

Tax Incentives In Rental Housing And The Reform Act of 1969

I. INTRODUCTION

This article will summarize the arguments for and against the use of federal tax incentives as a means of governmental action and describe income tax incentives given to real estate prior to the Tax Reform Act of 1969. Significant changes in income tax housing incentives contained in the new law are described and briefly evaluated in terms of their efficacy in meeting national housing goals. Finally, comment is made on areas which may have influence in determining the size and quality of the national housing inventory but are not yet within the reach of federal income tax incentives.

Under current programs, the housing problem in the coming decade shows little promise of improving. Our nation must build and rehabilitate 26 million houses and apartments in the next decade in order to provide decent housing for new households, allow vacancies for our increasingly mobile population, replace houses destroyed or demolished and eliminate substandard housing.¹ Our current annual rate of housing production must be expanded to rid our cities of substandard housing and provide homes for our growing population.²

¹PRESIDENT'S COMMITTEE ON URBAN HOUSING—A DECENT HOME 39-40 (1968) [hereinafter referred to as A DECENT HOME].

²In calendar year 1969, total housing starts were about 1.5 million, approximately 1.1 million below the annual rate needed to meet the national housing commitment. JT. ECONOMIC COMM., REPORT ON THE 1970 ECONOMIC REPORT OF THE PRESIDENT, H.R. REP. NO. 91-972, 91st Cong., 2nd Sess. 40 (1970). Even with the inclusion of

The dollar costs of meeting the nation's housing goals are estimated to be about \$480 billion, even under the most satisfactory economic conditions.³ Approximately \$100 billion of the cost of the nation's housing aspirations will be needed to accommodate households whose demand for housing cannot be translated into housing purchases because of income limitations.⁴ Because their demand does not evoke a change in housing supply, the housing demand of this group is noneffective in economic terms. For these approximately 7.8 million noneffective demand households governmental participation will be essential to finance needed housing adjustments in the next eight or ten years.⁵ No matter how it is financed, the solution of the overall housing problem will require a substantial amount of credit which is not likely to be forthcoming as a result of the normal operation of the nation's financial markets.⁶

Aside from financing the construction and rehabilitation of housing needed over the next decade, meeting the nation's commitment of a decent home for every family will require improved maintenance of existing housing in order to prevent dilapidation and neglect from taking as great a toll of the national housing inventory as it has in the past. Estimates of the amount of existing substandard housing range from nine million to over fifteen million housing units; equal to one fourth of the entire housing inventory.⁷

An attack upon the problems of inadequate housing should be a vital part of the campaign to improve the quality of American life. A decent home for every American family is the official policy and a

363,000 mobile home units in total housing production figures, the record for fiscal year 1970 is disappointing in light of overall housing needs and goals. HOUSE COMM. ON BANKING AND CURRENCY, SECOND ANNUAL REPORT ON NATIONAL HOUSING GOALS, H. DOC. NO. 91-292, 91st Cong., 2nd Sess. 11-12 (1970).

³HOUSE COMM. ON BANKING AND CURRENCY, SECOND ANNUAL REPORT ON NATIONAL HOUSING GOALS, H. DOC. NO. 91-292, 91st Cong., 2nd Sess. 29 (1970).

⁴2 PRESIDENT'S COMMITTEE ON URBAN HOUSING, TECHNICAL STUDIES 228 (1968) [hereinafter referred to as TECHNICAL STUDIES].

⁵*Id.* at 213. *See also* HOUSE COMM. ON BANKING AND CURRENCY, SECOND ANNUAL REPORT ON NATIONAL HOUSING GOALS, H. DOC. NO. 91-292, 91st Cong., 2nd Sess. 28 (1970), and PRESIDENT'S TASK FORCE ON LOW INCOME HOUSING, TOWARD BETTER HOUSING FOR LOW INCOME FAMILIES, at 7-8 (May, 1970). [hereinafter referred to as TASK FORCE].

⁶The major conclusion of a technical study conducted in connection with the work of the President's Committee on Urban Housing is that "there are likely to be financial obstacles in the way of any effort to deal with the low income housing problem over the next ten years unless additional measures are taken to increase the flows of funds into housing." TECHNICAL STUDIES, *supra*, note 4, at 195. *See also*, TASK FORCE, *supra* note 5, at 2.

⁷A DECENT HOME, *supra*, note 1, at 43-44.

national goal of the United States.⁸ A frequently mentioned strategy for achieving this socio-economic goal is one which includes a system of federal income tax incentives and credits.

II. THE TAX INCENTIVE APPROACH

Specific proposals involving housing tax incentives have been varied. Even recommendations from official blue-ribbon committees have been ambivalent. The President's Committee on Urban Housing recommended increased use of federal tax incentives to assist housing code enforcement and stimulate public housing investment,⁹ while the National Commission on Urban Problems conveniently took positions both for and against the use of tax incentives.¹⁰

Tax incentives as a mode of action to achieve governmental ends has increasingly been the subject of criticism and debate.¹¹ The recent income tax legislation of 1969,¹² while heralded as a major reform, has by no means restrained or dampened the enthusiasm of critics.¹³ Most discussion is centered on the concept that not collecting a tax from A, while collecting it from everyone else, is equivalent to spending on A an amount equal to the tax. Tax incentives derive their incentive character from the fact that they result in less taxable income, thus reducing the tax. The granting of a tax credit is even more easily seen as the equivalent of an expenditure, since it is usually in the form of a direct reduction of tax owed by the taxpayer. Tax incentives and

⁸Congress, in The Housing Act of 1949, declared a policy of a decent home for every American family. President Nixon has affirmed the goal of a decent home for every American. 6 WEEKLY COMP. PRES. DOC. 466 (April 6, 1970). In the Housing and Urban Development Act of 1968, Congress set a goal of 26 million new housing units by 1978.

