity and also a business property, it enjoys several advantages under the tax law. Although some of these tax principles apply to all property and all transactions, tax advantages have been particularly responsible for real estate's favored investment position. Several of the more significant of these tax advantages are: 1) allowance of a deduction for depreciation of wasting business assets; 2) application of more favorable rules respecting recapture of depreciation on real prop-

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9 Barron's, supra note 7, at 5.
11 Only 10 percent of the purchase price must be advanced if an investment is made in low-income housing that comes under Section 236 of the Housing and Urban Development Act of 1968, 12 U.S.C. §§ 1715z, 1715z-1 (1968).
12 Most investors in real estate assume or execute mortgages or deeds of trust securing payment of long term promissory notes for amounts ranging up to 90 percent of the acquisition price of the property. There is always the risk in these situations that the debt service obligation of a specific investment may be so great that the revenues generated from the property will be insufficient to meet the obligation. In the event of default in the payment of the obligation, the mortgagee may foreclose, sell the property securing the obligation, and apply the proceeds of the sale to the mortgage payment. If the proceeds are insufficient to meet the obligation, it may be possible to hold the investor personally liable for the deficiency. On the other hand, if the investment proves to be a profitable one, the investor can realize a substantial return on his relatively minor equity investment.
erty;\(^{14}\) 3) taxation of gain on the sale of investment property at capital gains rates;\(^{15}\) 4) treatment of borrowed money as a transfer of capital, rather than as receipt of taxable income;\(^{16}\) 5) nonrecognition of gain on the exchange of property of like kind;\(^{17}\) 6) allowance of a deduction for the cost of leveraging;\(^{18}\) 7) the right to elect to report the gain from the sale of property by the installment method;\(^{19}\) and 8) the step-up of the tax basis of the assets of a deceased individual to their fair market value on the date of the individual's death.\(^{20}\)

A simple example may prove helpful in conceptualizing the operation of a real estate tax shelter investment program.\(^{21}\) Lawyer X is an unmarried taxpayer who in 1972 had earnings of $100,000, personal deductions of $20,000, and a $39,390 potential tax liability.\(^{22}\) Lawyer X invested $30,000 in a real estate limited partnership syndicate comprised of twenty investors in February, 1972. The syndicate invested in a 150-unit garden apartment complex that cost the program $2,500,000; of this amount, $375,000 was paid in cash, and the balance was represented by a non-recourse mortgage.\(^{23}\) The apartment project was completed in October, 1972, and for the rest of that year generated $15,000 of net cash flow.\(^{24}\) However, through various techniques, including the expensing of prepaid interest, certain legal fees, and state and local taxes, the project was able to show a $400,000 loss for tax purposes.\(^{25}\) Lawyer X's share of the
Real Estate Tax Shelters

Cash flow was $750, his investment credit was $250, and his share of the loss amounted to $20,000. For 1973, it is assumed here that Lawyer X's share of the cash flow increased to $2,500, with his share of the year's loss being $12,000. Lawyer X's $20,000 share of the project's loss for 1972, along with the investment credit, were available to offset his income as an attorney and reduced his personal income tax liability to $26,213. This tax shelter arrangement resulted in a net tax saving of $3,177 to the taxpayer. In addition, the $750 cash flow was received as a tax-free return of capital. Lawyer X's basis in the investment was decreased by $20,750, representing the loss allocation plus the cash flow distribution.

B. Use of the Limited Partnership

1. In General—The limited partnership form of enterprise organization is virtually always used for tax shelter investment programs. The promoter, or a corporation which the promoter has formed, is the sole general partner, while the investors are the limited partners. The limited partnership format is selected because it meets the primary objectives of the tax shelter: to allow a flow-through of losses and other tax incidents to the individual investors; and to avoid imposition of tax at both the entity level and the investor level. Neither the Subchapter C, nor the Sub-

26 See Int. Rev. Code of 1954, §§ 38, 46, 702. See also Treas. Reg. § 1.46-1 (1972). Lawyer X's cash flow and loss were determined by dividing the number of investors in the program into the total net cash flow and total loss respectively for the program in 1972.

27 The figures cited have been arbitrarily selected to illustrate the increase in the cash flow in the second year of operation. This increase results from the receipt of revenues over an entire year and a decrease in losses due to a decrease in the depreciation deduction and other expenses. While in this hypothetical the total depreciation deduction would increase (reflecting depreciation during 1973 as compared to only three months in 1972), generally the depreciation deduction would decrease during the second full year of operation.


29 Lawyer X's total deductions for 1972 were increased by $20,250, giving him a taxable income of $59,750.

30 Lawyer X receives this tax-free share of the cash flow because of the discrepancy between the terms cash flow and net income. See note 24 supra. Although the program had a net loss for tax purposes as a result of the expensing of prepaid items and deductions for depreciation, for business purposes the program had a positive cash flow.


32 Int. Rev. Code of 1954, Subch. K, § 701. There may be other reasons for choosing this form of enterprise. Generally, the nontax characteristics of a limited partnership consist of the following: 1) A limited partner is not liable to the creditors of the partnership in excess of his capital contribution, unless he takes part in the active control and management of the partnership's business and affairs. Uniform Limited Partnership Act §§ 1, 7. 2) The general partner is responsible for the management and control of the business, except that certain voting privileges are vested in the limited partners. Id. § 9. 3) A limited partner's interest in the limited partnership is considered to be personal property, and its transfer may be restricted depending upon the terms in the limited partnership agreement. Id. § 18. 4) Absent modification by agreement, the death, retirement, bankruptcy, or withdrawal of the general partner dissolves the limited partnership. Id. § 20(a). 5) The death of a limited partner does not affect the existence of the limited partnership. Id. § 21.

33 Int. Rev. Code of 1954, § 301 et seq.
chapter S corporation, each of which is available as an alternative form of organization, offers the tax shelter features available to the limited partnership.\footnote{34 Id. § 1371 et seq.}

2. Tax Considerations—There are several significant aspects of federal taxation that relate to all limited partnerships and are important to investors interested in tax shelters: a limited partnership is not a taxpaying entity, so the partners report their distributive share of partnership income or loss individually;\footnote{35 The Subchapter C corporation pays income tax at the corporate level with no pass-through of losses to investors. Id. § 11. In addition, its distributions are of after-tax dollars which are then subject to an additional tax at the shareholder level. Id. § 301. The Subchapter S corporation is severely restricted in its utility as a tax shelter because of limitations imposed on passive income and restrictions at the shareholder level on the use of losses. Tax losses are limited to the extent of funds actually invested by the shareholders in the Subchapter S corporation. Id. §§ 1372(e)(5), 1374.} a limited partner's distributive share of income or loss is determined by the provisions of the Limited Partnership Agreement;\footnote{36 INT. REV. CODE of 1954, §§ 701-02, 704.} therefore, a large portion of the losses can be allocated to the limited partners, so long as avoidance or evasion of tax is not the principal purpose of the allocation;\footnote{37 Id. § 704(a).} and limited partnership losses for the current year are deductible to the extent of the adjusted basis of a partner's interest in the partnership as of the end of the year.\footnote{38 Id. § 704(b); Treas. Reg. § 1.704-1(b) (1964); Rev. Rul. 68-139, 1968-1 CUM. BULL. 311; Orrisch, 55 T.C. No. 395 (1970).} It should be noted that a limited partner's tax basis includes that individual's share of partnership liabilities, including a liability to which the partnership property is subject, so long as no partner is personally liable for the debt, \textit{i.e.}, nonrecourse loans.\footnote{39 INT. REV. CODE of 1954, § 704(d).}

In addition to the tax features of all limited partnerships, there are several tax features that benefit a real estate limited partnership in particular. In effect, these features are the guts of a tax shelter program from a tax

\footnote{36 INT. REV. CODE of 1954, §§ 701-02, 704.}

\footnote{37 Id. § 704(a).}

\footnote{38 Id. § 704(b); Treas. Reg. § 1.704-1(b) (1964); Rev. Rul. 68-139, 1968-1 CUM. BULL. 311; Orrisch, 55 T.C. No. 395 (1970).}

\footnote{39 INT. REV. CODE of 1954, § 704(d).}

\footnote{40 Treas. Reg. § 1.752-1(e) (1956). See also note 23 supra, and text accompanying notes 44-51 infra.}

