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Kenneth J. Guido, Jr.

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I. INTRODUCTION

Hidden by the storm surrounding the more controversial changes in the Tax Reform Act of 1969 are subtle alterations in the tax structure that may significantly affect the rate and nature of real estate development. The Tax Reform Act amended provisions of the Internal Revenue Code directly applicable to real estate investments,[1] purposefully redesigning them in the hope of stimulating the construction and rehabilitation of rental housing, particularly low-income housing.[2] The changes

* Assistant Professor of Law, University of Kentucky College of Law; B.S. 1964, California State College, Long Beach; J.D. 1966, University of Southern California; LL.M. 1967, Yale University.

1. The Tax Reform Act may affect the development of real estate in other ways. First, since real estate development is relatively expensive, the cost must be financed with long-term mortgages; therefore, the development of real estate is vulnerable to the vicissitudes of the capital markets. The cumulative impact of the Tax Reform Act on the economy may increase the rate of inflation, and indirectly depress the rate of real estate development. *Hearings on H.R. 13270 Before the Senate Comm. on Finance*, 91st Cong., 1st Sess. 3985-90 (1969) (remarks of Leon Keyserling) [hereinafter cited as *1969 Senate Hearings*]. *See also id.* at 4035-36 (remarks of Robert Pease). Secondly, the Tax Reform Act alters the tax treatment of financial institutions and consequently may alter the flow of mortgage funds into real estate in the same manner as the rate of inflation. *See generally id.* at 2357-90. The lack of agreement about the role tax policy plays in determining price levels, however, prevents a complete analysis of the impact of the Tax Reform Act upon the flow of mortgage funds into real estate development.

2. *Id.* at 4934. The attempt to use tax policy to regulate the quantity and quality of housing has run into the debate surrounding the use of the tax system to achieve nonrevenue goals. *See* Stone, *Tax Incentives as a Solution to Urban Problems*, 10 WM. & MARY L. REV. 647 (1969). From the point of view of the investor the tax incentive seems to be an expeditious tool. It avoids the delay, waste, and other disadvantages of the red tape that invariably go with government programs. Note, *Government Programs To Encourage Private Investment in Low-Income Housing*, 81 HARV. L. REV. 1295, 1318 (1968). From the point of view of the proponents of social reform, tax incentives are preferable to a direct subsidy since they are less visible politically than direct subsidies and therefore more permanent. *Id.* at 1310, 1318. Nevertheless, the arguments

in the basic tax structure[3] relative to real estate investments are an attempt to continue a national policy established in 1949, that of providing a "decent home and suitable living environment for every American family."[4] Since 1949, Congress has assumed that an independent housing market does not produce enough quality housing to meet the nation's needs, and has progressively increased housing subsidies.[5] In 1968 Congress reaffirmed the 1949 policy and recognized that the goal had not been fully realized for many of the nation's low-income families.[6] Congress then gave priority to the "construction or rehabilitation of 26 million housing units, 6 million of these for low and moderate-income families,"[7] and designed a series of laws to improve the housing conditions of the poor.[8]

The framers of the Tax Reform Act of 1969 hoped to increase the

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against the use of a tax incentive as a tool of social policy are fairly strong. Even a carefully designed tax incentive creates problems of administration. *Id.* at 1311; Stone, *supra* at 656-57. The tax subsidy, in addition, violates the principle of taxpayer equity by favoring the high-income taxpayer over the low-income taxpayer. Note, *supra* at 1310; *see* NATIONAL COMM'N ON URBAN PROBLEMS, THE FEDERAL INCOME TAX IN RELATION TO HOUSING, RESEARCH REP. NO. 5, at 99 (1968) (prepared by P. Slitor). Finally, the tax incentive cannot be subject to a cost-benefit analysis and related to other alternative approaches to the problem; therefore, it is almost impossible to evaluate either its effect or its costs. *Id.* at 97; Note, *supra* at 1310.

3. The use of the federal income tax to advance social policies has been a center of controversy. *See* Surrey, *Tax Incentives As a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures*, 83 HARV. L. REV. 705 (1970). *See also* TAX INSTITUTE OF AMERICA, TAX INCENTIVES (1971); Bittker, *Accounting for Federal "Tax Subsidies" in the National Budget*, 22 NAT'L TAX J. 244 (1969); Surrey & Hellmuth, *The Tax Expenditure Budget—Response to Professor Bittker*, 22 NAT'L TAX J. 528 (1969); note 8 *infra*.

4. *See* Housing Act of 1949, § 2, 42 U.S.C. § 1441 (1970).