⁹A DECENT HOME, *supra*, note 1, at 20, 22.

¹⁰Contrast the recommendation urging that direct grants or loans replace more indirect methods of government subsidy with recommendations that increased favorable tax treatment be provided for housing investors and improved maintenance of rental units. NATIONAL COMMISSION ON URBAN PROBLEMS, BUILDING THE AMERICAN CITY, H. DOC. 91-34, 91st Cong., 1st Sess. 182, 406 (1969). [hereinafter referred to as BUILDING THE AMERICAN CITY].

¹¹*E.g.*, the debate in B. BITTKER, J. GALVIN, C. MUSGRAVE, R. PECHMAN, A COMPREHENSIVE INCOME TAX BASE? A DEBATE (Federal Tax Press, 1968).

¹²Tax Reform Act of 1969, PL 91-172; 83 Stat. 487.

¹³See *e.g.*, Surrey, *Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures*, 83 HARV. L. REV. 705 (Feb. 1970). [hereinafter referred to as Surrey, *Tax Incentives*].

credits have understandably been translated as "tax expenditures"¹⁴ and "back-door spending."¹⁵

The controversy over whether tax incentives and credits should be reflected in the revenue or expenditure side of the federal balance sheet might appear somewhat remote from the more pressing need for housing. But the fact that present tax policy automatically distributed tax expenditures totaling a quarter of a billion dollars in 1968 on privately owned rental housing¹⁶ gives the debate strong elements of relevance. This is especially true when it is observed that expenditures made by revenue laws are not subject to the usual scrutiny of congressional authorization and appropriation committees.

The method of distributing tax dollars has little impact on the federal budget. A tax credit of ten per cent of an investment provides the same result as granting an investor a tax free subsidy equal to ten per cent of the cost of his investment. Allowing a taxpayer accelerated depreciation permits him to reduce his tax payment in early years while increasing future tax payments as compared to payments which he would have made had he been allowed only straight-line depreciation. This benefit is similar to loaning the taxpayer, interest free, an amount equal to the amount of tax saving resulting from the rapid depreciation. A realistic comparison between tax incentives and direct expenditures as a method of achieving social policy objectives must recognize that a tax incentive does involve the expenditure of government funds.¹⁷

Recognizing a tax incentive would appear to be a relatively easy task. In the area of housing, tax free exchanges of property,¹⁸ accelerated depreciation,¹⁹ and local property tax write offs²⁰ are a few readily identifiable provisions which involve federal expenditure through favored tax treatment. Beyond this, however, the definitional task is not as easy as it would seem.

¹⁴Address by Stanley S. Surrey, Money Marketeers, November 15, 1967, as excerpted in 1968 SEC. TREAS. ANN. REP. ON STATE OF FINANCES 322.

¹⁵"[E]xpenditures we turn away from the front door we must not allow to enter through the back door. If we decide that certain programs, however worthy their purpose, cannot be financed at the time by increased spending, because other needs have priority, we should not then turn around and sanction some form of indirect subsidy—in the form of special tax relief—for these programs." 113 CONG. REC. 36404 (1967) (remarks of Congressman Wilber D. Mills).

¹⁶1968 SEC. TREAS. ANN. REP. ON THE STATE OF THE FINANCES 334; *Hearings on the 1969 Economic Report of the President*, 91st Cong., 1st Sess. 8-44 (1969).

¹⁷Surrey, *Tax Incentives*, *supra*, note 13, at 715.

¹⁸INT. REV. CODE of 1954, § 1031(a).

¹⁹INT. REV. CODE of 1954, § 167(b).

²⁰INT. REV. CODE of 1954, § 164(a).

Identifying deviations from the "ideal" tax (one which is entirely neutral, i.e., does not influence a taxpayer's decision one way or another) depends upon definition of the "ideal" system. Whether the federal principal of a graduated tax on net income is an ideal system is always an interesting question. Whatever the answer may be, within the context of our present statutory system, presumably any exception to the principal of a graduated tax on net income must be taken as some type of incentive whether negative or positive in nature. Complete identification of existing tax incentives becomes a will-o-the-wisp since, in the end, it depends upon a demonstrably consistent definition of income. The search is not made easier by knowledge that not all experts agree an income tax system requires any definition of income at all.²¹

A. TAX INCENTIVE SPENDING. *The Arguments*

Advocates of the tax incentive approach to federal spending usually point to the following²² in support of their case.

1. Tax preferences built into the Internal Revenue Code are less likely to be changed from year to year than a corresponding federal expenditure through the authorization and appropriation process. Long-range planning, based on this built in stability, is encouraged, which in turn stimulates greater participation by private business in government programs.

2. Tax incentives involve less direct governmental interference with private business operations and encourages private enterprise rather than governmental decision making. Less governmental supervision means simpler and more efficient administration.

3. Tax incentives are effective in that they influence decision making by taxpayers in directions favorable to governmental policy objectives.