In order for a limited partnership to be treated as a partnership for tax purposes, it must qualify as a partnership rather than an association. It must, therefore, have more noncorporate characteristics than corporate characteristics. Treas. Reg. § 1.7701-2(a)(3) (1960). In determining whether an entity constitutes a limited partnership or a corporation for federal income tax purposes, Treasury Regulation § 1.7701-2(a)(1) calls for a review of six corporate characteristics: 1) the presence of associates; 2) an objective to carry on a business and to divide the gains therefrom; 3) continuity of life; 4) centralization of management; 5) liability for corporate debts limited to corporate property; and 6) free transferability of interests. The first two characteristics are always present in a business entity of at least two persons. Therefore, the presence of a majority of the remaining characteristics is crucial to the determination of the form of the taxable entity. For a detailed discussion of the association problem, see Halperin & Tucker, \textit{Low Income Housing (FHA 236 Programs: One of the Few Tax Shelter Opportunities Left,} 36 J. Tax. 2, 3-5 (1972). Where the sole general partner of a limited partnership is a corporation, the Internal Revenue Service (IRS), as a condition to issuing a tax ruling that the limited partnership will not be taxed as a corporation, requires that certain net worth and investment requirements be met by the corporate general partner. Rev. Proc. 72-13, 1972-2 CUM. BULL. 42. See also Halperin & Tucker, supra at 5.
standpoint, and they are the tax provisions that are most susceptible to revision if reform is to be effective.\textsuperscript{41} 

\textit{a. Tax Deductions During Construction—}Tax deductions are permitted during construction of a real estate project. Deductions may include interest paid on the building loan, fees for loan commitments (points), local taxes, and certain other expenses, in addition to the capital outlays for construction.\textsuperscript{42} These deductions create operating losses for the investment program, since revenues from the project have not yet begun. As a result, an investor receives significant tax deductions which he can use to offset his "other income."\textsuperscript{43} These deductions, of course, are especially helpful to investors in the high income tax brackets. In contrast to this tax deduction treatment, which implies a loss of equity capital during construction, generally accepted accounting principles prescribe capitalization of all monetary outlays during construction. Because rental real estate construction usually involves the use of substantial leverage—up to 90 percent of the costs may be represented by mortgage debt which has been borrowed on a nonrecourse basis—deductible expenses may account for most or even all of the equity by the time the construction has been completed. It has been stated that "for a high bracket taxpayer this can, in some cases, mean tax savings of up to 75 percent of his total investment. A 60 percent recovery during construction could be regarded as typical."\textsuperscript{44} 

\textit{b. Use of Depreciation—}A taxpayer is permitted to depreciate the full cost of the structure and improvements less salvage value after construction has been completed,\textsuperscript{45} even though most of the cost has been financed, and the taxpayer has no personal liability on the mortgage debt. The maximum allowable rate of depreciation varies, depending upon the type of real estate project, but some form of accelerated depreciation generally is available.\textsuperscript{46}

\footnotesize{\textsuperscript{41} See Kanter, supra note 21, at 786-94; part III infra.} 
\footnotesize{\textsuperscript{42} Panel Discussions, supra note 21, at 568.} 
\footnotesize{\textsuperscript{43} See text accompanying notes 21-31 supra.} 
\footnotesize{\textsuperscript{44} Panel Discussions, supra note 21, at 524. Whether interest payments are deductible in full in the year made, or whether the deduction must be allocated over the taxable years involved, is governed by the principles of Revenue Ruling 68-643, which states in part:} 
\footnotesize{A deduction for interest paid in advance on each indebtedness for a period not in excess of 12 months of the taxable year immediately following the taxable year in which the prepayment is made will be considered on a case by case basis to determine whether a material distortion of income has resulted . . . . If interest is prepaid for a period extending more than 12 months beyond the end of the current taxable year, the deduction . . . will be considered as materially distorting income.} 
\footnotesize{Rev. Rul. 68-643, 1968-2 CUM. BULL. 76. See also Rev. Rul. 60-582, 1969-2 CUM. BULL. 29. On finding such a material distortion of income, the IRS would require that the taxpayer allocate such prepayment over the taxable years involved.} 
\footnotesize{\textsuperscript{45} INT. REV. CODE of 1954, § 167. See also Treas. Reg. § 1.167 (1956).} 
\footnotesize{\textsuperscript{46} Accelerated methods of depreciation increase the value of the tax shelter in two ways. First, at any time before the end of the investment's useful life, the total depreciation deductions allowed under accelerated depreciation will be greater than}
The allowance of the depreciation deduction is based on the premise that when "a taxpayer is deriving income from a wasting economic asset, an appropriate measure of his taxable net income on an annual basis is obtained by prorating the cost of the asset over its life, as an offset against the gross income from it." Thus, even though the depreciation expense does not represent a cash outlay by the investor, and despite the fact that the property may in fact be appreciating in value, depreciation deductions on buildings and other improvements can be taken in determining taxable income for federal income tax purposes.

In addition to gaining the advantages of the depreciation deduction, investors may receive cash distributions from the investment. Distributions may be available even though the project may show a net paper loss, resulting from noncash expenses such as the depreciation deduction. The amount of the tax-free cash distribution is directly related to the excess of the depreciation deductions over the amount of the mortgage amortization payments. Since amortization payments typically are smaller in the earlier years of a project's life and increase in later years, use of accelerated depreciation will result in significant tax-free cash distributions in the early years of a project. These distributions represent a nontaxable return of capital to the extent of the investor's basis.

Thus, depending upon the rate of depreciation and other factors, the ability to deduct depreciation may result in both a tax-free cash return to the investor and a tax loss that will reduce any other taxable income that the investor may have. The depreciation deduction creates a "shelter" for some or all of the cash flow from the project and may produce excess deductions, which will then shelter income from other sources.

Because an investor can deduct losses only to the extent of his basis in the partnership investment, how can he use losses generated by the investment to offset income from other sources that is in excess of his original capital contribution to the partnership? In answering this question, it is helpful to turn to the Supreme Court's decision in *Crane v. Commissioner.* The *Crane* case established two generally accepted and interrelated principles. First, regardless of whether the owner of property has any personal liability on a mortgage, the amount of the mortgage li-

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47 Panel Discussions, *supra* note 21, at 512.
48 The depreciation deduction on investments in realty is the main reason that net income and cash flow are not synonymous. *See* note 24 *supra.*
50 *See* text accompanying notes 21-31 *supra.*
51 331 U.S. 1 (1947).
ability is included in the tax basis of the property that is acquired subject to the mortgage.\(^5\) Second, on the sale of the property, the amount realized, for the purpose of calculating gain or loss on the sale, includes any liabilities to which the property transferred is subject.\(^5\)

The *Crane* doctrine is of considerable importance when property subject to a mortgage is depreciable, because depreciation is calculated on the tax basis of the property.\(^5\) The Internal Revenue Code (Code) provides that ordinarily the initial basis of property is its cost.\(^5\) The *Crane* case, by permitting the taxpayer to include the amount of the mortgage in his cost basis, allows a taxpayer to deduct depreciation charges in excess of his original capital contribution.\(^5\) In the early years of ownership, the effect is magnified if the property is subject to accelerated depreciation.

The *Crane* doctrine is applied to real estate limited partnerships that have received loans to finance acquisition of depreciable property. In the typical real estate limited partnership, while each of the partners contributes part of the cash necessary for the undertaking, the bulk of the construction costs or purchase price is financed by a loan secured by a lien on both the land and the building. Reflecting the influence of the *Crane* decision, the Code treats the loan to the partnership as a contribution by one or another of the partners.\(^5\) The statutory provision is amplified by a Treasury Regulation which states that where all of the partners are personally liable for the partnership indebtedness, each partner is entitled to a pro rata increase in the basis of his partnership interest.\(^5\) Similarly, if the loan is secured by only a lien on the real estate, so that no partner is personally liable on the note (i.e., a nonrecourse loan), each partner is also entitled to increase the basis of his partnership interest by a pro rata share of the indebtedness.\(^5\)

The provision that allows a step-up in the basis of a partnership interest to the extent of a pro rata share of nonrecourse loans enables each partner to deduct losses in excess of his capital contribution, thereby sheltering his income from other sources.

c. Conversion of the Depreciation Deduction into Capital Gain—The *Crane* case established the principle that on the sale of investment property, the amount realized includes any liabilities to which the property transferred was subject.\(^6\) Therefore, on the sale of the investment property by a partnership, the partners will have to include their respective

\(^{53}\) 331 U.S. at 11-12.
\(^{54}\) Id. at 12-14.
\(^{55}\) INT. REV. CODE of 1954, § 167(g).
\(^{56}\) Id. § 1012.
\(^{58}\) INT. REV. CODE of 1954, § 752(a).
\(^{59}\) Treas. Reg. § 1.752-1(a) (1956).
\(^{60}\) Treas. Reg. § 1.752-1(e) (1956). If only some of the partners are personally liable on the partnership's indebtedness, then only those who are personally liable are considered to have made a contribution of money to the partnership that permits a step-up in the bases of their interests. See Int. Rev. Code of 1954, §§ 752(a), 722.
\(^{61}\) See text accompanying note 54 supra.
shares of the unpaid balance of the mortgage in the amount that they receive. Since the partners' adjusted basis, as reduced by depreciation deductions, may well be exceeded by the unpaid balance of the mortgage, the partners may be forced to recognize a gain in excess of the cash or property received in consideration for the sale of the property. Even so, the partners, in effect, have been able to convert ordinary income into capital gain by offsetting the property's ordinary income with the deductions for depreciation and other expenses. Furthermore, the partners have had the opportunity to defer the tax on the income that was sheltered by the deductions; thus they have received an interest-free loan from the government, in the amount of the tax they would otherwise have had to pay.\textsuperscript{62}

d. \textit{Refinancing of Property Investments}—In a situation where the value of the investment property appreciates, the general partner, rather than selling the property, may decide to refinance the project by obtaining a new loan secured by the property's appreciated value. The effect of refinancing is to give the partnership the difference between the new loan and the original loan; this difference may be distributed to the partners tax-free. Although this is the same result that sale of the property would produce, refinancing is even better than sale of the property, for if the property is sold, a tax on the profit would have to be paid. Further, refinancing, creating a larger indebtedness, not only postpones taxation, but also increases interest payments, which thereby generate increased tax deductions. Even though a tax may be due upon the eventual disposition of the property, the partnership will be able to receive tax-free use of the loan proceeds, to postpone the payment of tax until the disposition of the property (in effect obtaining an interest-free loan), and to increase the capital gains tax advantage allowed under the Code by stretching out the period of ownership and thereby reducing the effects of recapture.\textsuperscript{63}

\textsuperscript{62} This general statement is limited by Section 1250 of the Code, which provides that in some instances a portion of the gain from the sale or exchange of depreciable real property may be treated as ordinary income, if the taxpayer has taken depreciation in excess of that allowed by the straight-line method. See text accompanying note 115 infra. Section 1245, however, which applies to personal property, contains a much more strict recapture rule that virtually eliminates the conversion of ordinary income to capital gain through depreciation charges taken after 1962.


It is often stated that a tax incentive is really like a loan, since a significant percentage of the money must be returned in taxes when the property is sold; therefore, it is felt that the incentive occurs only in the early years when depreciation deductions are high. However, the loan is in fact extremely valuable (see text accompanying note 62 supra), and its value does not diminish markedly despite the dramatic decline in the size of the annual deduction. McKee, \textit{The Real Estate Tax Shelter: A Computerized Expose}, 57 VA. L. REV. 521, 555 (1971).

An alternative to refinancing would be the use of a wraparound mortgage. The wraparound mortgage is a second mortgage, subordinate in all cases to an existing first mortgage, which remains outstanding and unsatisfied. It differs from the conventional second mortgage in that the face amount is greater than the outstanding first mortgage, and it incorporates a special agreement between the parties providing for payment of the debt service on the first mortgage. The loan is otherwise evidenced and secured by the usual form of promissory note and second mortgage. The
The essence of the real estate tax shelter, therefore, is a combination of high leverage, accelerated depreciation, use of the limited partnership entity, and the basic tax rules for treatment of nonrecourse mortgages.

II. TAX POLICY

A. The Real Estate Tax Shelter: Loophole or Incentive?

One commentator has noted that

[1]he real estate tax shelter is an outgrowth of the accelerated depreciation deductions in 1954, and typifies the tax preference or tax loophole created largely by accident. The focus of the 1954 liberalization was the proper allowable depreciation for machinery and equipment, but there was little or no analysis of the possible impact of the liberalized depreciation methods on investment in real estate.64

Thus, it has been claimed that the birth of the real estate tax shelter was the result of the promiscuity of tax reformers, who were unaware of the ramifications of their amendment of the Code's provision for depreciation deductions.

Professor Boris Bittker of Yale has noted that "[1]he term 'tax loophole' is often used to denote a flaw in the language of the... Code or in the Treasury Regulations, discovered by a sharp-eyed lawyer or accountant

and exploited by his clients. However, if the loophole is, in effect, a legislative error, once it comes to light it should be corrected by Congress. Professor Bittker thus notes that "[w]hen discovered by a tax expert . . . a loophole is a wasting asset that he must exploit quickly but warily." If Professor Bittker's explanation is correct, it would appear that the real estate tax shelter, although possibly once the result of a legislative error, can no longer be deemed a loophole since it is now ubiquitously known to tax attorneys, accountants, and their clients.

If the real estate tax shelter is no longer a loophole, perhaps it should be considered a tax incentive. Several factors point to this conclusion. Since the appearance of the real estate tax shelter opportunity in 1954, Congress and the Treasury Department have continually voiced their support for this tax preference, thereby creating an indirect government subsidy to the housing industry. Although machinery and equipment investments were initially favored by the allowance of accelerated depreciation of these assets for tax accounting, "subsequent Congressional action to limit the benefit of the depreciation through recapture has been more restrictive with respect to personality than reality." In addition, the Congress has continually approved tax legislation which has been favorable to the development of low- and middle-income housing.

If it is assumed for the sake of argument that, in order to meet the country's needs, real estate development, particularly of low- and middle-income housing, should be encouraged through government-sponsored financial assistance, it is then necessary to compare the tax incentive method of encouraging development with financing by direct governmental expenditures.

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66 Id. at 1103.
67 Professor Bittker goes on to say that [lacking a more systematic study of this question, I offer the hypothesis that loopholes . . . are comparatively rare. The quality of legislative drafting in the federal tax field is unusually high, the Internal Revenue Code is subject to frequent revision, and I know of no area of the law in which the courts are more likely to search for the legislative purpose and prefer it, whenever it can be discerned, to a literal construction of the statutory language. Id. at 1107.
68 See Panel Discussions, supra note 21, pt. 6, at 792 n.66:
   The legislative history of sections 167 and 1250 of the Code illustrate the continued Congressional intent to base Federal aid to the housing industry upon an indirect subsidy through the Internal Revenue Code as well as a direct subsidy through the National Housing Act.
69 Id. In 1962, Section 1245 was adopted. This section converted the gain on the sale of depreciable personal property from capital gain to ordinary income to the extent of all post-1961 depreciation deductions. In 1964, Section 1250 was enacted. It provided that gain on the sale of depreciable real property within ten years of acquisition was to be taxed as ordinary income to the extent of a declining percentage of the excess of post-1963 depreciation over straight-line depreciation. In 1969, Congress reduced the tax advantage of real estate investment, by reducing the methods of depreciation available with respect to real property and by broadening the reach of the recapture rules. See part III B infra.
70 Panel Discussions, supra note 21, pt. 6, at 793 n.69-70.
B. Use of Tax Incentives to Achieve Societal Goals

1. The Objectives of Tax Reform—It has been suggested that "the prime objective of tax reform is to achieve greater fairness in the federal tax system." Many tax experts feel that tax shelter investments severely diminish public confidence in the tax system, by creating the belief that there are privileged groups who can escape the obligation of paying taxes, while the average person is forced to pay his tax bills. Viewed in this light, it is felt that an income tax system remains fair only if it reaches all income and "only if there are no preferences or loopholes through which some people and corporations can escape."

Professor Stanley S. Surrey of Harvard is a strong advocate of tax reform, especially with regard to tax shelters. Testifying before the House Ways and Means Committee, he stated:

Most persons pay their income tax weekly or monthly through withholding, and thus can be led to think the system works methodically and inexorably for everyone else. The wealthy investor knows differently, because his investment advisors guide him to 'tax shelters' through which he can become still wealthier. The high-income individual can join partnership syndicates in real estate ... activities that produce large 'tax losses.' But these are 'losses' only in the eye of the tax law. In the real world and in the investors' own accounts they are his outlays on which he intends eventually to make money from the investment. In the meantime, on his tax return these 'tax losses' can be used to offset income from other sources—his professional income, dividends, salary—thereby making much of that other income non-taxable. There is something terribly amiss when to provide low-income housing for shelter of the poor, we at the same time shelter tax millionaires. As a result of these tax shelter and other tax escapes, persons with actual incomes in the hundreds of thousands, even millions, either pay no income tax or pay at a rate less than that of skilled or even semi-skilled workers. These situations are an offense to our sense of fairness and decency. This is why tax reform is really a moral issue. It is not just a technical exercise to be engaged in by skilled experts. It is an effort to restore fundamental morality to a tax system by ending both its unfairness and the cynical, immoral way the tax game is played today by those with money and knowledgeable advisors.