4. Tax incentive spending is often a practical course when the equivalent direct expenditure appropriation is politically difficult if not impossible to achieve.

On the other hand, critics of tax incentive spending have more and more placed the burden of proof on those who press for tax incentives

²¹See Bittker, *A Comprehensive Tax Base as a Goal of Income Tax Reform*, 80 HARV. L. REV. 925 (1967); Bittker, *Accounting for Federal Tax Subsidies in the National Budget*, 22 NAT'L TAX J. 244 (June 1969).

²²The summary which follows is adapted from P. HODGE & P. HAUSER, *THE FEDERAL INCOME TAX IN RELATION TO HOUSING*, 86-100 (Nat'l Commission on Urban Problems Research Rep. No. 5, 1968) [hereinafter referred to as HODGE & HAUSER].

over other more direct methods of governmental spending.²³ Criticism of the tax incentive approach usually includes the following arguments:

1. Tax incentives become entrenched in the revenue side of the federal budget where they escape the cost-benefit scrutiny of Congressional watchdog committees and agencies such as the General Accounting Office. As a result, costs tend not to be clearly calculated. To the extent they are granted to taxpayers who haven't done anything they would not have done anyway, tax incentives represent a windfall to the taxpayer and an unwarranted expenditure of limited federal resources.

2. To have a significant impact on a given problem, any tax incentive plan must be selective and reach the points intended without dissipating its effect across the entire economy. To be selective in effect, a tax incentive program would appear to require rules for application and criteria for qualification or review. Review and certification adds red tape to the process rather than simplicity.²⁴

3. Those opposed to tax incentive spending usually point to inherent limitations of any social or economic programs carried out through the income tax law. A tax incentive plan can only reach those who are within the tax system. A taxpayer receives government tax incentive payments to the extent he is a taxpayer. Selecting recipients of federal money on the basis of ability to utilize tax incentives tends to single out high income taxpayers for preference. Such preference is in conflict with the principal of progressive taxation since it reduces the effective tax rate of high income taxpayers.

4. The utilization of tax incentives for one purpose invariably raises pressures for additional preferences favoring other interests.²⁵ The result is a smaller tax base with higher rates for remaining taxpayers unable to qualify for preference.

5. Finally, the further proliferation of tax incentives and credits precariously tips the essential balance between simplicity and equity within the tax system²⁶ and is contrary to announced standards of tax

²³Most notable is Professor Surrey's previously mentioned direct assault on tax incentives as a method of government spending in Surrey, *Tax Incentives*, *supra*, note 13.

²⁴There is a good indication the Treasury Department, despite the opportunity for kingdom building, does not relish the prospect of increasing the complexity and burden of its operations. See statement of Joseph Barr, Under Secy. Treas., in *Hearings on S2100, Tax Incentives to Encourage Housing in Urban Poverty Areas, Before Sen. Finance Comm.*, 90th Cong., 1st Sess. 144 (1967).

²⁵*Id.*

²⁶S. Surrey and G. Brannon, *Simplification and Equity as Goals of Tax Policy*, 9 WM. & MARY L. REV. 915 (1968).

reform.²⁷

For good or bad, tax incentives as a method of government spending is a fact of life. In 1968, federal tax expenditures for community development and housing was estimated by the Treasury at over \$3.9 billion. These tax expenditures were about equal to budget outlays made for the same purposes. For 1970, the Treasury estimates tax expenditures will be almost double budget outlays.²⁸ In round numbers, total tax expenditures for 1968 were \$45 billion.²⁹ With this amount of money being distributed by the tax system, an inquiry into the nature of the tax incentives involved becomes more than an academic exercise.

III. PRE-1970 REAL ESTATE TAX INCENTIVES—THE TAX SHELTER

Prior to the Tax Reform Act of 1969³⁰ tax advantages incident to participation in housing investment and ownership were grounded on the interplay of generally increasing real property values and several specific provisions of the Internal Revenue Code. The aggregate of these preferential provisions is known as the "tax shelter" in real estate.³¹

The principal feature of the pre-1970 tax shelter was the availability of accelerated methods of depreciation on real estate used in a trade or business or held for the production of income.³² First year depreciation deductions amounting to more than twice that allowed by the usual straight-line method of accounting was available on new properties, and a depreciation rate one and a half times that of the

²⁷Mills, *Some Dimensions of Tax Reform*, 23 ARK. L. REV. 159 (1969).

²⁸*Hearings on the 1969 Economic Report of the President Before Jt. Econ. Comm.*, 91st Cong., 1st Sess. 38 (1969).

²⁹*Id.* at 32-44.

³⁰PL 91-172; 83 Stat. 487, enacted December, 1969. Generally, the act became effective January 1, 1970.

³¹Much is made in lay and trade circles alike of the tax shelter available to investors. *See, e.g.*, NATIONAL INSTITUTE OF FARM AND LAND BROKERS, *Use of Real Estate as a Tax Shelter*, in FEDERAL TAXES AFFECTING REAL ESTATE 231 (2d Ed., 1966); ANDERSON, TAX FACTORS IN REAL ESTATE OPERATIONS 1-19 (1965); LASSER, SUCCESSFUL TAX PLANNING FOR REAL ESTATE (Lasser Institute, 1965).

³²Use of a building for residential rental purposes qualifies the owner for depreciation deductions since such use may be considered either as in connection with a trade or business, *Snyder v. Commissioner*, 295 U.S. 134 (1934), or as property held for the production of income, *Heiner v. Tindle*, 276 U.S. 582 (1928).

corresponding straight-line rate was available on used rental properties.³³ Whatever method was applicable, the entire cost of the unit was depreciable, even though the property was acquired with little equity and a large mortgage.

As a result of accelerated depreciation, a taxpayer could deduct amounts greater than his otherwise taxable income, leaving him with no current income tax liability at all.³⁴ If the taxpayer resold the property, the depreciation previously taken in excess of straight-line depreciation and gains on the sale itself were taxed as capital gains, i.e., at one half the taxpayers regular tax rate.³⁵ As a result, real estate operations that in reality proved economically profitable would normally produce substantial losses for tax purposes, and thereby shelter from income taxation the economic profit of the operation and permitting avoidance of income tax on the owner's other ordinary income.

As properties held for substantial periods of time begin to become more fully depreciated the amount of the accelerated depreciation deductions become less and consequently the tax shelter becomes smaller. To continue to enjoy a tax shelter, a sale of the property (enjoying capital gain treatment and only limited recapture) or an exchange (in which taxes on income realized from the exchange may be deferred indefinitely) was necessary.

This dealing in tax shelters spread housing investment incentives over repeated turnovers of older properties rather than focusing the tax expenditures involved on new construction needed to provide decent homes. It has been asserted that frequent turnover is associated with inadequate maintenance and unsound financial structures.³⁶

³³INT. REV. CODE of 1954, § 167, as amended, prior to the 1969 Tax Reform Act. For a detailed treatment of depreciation see LYON, DEPRECIATION AND TAXES (Tax Management Institute Inc., 1962).

³⁴If we assume a taxpayer with annual net income of \$10,000 were to give \$20,000 cash and a 7% mortgage of \$80,000 for a new apartment unit with a useful life of 40 years, the following interest and depreciation deductions would be available to reduce his taxable income in the first year of operation.

Taxable income		\$10,000
Depreciation deduction	\$5,000	
Interest deduction	<u>5,600</u>	
Total deductions		\$10,600

³⁵INT. REV. CODE of 1954, §§ 1250, 1231. Prior to the Tax Reform Act of 1969, § 1250 provided for taxation at ordinary income rates of excess depreciation at the time of resale if the property was held for a period less than 120 months. However, it was a sliding recapture provision and substantial amounts of excess depreciation could escape recapture much earlier. See generally HODGE & HAUSER, *supra*, note 22, at 14-16.

³⁶See H. R. REP. NO. 91-413, 91st Cong., 1st Sess. 166 (1969). See also HODGE & HAUSER, *supra*, note 22 at 36-42.

While the relationship between frequent turnover and maintenance has never been demonstrated, it is nevertheless often accepted as existent.

This, briefly, was the federal income tax shelter available to owners of rental housing. The magnitude of this back-door spending program in 1967 was estimated at \$850 million.³⁷ Since the tax shelter clearly benefits only those with income in need of sheltering and would have practically no effect on taxpayers in lower income brackets, the beneficiaries of the federal tax shelter expenditures have been individuals hardly in need of public assistance. Out of a group of thirteen active real estate operators studied by the Treasury, tax liability for the year 1966 was reduced to zero for nine of them and to less than \$25 for two others. Aside from real estate investments, the thirteen individuals had wages and income of almost one million dollars.³⁸ The more passive real estate investor also participated in federal real estate subsidies. Of nineteen such taxpayers studied by the Treasury the average "tax loss" claimed from real estate investments was \$77,500 which was used to offset a part of other ordinary income which averaged \$140,000. These investors paid tax on only fifty-three per cent of what would have been their taxable income were it not for their participation in real estate ventures.³⁹

It was against this background Congress set out to reduce the tax incentive aspects of real estate depreciation and limited recapture and to create a tax incentive to encourage rehabilitation of existing housing units.⁴⁰

IV. CHANGES IN HOUSING TAX EXPENDITURES IN THE 1969 TAX ACT

In its consideration of the 1969 Tax Reform Bill,⁴¹ Congress had its eye on the high income taxpayer who had a low effective tax rate

³⁷HOUSE COMM. ON WAYS AND MEANS AND SENATE FINANCE COMM., 91st Cong., 1st Sess., TAX REFORM STUDIES AND PROPOSALS U.S. TREASURY DEPT. 441 (Comm. Print 1969). [hereinafter referred to as TREAS. TAX REFORM STUDIES]. The study notes at page 442 that only about \$50 million went into the process of rewarding investors who had currently or recently made commitments increasing the low and moderate income housing supply.

³⁸*Id.* at 452.

³⁹*Id.* at 454-455.

⁴⁰H.R. REP NO. 91-413, 91st Cong., 1st Sess. 166 (1969).

⁴¹HR 13270, later to become PL 91-172; 83 Stat. 487.

as a result of itemized deductions and capital gain treatment.⁴² The real estate tax shelter and its supposed negative effect on maintenance and rehabilitation of housing was a specific concern.⁴³ Five sections of the Reform Act deal more or less directly with housing tax incentives and the tax shelter.