Besides the inequities suggested by Professor Surrey, another reason for tax reform is to foster efficiency and economy in the indirect expenditure of government funds. Professor Surrey believes that tax incentives received by industries such as real estate are, in effect, a government expenditure program carried out through a special

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71 Panel Discussions, supra note 21, pt. 1, at 12.
72 Id.
73 Id.
provision in the tax system. The special tax provision is a method of providing financial assistance from the Government to the activities and persons who fit within the provision. These special tax provisions really have nothing to do with the essentials of an income tax . . . instead [they] . . . are methods of spending Government funds.74

Given that there are various methods of achieving a certain societal goal, it is important to evaluate the tax incentive method that is currently in use.

2. The Pitfalls of Tax Incentives—There are at least three reasons for using tax incentives to accomplish socially desirable aims: 1) tax incentives are often the most expeditious manner of accomplishing a desired result; 2) tax incentives achieve the result at a lower cost to the Treasury than that of a non-tax incentive program (e.g., a direct grant); and 3) tax incentives benefit society by involving thousands of individuals in making expenditure decisions, rather than merely concentrating additional resource-allocation power in the hands of government bureaucrats.75

A proper consideration for tax reform is whether indirect government expenditures are preferable to direct expenditures. Recently compiled statistics show that the tax incentive system is being abused. For example, the growth of losses in major tax shelter industries has been astonishing. From 1965 to 1971, the aggregate net losses sustained by all partnerships reporting real estate losses increased by 330 percent. The increase in losses for all the major tax shelter industries combined was 372 percent. In 1965, partnerships in these industries reported $900 million of net losses and $1.4 billion of net profits. By 1971, however, the figures had dramatically reversed, so that losses amounted to $4.2 billion, while profits totaled $2.4 billion.76

The demand for tax deductions is also soaring. It has been said that the market for deductions is "[n]o longer the domain of a limited number of financial sophisticates, [rather,] the market for deductions has become a mass market."77 All the available evidence points to the conclusion that this trend will continue. The National Association of Securities Dealers reported an increase of 61 percent in the number of registered filings of tax shelter programs and a 106 percent increase in the dollar volume of such filings between 1971 and 1972. In a two-year period, 1970-72, publicly offered tax shelter filings increased from 145 to 539, with a more than three-fold increase in dollar volume occurring during the same period.78

74 Id. at 13.
75 For a discussion of the reasons that the benefits of tax incentives are illusory, see Surrey, supra note 64, at 715-19.
76 Remarks of Mr. John H. Hall, Deputy Assistant Secretary of the Treasury for Tax Policy, before the California Certified Public Accountants Foundation, in Los Angeles, California, Sept. 20, 1973, at 3 [hereinafter cited as Remarks], on file with the University of Michigan Journal of Law Reform.
77 Id. at 4.
78 Id.
The abuse of the tax system, which is documented by these figures, can be traced to a number of substantial defects in the present tax incentive program. Tax incentives inefficiently distribute tax benefits because their impact cannot be directed solely toward the activities that Congress deems deserving of favorable tax treatment. In most instances, the tax incentive can be used by others who are not directly involved in the activity that Congress wants to encourage. For example, with respect to real estate, the tax incentives, in the form of depreciation and other deductions, encourage the building of apartment houses for upper income tenants, shopping centers, office buildings, and other luxury structures, as well as low- and middle-income housing. The economic motivation to develop real estate exists because all builders can receive the benefit of tax incentives, even though the primary intention of Congress in permitting these incentives was to encourage only the development of low- and middle-income housing.

One commentator states that "[when Congress offered this tax incentive to all residential rental buildings, it laid compulsory claim on [the taxpayers'] dollars to help finance 'tax shelter' projects for the rich as well as the poor."

Even more significant, however, is the evidence that real estate tax incentives have not fulfilled the purpose for which they were designed, i.e., they have not appreciably increased the size of the nation's stock of low- and middle-income housing. Studies reveal that the primary long-term effect of the real estate tax incentives is to encourage inefficient resource allocation, and not to increase significantly investments in depreciable realty.

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79 See Surrey, supra note 64, at 719-26.
80 See notes 109-10 and accompanying text infra.
81 P. Stern, supra note 63, at 179.
Testimony before the House Committee on Ways and Means has revealed how ineffective the tax incentives for low- and middle-income housing have been:

For the past two years, total housing starts have dramatically exceeded this nation's housing goals. In fact, the number of new units built between 1950 and the end of 1970 totalled about 31 million. During the same period the total number of households grew by about 21 million. In other words, over a 20-year period about one and a half new housing units were constructed for each additional family. But, if you examine completion data for conventional apartments with rents of '$125 per month and below,' they rather consistently amount to extremely low percentages of the total. For example, in calendar year 1968, about 400,000 apartments were completed. But only 8% of that total had rents below $125; 71% were $150 or more. In 1971, the decline in percent of units completed below $125 was rather precipitous—only 3% of more than 330,000 finished apartments. In the third quarter of 1972, about 140,000 units were completed—82% had rents structured at $150 or above—36% of this total at $200 or more. There is a very energetic effort to build apartments on a conventional basis in this nation—but very little of it is directed toward low- and moderate-income families in desperate need of shelter.

Hearings on General Tax Reform Before the House Comm. on Ways and Means, 93d Cong., 1st Sess., pt. 7, at 3167 (1973) [hereinafter cited as Hearings].
Tax incentives, as opposed to direct subsidies, are not reviewed by Congress every fiscal year. Tax incentives continue to exist even if Congress fails to act, whereas direct expenditures cease if Congress does not appropriate funds.

Tax incentives may provide startling tax "write-offs" for the wealthy, thereby spreading dissatisfaction among taxpaying low- and middle-income families. It has been said that the "widely-observed spectacle" of upper income taxpayers investing in tax shelters as an alternative to paying the prescribed taxes on their incomes has a demoralizing impact on those taxpayers with considerably less income. Any activity that can lead to an erosion of compliance levels must be viewed with the utmost concern.

The use of tax incentives exacerbates the inequities in the amount of return, on the same investment, received by taxpayers in varying tax brackets. Although deduction-funded subsidies are usually worth more to high bracket investors, the subsidy constitutes only a moderate portion of the overall rate of return; thus, differences between the rates of return are not large in an absolute sense. However, a high bracket taxpayer who has invested in depreciable realty uses the principles of leverage to magnify the rewards of his larger subsidy. The incentive, therefore, can become the primary source of return, with the result that high bracket investors often receive twice the rate of return received by equivalent investors who fall in lower tax brackets. In addition, high mortgage interest rates may discourage lower bracket taxpayers from investing, whereas the rate of return available to high bracket investors may alone be sufficient to induce an investment in realty.

Tax incentives encourage the investor in a tax shelter program to be concerned solely with the tax losses generated by the program, and not with the business or economic worth or flaws of a particular investment. It has been noted that the tax shelter industry entails an

unfortunate and growing waste of scarce capital resources. While there is a crying need for more capital and increased production in housing, the diversion of economic resources into the pursuit of deductions frequently results in investments of an uneconomic nature. To be blunt, a lot of tax shelter money goes into unworthy economic deals which offer the most glittering promises of deductions. Meanwhile, there is no such abundance of capital in the country that we can afford to see billions of dollars used with less than optimum productivity.

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83 Remarks, supra note 76, at 7.
84 Id. at 7-8.
85 The rate of return for a real estate investment is derived by dividing the sum of the net annual income of the investment before tax and the finance charges, by the purchase price.
86 McKee, supra note 63, at 573 (app. figure 5).
87 Id. at 558 n.92.
88 Remarks, supra note 76, at 8-9.
The economic waste stemming from real estate tax shelter investments is tremendous. For example, if a builder is to produce low- and moderate-income rental housing pursuant to statutory mandate, his profit must usually be obtained through a syndicate of wealthy investors. The primary goal of the investors is to shelter their outside income and not necessarily to create better and more low- and middle-income housing. The developer receives his profits by selling "tax losses" to others, and only the wealthy investors are interested in purchasing "losses." Thus, "in this sense, the syndication vehicle and investor limited partners are totally superfluous, parasitic participants in the development process."  

Using the tax system as a method of attracting investors forces the developer to absorb substantial expenses related to the sale of interests in the real estate tax shelter. These expenses can amount to thousands of dollars if the developer is to realize a profit from sale of the investment property. These costs have no direct relationship to the cost of constructing the housing. The tax shelter vehicle also encourages the developer to build expensively. This incentive exists because the amount of profit a developer can generate for investors is primarily a function of the conversion of tax benefits to cash through syndication. Since the size of the depreciation deduction that can be taken on a project is a key factor to investors, it follows that it is to the developer's advantage to build the most expensive structures possible, while still being able to rent all units in the project. In addition, as a result of the step-up in an investor's basis that results from nonrecourse loans, developers have every incentive to seek a commitment for the largest possible mortgage. The developer has relatively little incentive to achieve construction economies. To do so would simply reduce the tax benefits that the developer must show in order to obtain the maximum profit from the syndicators who sell the partnership interests.