A. IRC SECTION 167, 1250: DEPRECIATION AND RECAPTURE

The amendment of these sections changes the methods of depreciation on real estate. The fastest write-off methods, double-declining balance and sum-of-the-digits methods, are now applicable only to new rental housing property. The quickest depreciation method available on older housing is the 125% declining-balance method.⁴⁴

The recapture rules were also changed to reduce tax expenditures through incentives. The law now requires residential rental property to be held for 16 years, 8 months before all recapture of excess depreciation is avoided.⁴⁵ These changes in depreciation method and recapture deal with the heart of the real estate shelter. Together they are estimated as reducing annual federal tax incentive expenditures by about \$350 million by 1979.⁴⁶ Of course, recapture of excess depreciation does not directly reduce tax expenditures. Rather, it recovers some earlier expenditures. In the aggregate, net expenditures for any given year might be smaller. Whether the revised section will have an effect measurable in terms of an increase housing inventory or only in a narrower range of taxpayers for whom the tax shelter will be profitable is uncertain.

The new law does appear to reduce the profitability of dealing in tax shelters by limiting depreciation on used residential property to the 125% declining balance method. The difference between depreciation allowable on new (200% declining balance) as opposed to used (125% declining balance) residential rental housing is now 75%. This could tend to divert real estate equity investment from used properties to new construction, assuming the investor's purpose is primarily to shelter ordinary income by accelerated depreciation deductions and

⁴²S. REP. NO. 91-552, 91st Cong., 1st Sess. 13 (1969); H.R. REP. NO. 91-413, 91st Cong., 1st Sess. pt. I at 9 (1969).

⁴³S. REP. NO. 91-552, 91st Cong., 1st Sess. 212, 213 (1969); H.R. REP. NO. 91-413, 91st Cong., 1st Sess. pt. I at 165, 166 (1969).

⁴⁴INT. REV. CODE of 1954, §167(j).

⁴⁵INT. REV. CODE of 1954, § 1250(a)(1)(c)(iii).

⁴⁶S. REP. NO. 91-552, 91st Cong., 1st Sess. 215 (1969).

thin equity financing. This also assumes there is a new construction venture available to the equity investor or that the equity investor is willing to take the risks of entrepreneurship involved in promoting a housing construction project. Passive equity investment in used rental real estate could as easily be diverted to areas more profitable than housing as a result of the new provisions.

The changes in allowable depreciation do not help with the problem of where or on what type of housing the tax incentive expenditure should be spent, nor does it overcome the objections inherent in all tax incentives, that it is destined to be spent on those who do little or nothing for it and on those who are in least need of federal aid. The law makes available the double declining balance tax shelter on new luxury townhouses as well as on low or moderate income housing regardless of the fact that most housing demand is for the latter type. The same tax incentive to build housing exists in crowded New York City as in Abilene, Kansas, regardless of the individual housing needs of those two cities. The incentives left in the tax law in the form of accelerated depreciation and limited recapture, while not as expensive as the old ones, are not focused on those areas where new housing is particularly needed.

B. IRC SECTION 167 (K): REHABILITATION WRITE-OFF

This new provision allows rapid write-off of certain rehabilitation expenditures made to improve existing rental housing. It was inserted in the code to encourage rehabilitation of low and moderate income rental housing.⁴⁷ Rehabilitation expenditures on used properties may be depreciated over 5 years using the straight-line method and a zero salvage value, provided the rental units rehabilitated are rented to persons of low or moderate income.⁴⁸ Only the first \$15,000 of rehabilitation costs may qualify for this preferential treatment and qualifying expenditures may not be less than \$3,000 per unit. Expenditures incurred during two consecutive years may be aggregated to qualify.⁴⁹ When the rehabilitated property is sold, gain from the appreciation resulting from the improvement is subject to the new recapture rules applicable to excess depreciation.⁵⁰

Aside from doubts raised by any tax incentive program, these rehabilitation write-off provisions seem misdirected. Since high in-

⁴⁷*Id.* at 213; H.R. REP. NO. 91-413, 91st Cong., 1st Sess. pt. I at 166 (1969).

⁴⁸INT. REV. CODE of 1954, § 167(k)(1).

⁴⁹INT. REV. CODE of 1954, § 167(k)(2).

⁵⁰INT. REV. CODE of 1954, § 1250(b)(4).

come taxpayers are more attracted to tax losses than other taxpayers, and since a greater tax loss is available from rehabilitation expenditures which represent a very high proportion of original cost, the provisions appear to favor the high bracket taxpayer who makes expensive improvements on property of little or no value. Whether this will result in more housing is unknown. Even if it does, the fact the prior depreciation deductions from the property are subject to recapture at ordinary income rates would seem to dampen any tendency of investors to make substantial rehabilitation expenditures.

The budget cost of the rehabilitation allowance is estimated to eventually reach \$330 million.⁵¹ While Congress may have intended this money be spent rehabilitating dilapidated or marginal low and moderate income housing units, there is no way to be sure this will happen. The incentive, as mentioned earlier, is to spend large amounts on properties which arguably should not be preserved. In terms of number of housing units bought, better results might be obtained from a similar amount spent directly on new construction.

Low and moderate income tenants are entirely excluded as direct participants from this tax expenditure program designed to encourage proper maintenance and rehabilitation of existing housing. Also excluded are nonprofit and charitable organizations who may be peculiarly adapted to renewal and rehabilitation activities.