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89 See note 11 supra.

90 Hearings, supra note 82, at 3166.

91 As an example, a typical public offering of $15 million of partnership securities can generate $245,000 of expenses completely unrelated to the partnership's real estate investments. These expenses include fees for registration with the Securities and Exchange Commission and the various state securities commissioners; the NASD filing fee; accounting, legal, printing and organizational fees; and miscellaneous expenses. See the registration statement of MultiVest Real Estate Fund, Ltd., Series VI, pt. II, item 27 (Oct. 16, 1973) (File No. 2-4858, Securities and Exchange Commission, Washington, D.C.).

92 See notes 51-60 and accompanying text supra.

93 A recent Wall Street Journal article highlights the situation in which investors often find themselves once they have purchased their interests in real estate tax shelter syndications:

At first, all goes well. You get your initial tax shelter, the place then fills up, and you start getting a tax-free check every month. Then the checks stop. The promoter's phone is disconnected. You find out that your syndicate is broke. The promoter has gone off into the sunset carrying a sizeable hunk of the partners' investments in the form of fees and commissions; the swingles have moved to the beach, and Whoopee Towers is half-empty and losing money. Then the Internal Revenue
The inevitable consequence of using our tax system in this manner is clear; there are enormous indirect losses to the federal government, wholly extraneous parties are introduced to the housing process and hundreds of millions of dollars are diverted away from building. It's all virtually required by our present tax laws.94

Service tells you that because of the syndicate's demise, you owe a bundle to Uncle Sam. You think about moving to the Bahamas. Wall Street Journal, Dec. 4, 1973, at 1. The article notes that nobody knows how many real estate syndicates have gone bankrupt, but that the number is considerable, and if the critics are right, a lot more will be folding before long. "Many syndicates face trouble . . . . The promoters' fees and expenses are exorbitant, the properties they buy or put up are run down, or the syndicator doesn't manage the property properly. Also, many parts of the country are already overbuilt." Id.

The California Department of Corporations has released a study dealing with the increasing numbers of failures of real estate tax shelter syndications. The study was prompted by the receipt of numerous complaints by investors, and it was determined that the principal reasons for the failures were:

1. Front-end compensation and other promotional interests received by the syndicator and his or its affiliates.
2. Excessive purchase price paid for the property.
3. Insufficient down payment with large balloon payments.
4. Absent or poor management of the properties involved.
5. Failure by the limited partners to contribute additional assessments.
6. Lack of experience or expertise of the syndicator to select suitable properties and to arrange sound financial structuring.
7. Certain economic factors.

CALIF. DEP'T OF CORP., SYNDICATION FAILURES, A SURVEY OF SOME BASIC REASONS BEHIND THE FAILURE OF REAL ESTATE SYNDICATIONS 2 (1973), on file with the University of Michigan Journal of Law Reform.

In an attempt to check the proliferation of real estate syndications that are fraudulently misrepresenting the economic and tax advantages of their programs, the Securities and Exchange Commission (SEC) has filed complaints against more than a half-dozen promoters within the past two years. In SEC v. United Professional Planning, Inc., Civil No. 73-141 (C.D. Cal., filed Jan. 24, 1973), the SEC alleged that the promoters (who had gone into bankruptcy stranding 2500 investors who had put $19 million into various projects) of two real estate limited partnerships had fraudulently induced the purchase of limited partnership interests, by failing to disclose to investors that the programs' property investments were purchased from conduits for the promoter and its affiliates; that the property investments were made at highly inflated prices, bearing no relation to their fair market values; that the promoters falsely represented that substantial tax deductions could be claimed by investors when in fact such deductions were very likely to be disallowed on audit; and that the claimed tax shelter aspects of the program were generated by the materially increased price, cost, and risk that investors were made to bear. The suit was subsequently settled by a consent decree, whereby the promoters agreed not to do the acts complained of, although they did not admit that they had violated the law. See also SEC v. A. J. Groesbeck Financial Advisors, Inc., Civil No. 73-2678 (C.D. Cal., filed Nov. 15, 1973).

94 Hearings, supra note 82, at 3166-67.

The following example illustrates the excessive cost to the government that results from a syndication of a $2 million apartment project:

In a typical 236 rehabilitation project, an investor would give a tax shelter broker $500,000 to invest. The broker keeps $100,000 as his fee and gives $400,000 to the developer. The developer spends $60,000 on the actual housing project and keeps $340,000 as his fee. In return for his $500,000 investment, the high tax bracket investor has (up to) $200,000 a year taken off his tax (liability) for five years—due to rapid depreciation permitted by the law—and after about 20 years he will sell
Regarding the quest by taxpayers for "losses," it has been observed that in this remarkable field, the greater the losses, the more salable the investment. The choicest deal of all is the one where you get to lose more than your total investment. . . . The syndicated shelter promises the hope of economic gains, but advertises the certainty of immediate writeoffs, and all the magic is in the latter. The consequence of this is an unseemly scramble to promise more losses than promised by the next competing shelter, all of which . . . leads to the sale of deductions which really aren't there—which won't withstand audit.95

Tax incentives create windfalls by rewarding taxpayers for doing what they might ordinarily do anyway i.e., invest in a particular activity. They distort the choices of the marketplace and produce inefficiency in the allocation of resources. Tax incentives also keep tax rates high by constricting the tax base and thereby reducing revenue. This effect partially results from the open-ended character of the revenue loss from the use of tax incentives: it is difficult to foretell how much will be indirectly spent by the government through a particular incentive. Revenue losses from tax shelters in 1973, for example, are estimated to be well in excess of one billion dollars.96

Thus, although the real estate tax shelter was primarily the result of a legislative error,97 its proponents attempt to justify its continued existence by claiming that it is an incentive for investment in depreciable realty.98 It can readily be seen that manipulation of the tax system may not be an appropriate tool for stimulating investment in socially favored sectors of

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95 Remarks, supra note 76, at 5-6.

96 Remarks, supra note 76, at 5. In addition, the Treasury estimates that the subsidy to nonowner-occupied buildings for just the accelerated portion of real estate depreciation deductions was $750 million in fiscal 1968. See Surrey, supra note 64, at 709-10.

97 See text accompanying note 64 supra.

98 But see text accompanying notes 80-82 supra.
the economy. Particularly with respect to real estate investment, the defects of the tax incentive method are readily apparent. Sound economic, social, and tax policy considerations require that reform measures be implemented to abate the growth of the tax shelter investment industry.

III. REFORM OF TAX SHELTER INVESTMENTS

There have been several attempts, over the years, to enact measures designed to deal with the problems which arose after enactment of Section 167(b) of the Code in 1954. The 1954 changes in the Code, which permitted depreciation on new investments in capital equipment and structures to be computed by accelerated methods (either the double declining balance method or the sum-of-the-years'-digits method), thereby allowed recovery of a greater portion of costs in the earlier years of an investment's life. These favorable depreciation determination methods, in combination with extremely high marginal tax rates and favorable tax treatment of long-term capital gains, originally encouraged the development of the real estate tax shelter.

A. The Tax Reforms of 1962 and 1964

After the 1954 changes, Congress gradually came to realize that the liberalized depreciation methods were the direct cause of tax abuse involving investments in real and personal property. Congress then began to consider various reform measures that would correct the error it previously had made.

In 1962, Congress instituted a recapture rule, but only with respect to depreciable personal property. Under this rule, the gain on the sale of personal property is treated as ordinary income to the extent of all depreciation deductions attributable to periods after December 31, 1961. Congress rejected the Department of the Treasury's suggestion that the same rule apply to depreciable real property.

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99 See Surrey, supra note 64, at 734-38.
100 INT. REV. CODE of 1954, § 167(b)(2). Under this method, the taxpayer is able to compute the depreciation deduction on the basis of twice the straight-line rate applied to the adjusted basis. INT. REV. CODE of 1954, § 167(g).
101 INT. REV. CODE of 1954, § 167(b)(3). Using this method, the rate of depreciation for any year is a fraction the numerator of which is the remaining useful life at the beginning of the year and the denominator of which is the sum of the digits representing years of useful life.
102 See INT. REV. CODE of 1954, § 1.
103 See INT. REV. CODE of 1954, §§ 1201, 1202.
104 INT. REV. CODE of 1954, § 1245.
105 President's 1961 Tax Recommendations Before the House Comm. on Ways and Means, 87th Cong., 1st Sess. 44-45 (1961). The Treasury had recommended that the amount of depreciation subject to recapture with respect to real property be phased out at the rate of 1 percent per month for each month that the property was held in excess of seventy-two months. Hearings on the Revenue Act of 1962 Before the Senate Comm. on Finance, 87th Cong., 1st Sess. 88-89 (1962).
In 1964, however, Congress enacted a recapture rule for real property. Under the 1964 reforms, the gain on the sale or exchange of depreciable real property, where such disposition takes place within ten years after acquisition, is considered ordinary income to the extent of a declining percentage of the excess of the post-1963 depreciation over straight-line depreciation. The recapture percentage is phased out at the rate of one percentage point for each full month the property is held over twenty months. Therefore, if the real property is held for over ten years, none of the excess of accelerated over straight-line depreciation is recaptured as ordinary income.

The 1964 recapture rule was the first serious congressional attempt since the 1954 enactment to limit real estate tax abuse. The congressional remedy was not to be accomplished by denying the accelerated depreciation deduction that had given rise to the abuse, but by limiting the possible conversion of ordinary income into capital gain upon the disposition of the property.

B. The Tax Reform Act of 1969

To deal with the nation's housing problem, Congress enacted the Housing and Urban Development Act of 1968, which declared its goal, as a matter of national policy, to be the provision of federal assistance for the construction and rehabilitation of twenty-six million housing units by 1976, of which six million were to be subsidized for low- and middle-income families. The 1968 housing legislation was partially in response to the prevailing high interest rates and decreasing money supply, both of which made it difficult to meet the nation's housing needs through normal market means.

After this enactment, both Congress and the Administration recognized the need for reconciling the objectives of tax reform with the stated goal of providing housing. The Tax Reform Act of 1969 attempted to strengthen the provisions on real property recapture that had been imposed by the 1964 reforms, and, at the same time, to encourage construction of certain types of housing.

Seeking to curb the tax shelter that had been available to all real estate investments, Congress made a number of changes which reduced the tax

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106 INT. REV. CODE of 1954, § 1250.
108 See notes 61-62 and accompanying text supra.
110 42 U.S.C. § 1441(a) (1968). See also S. Rep. No. 1123, 90th Cong., 2d Sess. 2 (1968). The legislation was in response to a report by the Department of Housing and Urban Development which concluded that some twenty million Americans were living in substandard housing.
111 The credit squeeze made it difficult to obtain financing to purchase or construct housing. Even where financing was available, high interest rates deterred people from borrowing.
benefits available to investments in nonresidential real estate. The 1969 reforms eliminated two forms of accelerated depreciation: the double declining balance and the sum-of-the-years'-digits methods. The maximum depreciation rate now available for new property is 150 percent of the declining balance;¹¹³ used property can be depreciated only on the straight-line method.¹¹⁴ The 1969 reforms also provided for unlimited recapture of the excess depreciation over straight-line depreciation taken after 1969,¹¹⁵ thereby significantly reducing the possibility that the taxpayer could obtain capital gains treatment on the eventual sale of the property.¹¹⁶

At the same time being conscious of the nation's increased need for housing, Congress preserved, and in some ways increased, the tax advantages available to investments in residential real estate. Under the 1969 reform provisions, new residential housing¹¹⁷ can be depreciated under either a 200 percent of the declining balance method or the sum-of-the-years'-digits method.¹¹⁸ Used residential housing can be depreciated at 125 percent of the declining balance, provided that the property has a remaining life of at least twenty years.¹¹⁹ In addition, other provisions were enacted to encourage rehabilitation of existing low-income rental housing.¹²⁰

The 1969 modifications also revised the depreciation recapture rules with respect to residential property. Under the revised rules, a 200-month holding period is required in order to eliminate recapture.¹²¹ If residential real property is sold during the first hundred months, the entire amount of depreciation claimed in excess of straight-line depreciation is recaptured as ordinary income, but the recaptured amount cannot exceed the gain recognized. If the property is sold during the second hundred months, the amount of recapture is reduced by a percentage equal to one percentage point a month for each month after the first hundred months.¹²² Special rules are provided where governmentally subsidized housing projects are involved.¹²³

¹¹⁵ INT. REV. CODE of 1954 § 1250(a)(1).
¹¹⁶ The new rule applies to properties purchased both before and after the effective date of the Reform Act. Id.
¹¹⁷ In order to qualify as "residential housing," at least 80 percent of the gross income from the property must be rental income from dwelling units. INT. REV. CODE of 1954, § 167(j)(2)(B). It should be noted that the test is applied on a yearly basis, and therefore a property might meet the test in some years and not in others.
¹¹⁸ INT. REV. CODE of 1954, § 167(j)(2).
¹¹⁹ INT. REV. CODE of 1954, § 167(j)(5).
¹²⁰ See INT. REV. CODE of 1954, § 167(k).
¹²³ For example, an FHA 236 [12 U.S.C. §§ 1715z, 1715z-1 (1968)] housing project is still subject to the old ten-year recapture rule instead of the extended 200-month (sixteen years, eight months) rule. INT. REV. CODE of 1954, § 1250(a)(1)(C)(ii).

In addition, a roll-over feature for federally assisted projects permits investors to defer tax on the gain resulting from a sale of the property to tenants or to an approved tenant organization, provided that the proceeds are reinvested within a prescribed period. INT. REV. CODE of 1954, § 1039.
In an attempt to discourage investments in tax shelters, the 1969 reforms also introduced the concept of the minimum tax. This tax is based on the principle that individuals or corporations should not be able to combine tax preferences to escape totally their liability for federal income taxes. A minimum tax is placed on tax preference items such as the excess of accelerated depreciation over straight-line and the excess of investment interest over investment income in net lease situations.

C. Current Tax Reform Proposals

Although the tax reforms of 1969 made some progress toward limiting the tax abuses of real estate tax shelters, the overall effect of these reforms has been negligible. The recapture rules and new depreciation rates have had no real effect on limiting the growth of real estate tax shelters or encouraging the development of low- and middle-income housing. John H. Hall, Deputy Assistant Secretary of the Treasury for Tax Policy, has stated that "as long as the basic tax principles of partnership flow-through, cash method accounting, leverage, and such basic deductions as accelerated depreciation are retained, I am not optimistic that any fundamental relief will be achieved by administrative means."

Because of the pervasive abuses that exist today, a number of tax reform proposals have been advanced to deal with tax shelters in general and real estate tax shelters in particular.

1. Treasury Proposals—Certain tax reform proposals, which were submitted to the House Ways and Means Committee by former Treasury Secretary George P. Schultz, would have a significant impact on tax shelter programs. It is the Administration's feeling that enactment of the proposed legislation is the only realistic solution to the tax shelter problem.

\[124\text{ See INT. REV. CODE of 1954, §§ 56-58.}\]
\[125\text{ Id. § 57(a)(2).}\]
\[126\text{ Id. §§ 57(a)(1), (b).}\]
\[127\text{ See McKee, supra note 63, at 552-53.}\]
\[128\text{ See text accompanying notes 77-79 supra.}\]
\[129\text{ See notes 80-82 and accompanying text supra.}\]
\[130\text{ See Remarks, supra note 76, at 10. The Internal Revenue Service (IRS) has been attempting to employ administrative measures as a stopgap solution, until effective legislation is adopted. For instance, the Los Angeles office of the IRS has moved aggressively against a number of popular shelter techniques. "The effort is seen by some as the leading edge of a growing IRS effort nationwide to stunt the explosive growth of shelters." Wall Street Journal, Nov. 14, 1973, at 1, col. 5. It is reported that the IRS has been challenging selected taxpayers and then letting word of the action spread through the "tax lawyer grapevine." Id. See also New Crackdown on "Tax Shelters," U.S. NEWS & WORLD REPORT, Dec. 24, 1973, at 47, 49.}\]
\[131\text{ PROPOSALS FOR TAX CHANGE, supra note 2, at 95.}\]
\[132\text{ Remarks, supra note 76, at 11. Former Secretary Schultz has stated that the aim of the proposals is to improve the image of fairness in the tax system by reducing to zero if possible "horror stories" about the wealthy whose tax returns show little or no tax . . . . We must deal effectively with aspects of the system that may undermine confidence in it and, therefore, cooperation with it.}\]

N.Y. Times, Apr. 29, 1973, (Sunday Business Section) at 1.
The proposal that is specifically designed to control tax shelter abuses is entitled Limitation on Artificial Accounting Losses (LAL). This provision is aimed at artificial losses that are created for an otherwise profitable business through tax accounting rules, and which are then used to shelter income from other unrelated sources.

The intended effect of LAL is to require that new investments of outside money in tax-preferred industries be made with hard dollars. In other words, first you pay the tax on your regular income... then you may invest in any attractive opportunity you find. If you then have an economic loss—as distinguished from a mere tax loss—you can claim it for tax purposes against your other income.... The basic reasons for the LAL approach are not complicated.... While it still permits an investor to shelter all or part of the income from his investment in... housing, the investment itself will have to be in hard dollars—the investor's outside income will no longer be sheltered. [The Treasury] believe[s] that when all of the money invested is that of the investor himself and not the Government, more care will be used in selecting economically desirable investments. And at the same time, the long-time bona fide operator in the industry will have less unfair competition from those who are really more interested in deductions....