C. IRC SECTIONS 56, 57, 58: THE MINIMUM TAX

These sections require individuals and corporations with substantial amounts of otherwise tax free income to pay significant amounts of tax through the use of a limit on tax preferences. The minimum tax does not nor was it intended to attract new investors into housing markets, or affect the rehabilitation or maintenance of existing housing. To the extent its purpose was to curtail the practice of stringing together preferential provisions of the tax law to form large amounts of tax free income, its effectiveness is in doubt. At best, it will require that some very high income taxpayers, who before had paid little or no tax, will now pay some tax.

The new minimum tax provisions exempt from their operation the first \$30,000 of tax preference income⁵² plus an amount equal to

⁵¹S. REP. NO. 91-552, 91st Cong., 1st Sess. 215 (1969).

⁵²INT. REV. CODE of 1954, § 57 lists the following items as tax preference income:

1. excess interest.
2. excess of accelerated depreciation over straight line on real property.
3. excess of accelerated depreciation over straight line on personal property subject to a net lease.

the taxpayers federal income tax.⁵³ Remaining tax preference income is taxed at 10 percent.

The impact of these sections on housing investment will probably be limited. Even the real estate operators and investors studied by the Treasury will continue to enjoy considerable tax shelter benefits. One of the real estate operators reported in the Treasury study⁵⁴ illustrates the point. For the period 1960 through 1966 this taxpayer's income was as follows:

Dividends		\$1,110,000
Interest		110,000
Fees, Misc.		700,000
Capital Gains		
Real Estate	4,330,000	
Other	1,220,000	
		<hr/>
		5,550,000
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Gross Income		\$7,470,000
Real Estate		
"Tax Loss"		3,000,000
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Taxable Income		\$4,470,000
Income Tax Paid		\$800,000
EFFECTIVE NET INCOME TAX RATE		18%

This same taxpayer, had the new minimum tax provision been in effect, would have paid additional tax as follows:

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4. excess of amortization of certified pollution control facilities over depreciation under any allowable method.
 5. excess of amortization of railroad rolling stock over depreciation under any allowable method.
 6. excess of fair market value of option stock over option price at time of exercise.
 7. for certain financial institutions, excess of deductions for additions to bad debt reserve over amount allowable by reason of experience.
 8. excess of percentage depletion over cost.
 9. an amount reflecting the preferential treatment of long term capital gains.

⁵³INT. REV. CODE of 1954, § 56.

⁵⁴TREAS. TAX REFORM STUDIES, *supra*, note 37, at 453.

Capital Gains Preference Income

Real Estate	\$2,165,000
Other	610,000
Total	<u> </u>

\$2,665,000

Less

Taxes Paid	\$800,000
Statutory Exemption	210,000
(\$30,000/year; 7 years)	<u> </u>

\$1,010,000

Preference Income Subject to 10% Tax

\$1,765,000

Additional Tax

\$176,500

Taxes Paid

\$800,000

Total Tax

\$976,500

EFFECTIVE NET INCOME TAX RATE

22%

This illustration does not, of course, include any minimum tax on the preference consisting of excess depreciation. However, even if the tax losses from real estate were deemed wholly excess depreciation, and thus subject to the minimum tax, his effective tax rate on gross income would increase from about 10 percent to only about 13 percent. Under the new minimum tax provisions, this taxpayer would have paid a 10 percent tax on income upon which, were he given no preference at all, he would otherwise have paid a 70 per cent tax. In other words, even with the new minimum tax, the federal tax expenditure program which treats gain on disposition of real estate as capital gains would have given this taxpayer over one and three-quarter million dollars over the seven year period.⁵⁵

⁵⁵

Tax preferred income	\$2,775,000
Normal marginal rate for this taxpayer is 70% or	\$1,942,500
Minimum tax is 10% of preferred income less \$30,000 per year as well as taxes paid, or	<u>176,500</u>
Tax Favored Income	\$1,766,000

D. IRC SECTION 1039: ROLLOVER

This provision was inserted to encourage the sale of government assisted housing projects to lower income occupants. The maximum sale price on such projects⁵⁶ is limited by federal housing laws and includes the element of income tax liability incurred through gain on the sale. Permitting nonrecognition of such gain is a method of reducing the sale price without decreasing the seller's return.

This provision is an exception to the general rule that gain is realized upon disposition of property. It allows an investor in a qualified publicly assisted housing project⁵⁷ to defer recognition of gains⁵⁸ upon a resale under certain conditions. This preference is equivalent to an interest free loan in the amount of taxes then deferred. To qualify, the sale must be to the tenants of the project or to a tax-exempt organization managing the property⁵⁹ and the gain which otherwise would be recognized must be reinvested, within a specified time,⁶⁰ in another publicly assisted housing project. The taxpayer's basis for the original investment is carried over (hence the term "rollover") and becomes part of the basis for the reinvestment property.⁶¹

Success of this provision in terms of new publicly assisted housing owned by low-income tenants will hinge not on the tax incentive as much as on other more direct programs which supply low cost credit or grants to the low-income tenant. Sale price reduction from the rollover deferral provisions are small compared to total price. Tenant ownership will result, if at all, from governmental action and expenditures made in other areas through different methods.

Whatever its effectiveness, the rollover provision overlooks a most important part of the housing sector. Since only publicly assisted housing qualifies, full private participation in meeting housing needs is distinctly disfavored compared to public-private partnerships. This makes little sense if one of the aims of our tax policy is to encourage tenant ownership and private investment in new housing.