The Administration believes that its LAL proposals will retain all the tax incentives presently available to real estate; however, certain tax incentives will be limited to the activity for which they were created, and their effects will not be permitted to spill over to offset income from unrelated activities. The LAL rules, in essence, would force an individual taxpayer (corporations are excluded from LAL) to treat his tax shelter activity apart from his other activities, thereby stripping away the artificial loss. In the event that a loss still results, even after the artificial loss has been excluded, it would then be recognized as a true loss, which could be used to offset other unrelated income. The artificial accounting loss would still be able to offset, i.e., shelter, income from the investment. Any artificial loss remaining after the permissible offsets would be placed in a deferred loss account, which would be available in the future to offset only income that arose from the tax shelter activity. Thus, the LAL provision would apply to that portion of any loss, attributable to the real estate, which would disappear if the taxpayer had no accelerated de-

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133 Remarks, supra note 76, at 11-12.
134 In any subsequent year the amount in the account would be increased by any related LAL loss. In a year in which the net related income exceeded the accelerated deductions for that year, the excess would be deducted from the account and allowed as a deduction. If the property that generated the LAL loss is sold or disposed of, the portion of the deferred loss account attributed to the property would be deducted from the account and added to the property's adjusted basis. This rule would not apply when the proceeds of the sale constitute related income—as in the case of the sale of housing held primarily for sale.
ductions for the taxable year.  

With respect to real property, the LAL rules would cover accelerated deductions taken in connection with investments in improved real estate that is held either for rental or primarily for sale in the ordinary course of business. These deductions include: 1) accelerated depreciation; 2) the special sixty-month depreciation allowance for rehabilitated housing; and 3) pre-opening construction costs, in connection with the constructed property or the associated land, which are paid or incurred during the period of construction or are attributable to that period.

In the case of residential rental property and housing held primarily for sale, the class of related income that can be offset by accelerated deductions would include rental income from all residential real estate, as well as sales income from housing held primarily for sale. However, the class of related income for nonresidential real estate would include only the rental income, or sales income if the property is held primarily for sale, from the particular property to which the accelerated deductions are attributable. Thus each nonresidential building will be treated as a separate property, unless one or more buildings on a single tract or on contiguous tracts are managed and operated as a unit, in which case all such buildings will be treated as a single property. Finally, the LAL proposals would retain the traditional property basis adjustments for nonresidential property.

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135 The following is an example of how the artificial loss would be determined. A taxpayer has earnings of $25,000 in 1974. He invests in a new rental apartment building and for the taxable year 1974 his share of the income and expenses from the building is as follows:

<table>
<thead>
<tr>
<th>Gross rents</th>
<th>$75,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest</td>
<td>$12,000</td>
</tr>
<tr>
<td>Operating costs</td>
<td>40,000</td>
</tr>
<tr>
<td>Straight-line depreciation</td>
<td>15,000</td>
</tr>
<tr>
<td>Accelerated depreciation</td>
<td>15,000</td>
</tr>
<tr>
<td>(in excess of straight-line)</td>
<td>82,000</td>
</tr>
<tr>
<td>Loss</td>
<td>$(7,000)</td>
</tr>
</tbody>
</table>

Under the present law the taxpayer has a tax “loss” of $7,000 which would be eligible to offset the taxpayer’s earnings. Under the proposed LAL rules, the net related income from the property is $8,000 ($75,000 gross rents, minus interest, operating costs, and straight-line depreciation). Thus, the additional accelerated depreciation of $15,000 is able to offset only the net related income of $8,000. The excess $7,000 of accelerated depreciation is an artificial accounting loss, and would therefore be added to the Deferred Loss Account, to be deducted against the taxpayer’s future net related income from residential real estate.

136 INT. REV. CODE of 1954, § 167(k).

137 These costs include interest, state, local, and foreign taxes, and incidental costs such as management, brokerage and legal fees, insurance, transfer and recording fees. PROPOSALS FOR TAX CHANGE, supra note 2, at 99.


139 The Administration believes “that this broader definition of related income gives effect to the more liberal legislative policy reflected in section 167(j) which provides the incentive of full accelerated depreciation for residential real estate.” PROPOSALS FOR TAX CHANGE, supra note 2, at 99.

140 The Administration feels that Congress did not apply a liberal legislative policy with respect to nonresidential property; therefore, the LAL proposal reflects a more conservative approach in its treatment of this type of property. Id. A taxpayer, who uses accelerated depreciation and has placed all or a portion of the deduction into his
The drafters of the LAL proposal claim that it is designed to have no effect on those taxpayers who are regularly and profitably engaged in the real estate business activity. But the proposal as it now stands would have a direct impact on only the developers of nonresidential real estate; investors in residential real estate tax shelters would be able to continue to "roll over" such investments with little or no tax cost, because of the method used in computing related income. Nevertheless, the Treasury estimates that the LAL proposal will slow the activity of the syndicate merchandisers considerably and will bring in an extra $500 million per year in revenues.

The Administration believes that the matching of income with the expense of earning it is "fundamental to our federal income tax system" and that LAL will help achieve that objective. While one commentator has stated that "the LAL proposal can... be questioned on two conceptual grounds: that it overemphasizes the importance of 'matching' as opposed to other tax accounting principles, and that the use of a suspense account fails to achieve matching," the Wall Street Journal, in a recent editorial in support of the LAL proposal, stated that LAL would stop ever-increasing amounts of capital from flowing into ever-increasing numbers of unjustifiable speculations. Making investors play with their own money would be a clear incentive for the more efficient use of capital.

2. Other Reform Proposals—In addition to the Treasury's LAL proposal, there are several other reform proposals that deserve consideration if truly effective reforms are to be adopted. While some of these proposals would eliminate tax shelters completely, others represent stopgap measures and, as such, would merely treat the symptoms rather than the cause of the problem. A brief sketch of these proposals may be helpful.

a. Elimination of Tax Shelters—One proposal would eliminate the tax shelter completely by dropping all tax incentives and adopting a system of direct governmental expenditures in their place. This solution has been suggested by Professor Surrey, who feels that there are distinct economic and social advantages to the direct expenditure approach. These ad-

defined loss account, would be able to use the full amount of the depreciation, computed under the method adopted by the taxpayer, for the purpose of basis adjustment. For example, even though a taxpayer used accelerated depreciation and had to place all or a portion of the deduction into the deferred loss account, the full amount of depreciation computed under the method of depreciation adopted by the taxpayer would be treated as allowed for purposes of basis adjustment. See INT. REV. CODE of 1954, § 1016.

141 A tax shelter investor will be able to avoid tax on the profit from the sale of residential property by offsetting that profit with losses on other residential property that have been accumulated in a deferred loss account.


143 PROPOSALS FOR TAX CHANGE, supra note 2, at 95.


146 Panel Discussions, supra note 21, pt. 1, at 23.
vantages are reflected in the salient differences between direct expenditures and tax incentives. First, in the case of a direct expenditure, there is public knowledge of the expenditure through circulation of the federal budget. Second, since most direct government assistance for business activities is given on a before-tax basis, the expenditure is entered as a plus in the accounts of the person benefited. Tax incentives do not work this way, because the financial assistance afforded by the tax incentive—which has the purpose of making after-tax profits high enough to induce the desired action by the taxpayer—is not included in income, but instead reduces taxable income.147 Thus while a direct expenditure works on a before-tax basis, the tax incentive operates on an after-tax basis.

One commentator, remarking on economic considerations, has noted:

Every tax incentive . . . means the open charting of a new tax escape path, a path whose instructions read that the wealthier the person who takes it, the larger are the rewards. Direct programs of Government assistance are not built that way and have no such instructions . . . . Today’s loopholes are not the product of tax brains fiendishly seeking hidden escape tunnels. The escape tunnels are sketched in the law for all to see. They are the product of misdirected attempts to use tax subsidies and incentives to reach goals that could, if to be sought at all, be achieved far more efficiently and fairly by direct government programs.148

b. Limitation on Tax Deductions—This proposal would eliminate the real estate tax shelter by limiting allowable tax deductions to the amount of economic depreciation. Structures would be classified according to their precise economic depreciation rates.149 In this way the depreciation deduction would more accurately represent the decline in the actual value

147 It has been said that
the tax incentive . . . produces both financial assistance and freedom from taxation. That freedom means much more to the well-off individual than to one in the lower brackets.

Panel Discussions, supra note 21, pt. 1, at 20.

148 Surrey, supra note 64, at 21. Professor Surrey suggests that the use of tax incentives is destructive of the fairness of the tax system:
The irony of all this is illustrated by the Treasury Department’s first proposing a housing rehabilitation tax incentive in 1969 and then having to suggest that the incentive is a ‘tax preference’ which must be guarded against by including it in the new minimum tax designed . . . to prevent the wealthy from escaping all tax burdens. The use of the direct expenditure route for this assistance to housing would have prevented this particular tax escape.

Id.

Professor Surrey also believes that tax incentives divide the consideration and administration of government programs, and confuse and complicate that consideration by Congress, in the Administration and in the budget process. Additionally, he is convinced that tax incentives do not improve the tax system and are likely to damage it significantly. Surrey, supra note 64, at 728-32.

149 Taubman and Rasche indicate that
[for both office and apartment buildings we find that the tax depreciation rules—even after the 1969 revision—confer substantial subsidies. For example, the true depreciation of office buildings in the first
of the property, rather than an artificially inflated rate of depreciation. One drawback to this plan, however, is that it would be difficult to determine the proper classification of structures and their corresponding depreciation rates.150

c. Full Depreciation Recapture—A third proposal would provide for full depreciation recapture instead of the present recapture of only the excess of depreciation deductions over straight-line depreciation.151 Under this approach, the difference between the amount received on the disposition of the partnership property investment and the depreciable basis of that property at the time of the disposition would be taxed as ordinary income. This proposal recognizes that even straight-line depreciation is excessive in almost all cases. Whether the depreciation is excessive in a particular case can be demonstrated if the depreciable property is sold for more than its depreciated basis. Since a significant portion of property investments held by real estate syndicates are eventually sold for more than their depreciated basis, a fortiori these property investments declined in value by less than the amount used in calculating the annual depreciation deduction.152

There are two arguments in favor of complete recapture. First, it can be argued that, on the sale of property, there is no sound reason to permit any part of a gain attributable to depreciation deductions to be taxed other than as ordinary income. Second, there is no justification for permitting the income generated by the property investment to be sheltered by excess depreciation deductions, thereby allowing ordinary income to be taxed at capital gain rates.153

d. Tax Deferrals as Loans—Another suggestion would limit the advantages of tax deferral, by treating deferrals as loans and requiring repay-

year is less than one-tenth of that allowed under straight line depreciation. Indeed, true depreciation for office buildings falls short of that allowed by the straight-line method for each of the first 45 years of the office building's useful life. We calculate that on a before tax basis, the straight line depreciation allowed by the law yields a subsidy of 18 percent of the purchase price while double declining balance adds approximately 10 percent more. The results are similar for apartment buildings. In the first year, true depreciation is less than one-fourth of that allowed under the straight line method and true depreciation does not exceed the tax allowance until after the passage of 40 years. The straight line tax depreciation method confers a subsidy of 14 percent while accelerated methods can double this. In both industries a reverse sum of the years digits method would approximate true depreciation.

Taubman & Rasche, supra note 82, at 342-43.

These remarks demonstrate the inaccuracy of current depreciation methods and the reasons for the authors' feelings that economic depreciation would be preferable. 150 McKee, supra note 63, at 564-65.

151 This is presently the case with nonresidential property that is held for less than one year. See notes 115-16 and accompanying text supra.

152 Panel Discussions, supra note 21, pt. 4, at 571.

153 Therefore, the recapture rule should be the same as the rule for personal property under Section 1245 of the Code. Panel Discussions, supra note 21, pt. 4, at 571.
ment of these loans with interest. Even full recapture, as described in the previous proposal, would not eliminate the economic advantage that real estate tax shelters derive from the excessive depreciation deductions taken on property investments. This is because investors in these tax shelters are able to obtain the use of the income that is sheltered by the depreciation deductions until the eventual disposition of the property investment; in effect, the use of sheltered income is a tax subsidy in the form of an interest-free loan. This proposal would at least prevent such loans from escaping interest charges.

e. Limitations on Leverage—Real estate tax shelters could be made less attractive by limiting the use of leverage. This could be accomplished in two ways.

One possible method would be to prohibit a step-up in the investor's tax basis of an investment, if the increase in basis would be attributable to the limited partnership investor's pro rata share of the partnership's nonrecourse loans. An investor thus would be allowed to take advantage of the increased basis only to the extent of his personal liability on the indebtedness. Since the amounts of nonrecourse loans would not be added to the bases of the individual limited partners, each partner's share of the partnership's deductions would be constrained by the amount of actual equity plus the amount of personal liability of the partner on the partnership's indebtedness.

A second, even more restrictive, approach would be to limit an investor's basis in the partnership investment solely to the partner's actual equity in that investment, regardless of any personal liability on the partnership's indebtedness. It can be argued than an investor who is personally liable on indebtedness which is secured by the partnership's property investments faces little if any actual economic risk, since in most cases the value of the property alone would be sufficient to cover any outstanding indebtedness on such property. It has been observed that "if a lender is willing to make a loan secured primarily by the property, then a market determination has been made that the value of the property will not be less than the remaining balance of the mortgage at any given time." Therefore, if this proposal were adopted, the investor would be permitted to step-up his tax basis in a partnership investment only to the extent of his equity in the partnership.

f. Capitalization of Costs—Finally, capital costs could be capitalized rather than expensed as is presently permitted. The allowance of deduc-

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154 This approach was adopted in 1965 by the Senate Finance Committee with regard to deferral of taxes by beneficiaries of accumulation trusts. S. REP. No. 91-552, 91st Cong., 1st Sess. 129-30 (1969).
155 See text accompanying note 62 supra.
156 See note 60 and accompanying text supra. See also Note, Tax Consequences of the Disposition of Property Subject to an Unassumed Mortgage, 49 COLUM. L. REV. 845, 851 (1949). Recent proposals to so limit depreciation deductions include H.R. 1040, 93d Cong., 1st Sess. (1973).
157 Panel Discussions, supra note 21, pt. 4, at 571.
158 Panel Discussions, supra note 21, pt. 6, at 867.
tions for capital costs during construction has a significant effect on the rates of return and provides an attractive feature of real estate tax shelters by enabling generation of huge first-year losses.\textsuperscript{159} The true economic need for allowing the expensing of capital costs during construction should be determined. Imposing a requirement for capitalizing these costs would be a means of controlling the abuse of incurring excessive losses for tax purposes and would be consistent with generally accepted accounting principles.\textsuperscript{160}

IV. Conclusion

Professor William S. McKee has tersely concluded that "[t]he real estate tax shelter is an inefficient and inequitable form of subsidy; it should be eliminated."\textsuperscript{161} This proposal should not be considered as a radical solution to the problem of real estate tax shelters. Granting indirect subsidies to the real estate industry through the tax system is not only efficient and inequitable, but it also creates a distortion of resource-allocation priorities and the tax system itself. If governmental financial assistance is required in order to stimulate certain types of real estate development, direct governmental expenditures would be preferable to the present indirect tax incentive method.

Above all, reform of tax shelters is essential in order to demonstrate to the American people that our tax laws can be fair.\textsuperscript{162} Two authors have aptly warned that "tax shelters will be the Achilles heel of the federal income tax if the Administration and the Congress do not move promptly to bring them under control."\textsuperscript{163} Fortunately, help may be on the way. There are preliminary indications that Congress is prepared to pass legislation in the near future that would place substantial restrictions on tax shelters.\textsuperscript{164} Although this legislation may not completely eliminate tax shelters, one can begin to hear high bracket taxpayers yelling "Gimme Shelter!"

\textsuperscript{159} See notes 42-43 and accompanying text \textit{supra}.
\textsuperscript{160} \textit{Hearings, supra} note 82, at 3165.
\textsuperscript{161} McKee, \textit{supra} note 63, at 567.
\textsuperscript{162} Adam Smith states the argument in this way: What we need, quite desperately at this point is a tax law that people believe is fair. The tax law is too complex to inspire the belief that it is fair . . . . People do not understand the laws; what they do know is that nobody pays the top rates . . . .
\textit{NEWSWEEK, supra} note 2, at 6.
\textsuperscript{163} Calkins & Updegraft, Jr., \textit{Tax Shelters}, 26 TAX LAWYER 493, 519 (1973). These authors go on to say that tax sheltering is the most misunderstood, and one of the most controversial, practices now fostered by our federal tax system. If it does not become more widely and accurately understood, thousands of investors will learn to their sorrow that what is represented to them to be a tax shelter may in fact be a tax trap. If some of the rules governing it are not changed at once, tax sheltering will in five years lead to temptations to tax evasion so strong that it will further erode self-assessment morality and produce a tax scandal of major proportions.
\textit{Id.} at 493.
\textsuperscript{164} Remarks, \textit{supra} note 76, at 16.