⁵⁶*E.g.*, FHA 221(d)(3) and 236 projects.

⁵⁷INT. REV. CODE of 1954, § 1039(b)(1) defines a qualified housing project as a project to provide rental or cooperative housing for lower income families which has a mortgage insured under the National Housing Act and with respect to which the owner is limited by that act to a certain return on his investment as well as to the rents which he may charge.

⁵⁸INT. REV. CODE of 1954, § 1039(a)(2).

⁵⁹INT. REV. CODE of 1954, § 1039(b)(2).

⁶⁰INT. REV. CODE of 1954, § 1039(b)(3) describes acceptable reinvestment periods.

⁶¹INT. REV. CODE of 1954, § 1039(d).

E. IRC SECTION 216 (b):
COOPERATIVE HOUSING CORPORATIONS

Advantages of housing cooperatives are unchanged by the Reform Act. Interest and taxes on the property are passed on, pro rata, to tenant-shareholders, thus giving housing cooperative shareholders the same tax advantages available to taxpayers who occupy their own home.

Formerly, to qualify for treatment as a housing cooperative, a minimum of 80 per cent of gross receipts had to be from residential tenants rather than commercial, governmental or industrial leases.⁶² New section 216(b) (4) provides that stock owned or proceeds from units rented by certain governmental agencies need not be taken as part of gross receipts when determining the cooperatives' eligibility under the 80 per cent rule. Consequently, tenant-shareholders in publicly assisted housing may deduct a proportionate share of interest and taxes even though more than 20 per cent of the cooperative's income is derived from a governmental agency.

The impact of the new section on housing inventories will be dependent upon availability of private entrepreneurship and public money to put together low cost housing cooperatives. Probably little can be expected from the new provision in terms of low-income housing. In terms of treatment by the federal income tax law, the main feature of housing cooperatives is increased tax deductions for tenant-shareholders. Persons of low income have little reason to be attracted by this incentive. Most favored will be higher-income taxpayers in housing cooperatives built with urban renewal assistance. Even adopting the "trickle-down"⁶³ theory of housing supply, persons of low income are unlikely to benefit from this type housing at any time in the near future.

**V. THE 1969 TAX REFORM ACT —
NOT ENOUGH OF A BAD THING?**

From the discussion above, it should be apparent Congress has

⁶²INT. REV. CODE of 1954, § 216 (b)(1).

⁶³Essentially, the trickle-down theory of housing supply has it that as upper and middle income families improve their housing situation, their old housing becomes available to housing consumers at the next lower income level, thus initiating an improvement all down the income level scale. With this theory of housing supply as a premise, housing assistance available to upper and middle income families is said to benefit all those in need of a housing adjustment.

left many familiar tax incentives related to housing investment in the federal income tax laws and added a few new ones. If housing tax incentives are to be a major tactic in meeting national housing goals, perhaps a broader approach to tax incentives should be considered. At the very least Congress has overlooked certain differences which appear to have significant potential for influencing housing supply.

A. DEBT CAPITAL VS. EQUITY

The housing tax incentives in the present code are encouragements to the owner of equity investment capital. The taxpayer who leverages his ten percent-of-cost investment is rewarded by tax benefits based on the total cost of a project. Many of these investors are partnership ventures or syndicates composed of high income professional people.⁶⁴ Assuming an incentive in the form of a tax shelter is necessary to obtain the commitment of the excess equity capital of this group, there remains the matter of those who supply the balance of development costs. It has been observed that the hard-core problem of housing the nation, especially low income families, is finding sufficient debt funds to assist in the effort.⁶⁵

Credit is a crucial element in any residential real estate transaction.⁶⁶ In the first three quarters of 1969, housing mortgage borrowers raised about \$20.2 billion as compared with \$18.6 billion and \$8.4 billion for the business and consumer sectors, respectively.⁶⁷ Housing is in continuous competition for available debt resources. While there are some governmental efforts to help fill the credit gap by diverting new money from the pool of available credit into housing,⁶⁸ the federal income tax law does little to provide any tax-based incentive to creditors who must provide most of the money needed to meet national housing goals. If we are to fund our housing program through the federal tax system, there should be some consideration given to money markets providing essential credit resources.

B. INVESTORS VS. ENTREPRENEURS

In developing new multi-family housing projects, publicly assisted

⁶⁴TREAS. TAX REFORM STUDIES, *supra*, note 37, at 452, 454.

⁶⁵TECHNICAL STUDIES, *supra*, note 4, at 229.

⁶⁶*Id.* at 204-20.

⁶⁷Federal Reserve System Board of Governors, FEDERAL RESERVE BULLETIN, March 1970 at A71.1.

⁶⁸*E.g.*, Federal National Mortgage Association and Federal Home Loan Board

or otherwise, the highest risk of the venture is incurred in the promotion stages. Once debt capital is found and sufficient equity is committed to a particular plan for a specific property, the entire package is eminently marketable. The risk of loss of capital falls heaviest on the entrepreneur who actually puts together the pieces of a housing project. Usually, rewards on successful promotions are attractive enough to warrant the original risks taken, particularly where the developer's investment is primarily "sweat capital."⁶⁹ Still, housing starts are far below the pace needed to meet housing goals.⁷⁰

Present tax incentives include no recognition of the essential part entrepreneurship plays in developing new housing. Tax expenditures are distributed to equity investors, not necessarily promoters. It is arguable, that since equity buys from promoters, the present tax incentives help create a market to which the promoter sells. Nevertheless, in view of their respective risks and potential impact on the housing inventory, promoters taking high risks in putting together housing packages should at least share more directly the preferences given to equity investors.

C. PREVENTIVE MAINTENANCE VS. REHABILITATION

To the extent preventive maintenance can reduce shrinkage of the housing inventory by preventing dilapidation, it is important in meeting overall housing needs. Present tax incentives are designed to encourage major rehabilitation no matter to what degree it may add to the total housing effort. No tax expenditures are presently distributed to those who are in a position to take preventive action to avoid later costly major rehabilitation. Tenants are given no incentive through the tax system to take advantage of their ideal situation in regard to preventive maintenance. If landlords must be encouraged, through tax incentives, to rehabilitate their own property, a similar incentive seems appropriate to encourage tenants to take reasonable care of a landlord's property. Rehabilitation and maintenance tax incentives, if appropriate at all, should be shared by owners and tenants.

pooled securities; Federal Reserve Board regulations favorable to Savings and Loans which provide most residential mortgage money, and for banks to encourage greater participation in residential mortgage operations.

⁶⁹Sweat capital refers to investments of the developer's time and energy rather than his cash.

⁷⁰See JT. ECONOMIC COMM., REPORT ON THE 1970 ECONOMIC REPORT OF THE PRESIDENT, H. R. REP. NO. 91-972, 91st Cong., 2nd Sess. 40 (1970); and *see also* HOUSE COMM. ON BANKING AND CURRENCY, SECOND ANNUAL REPORT ON NATIONAL HOUSING GOALS, H. DOC. NO. 91-292, 91st Cong., 2nd Sess. 11-12 (1970).

D. SUPPLIERS VS. USERS OF HOUSING

Tax incentives are lauded as utilizing the free enterprise system. Tax expenditures are made to housing investors as suppliers, with the expectation that housing will result. Through qualification of the tax incentive expenditures, hopefully the type of housing most needed will be built where it will do the most good.

If the principles of supply and demand economics are to be utilized to achieve the efficient production of needed housing, a more certain method of spending government revenue is available. Probably those most in need of a housing adjustment are the 7.8 million low-income families whose desire for improved housing is not translated into an effective economic demand.⁷¹ If they are given an ability to make their demand effective, the private enterprise system should respond. Reinforcing demand, rather than encouraging supply, has the advantage of giving those who receive government assistance the choice of where they will live, and what kind of housing they will have.⁷² Low-income taxpayers are beyond the reach of normal tax incentives. The tax system approach leaves out an essential party to any housing transaction. There is no clear and direct indication tenants are not benefitting from at least some part of the automatic expenditures being made by the tax system on housing. However, even if it is assumed that the tax subsidy is passed on to tenants, there is no evidence tenants receiving the subsidy are the kind of tenants a direct expenditure program would care to subsidize. The workings of the market place and national housing goals would be better served by strengthening demand through a negative income tax or other direct subsidies in place of the continued emphasis of the tax system on housing investor-suppliers.

VI. CONCLUSION

If national housing goals, as recently reaffirmed by the President,⁷³ are to be met by 1978, dramatic government assistance of some form will be necessary. Since the cost of achieving this ambition is huge, the most efficient methods of government participation will be re-

⁷¹TECHNICAL STUDIES, *supra*, note 4, at 213.

⁷²A DECENT HOME, *supra*, note 1, at 47.

⁷³6 WEEKLY COMP. PRES. DOC. 466 (April 6, 1970).

quired. Given the stiff competition for governmental and private money resources, the most housing must be obtained for the least number of dollars.

Tax incentive spending on housing is an inefficient way to spend federal revenues. Evaluation of results is extremely difficult and there is much to indicate results are not especially suited to achieving the national goal of a decent home for every American family. More direct subsidies would force more thorough evaluation and permit costs otherwise hidden from view to be recognized.

Tax incentives in real estate, after the 1969 Tax Reform Act, still provide preferences to high income taxpayers and exclude other important elements in housing; promoters, creditors, and tenants. The basic elements of a profitable tax shelter, leverage, depreciation, capital gains and tax free exchanges, are still available under the new law. Contrary to the principle of progressiveness and tax equity, they are available and most valuable to high income taxpayers.

If tax incentives are to be used, they should include all those necessary to achieve housing goals. The Tax Reform Act of 1969 does not recognize this premise, and leaves the equity investor as the single element receiving federal money for his assistance in building and maintaining decent homes for Americans.

The 1969 Act is thus short in vision. It may be this shortsightedness is inherent in the use of the income tax system to solve a difficult housing problem. By not reaching all those needed to create new and improved housing, this attempt to solve the housing problem is hindered and perhaps doomed to failure. If tax incentives were expanded to include all elements of the housing problem, the remoteness of the resulting tax effect from our usual concept of income would make the expenditure feature of tax incentives apparent. Thus, the irrationality of this funding technique is revealed. To work, those not in the tax system must be included. If the system is expanded to include them, the system loses any rational relation to a tax on net income, and again the subsidy aspect becomes clearer. Once the subsidy aspect becomes clear to enough people, perhaps the appropriate steps may be taken to put these subsidies outside the revenue laws and deal with them directly so that they will more effectively assist in providing a decent home for every American.

D. Steven Blake