5. R. NETZER, ECONOMICS AND URBAN PROBLEMS 72-73 (1970). For a thorough discussion of federal housing programs see Welfeld, *A New Framework for Federal Housing Aids*, 69 COLUM. L. REV. 1355 (1969); Note, *supra* note 2, at 1295; Note, *Government Housing Assistance to the Poor*, 76 YALE L.J. 508 (1967).

6. Housing & Urban Development Act of 1968, § 2, 12 U.S.C. § 1701t (1970). There are presently 8,000,000 housing units that are dilapidated or that lack separate sanitary facilities in this country. In addition there are about 8,000,000 over-crowded units. Demographic data indicate that a higher proportion of nonwhites than whites live in inadequate housing, of which a relatively large number are single, older persons or are members of very large families. THE REPORT OF THE PRESIDENT'S COMM. ON URBAN HOUSING, A DECENT HOME 39-45 (1968) [hereinafter cited as A DECENT HOME]; REPORT OF THE PRESIDENT'S COMM. ON URBAN HOUSING: TECHNICAL STUDIES, HOUSING NEEDS AND FEDERAL HOUSING PROGRAMS (1957). *See also Hearings on S. 2620 Before the Subcomm. on Housing of the Comm. on Banking and Currency*, 91st Cong., 1st Sess., 21, 22, 166, 348 (1970); Keith, *An Assessment of National Housing Needs*, 32 LAW & CONTEMP. PROB. 209 (1967).

7. Housing & Urban Development Act of 1968, § 2, 42 U.S.C. § 1441a (1970).

8. Federal housing legislation now contains expanded subsidies, including rent subsidies, rehabilitation subsidies, and reduced interest rates that attempt to narrow the gap between the effective demand of low-income families and housing costs. Housing & Urban Development Act of 1968, 12 U.S.C. § 1715z (1970); National Housing Act of 1949, 12 U.S.C. §§ 1702-06d (1970).

construction of new housing and the rehabilitation of used housing by altering after-tax housing investment yields. It was thought that investors would be induced to invest in low- and moderate-income housing, and thus increase the available supply of capital needed for construction and rehabilitation. The quality of housing, however, is a function of many factors,[9] including the quantity available.[10] Health and safety codes define what housing is socially acceptable; building and housing codes determine what is habitable; the prime interest rate charged by major banks regulates the amount of mortgage money that is available to finance construction and rehabilitation; and the degree of inelasticity of the factors of production—land, labor, and materials—imposes limits on the rate at which construction can increase in the short run.[11] Moreover, geometric population growth and rapid urban-suburban migration have resulted in a shortage of adequate housing, and the housing industry has been unable to build enough houses to meet the rising demand. Builders, workers, and lenders have reacted to this shortage by increasing the prices they demand for their services, and owners, who must capitalize these higher prices, have increased rents.[12] Consequently, the effectiveness of a program designed to alleviate the shortage of adequate housing, especially one that attempts to do so by altering investment yields, is partially dependent upon the interplay of these market forces.

This article will attempt to analyze the impact of the changes brought about by the Tax Reform Act of 1969 upon the nation's housing goals, and will expand toward an analysis of the interaction between the real estate provisions embodied in the Tax Reform Act and the market forces that determine their effectiveness. To understand the modifications made by the Tax Reform Act and their implications relative to real estate investment, an initial explanation of the way in which real estate ventures were taxed before 1970 will be helpful.

II. THE STRUCTURE OF THE FEDERAL INCOME TAX RELATIVE TO REAL ESTATE DEVELOPMENT

The Internal Revenue Code, prior to the enactment of the Tax

9. R. NETZER, *supra* note 5; Note, *Accelerated Depreciation for Housing Rehabilitation*, 79 YALE L.J. 961, 972 (1970).

10. G. BEYER, HOUSING AND SOCIETY (1965); A DECENT HOME, *supra* note 6, at 113-216; R. MUTH, CITIES AND HOUSING 307-35 (1969); M. REID, HOUSING AND INCOME (1962).

11. R. NETZER, *supra* note 5, at 77.

12. *Id. See also* NATIONAL COMM'N ON URBAN PROBLEMS, U.S. LAND VALUES, THREE LAND RESEARCH STUDIES, RESEARCH REP. NO. 12 (1968); NATIONAL COMM'N ON URBAN PROBLEMS, U.S. LAND PRICES—DIRECTIONS AND DYNAMICS, RESEARCH REP. NO. 13 (1968); *Hearings on Rising Costs of Housing: Lumber Price Increases Before the House Comm. on Banking and Currency*, 91st Cong., 1st Sess. (1969).

Reform Act of 1969, did not make any special provision for rental housing. The general provisions of the Code when applied, however, provided clearly defined incentives for investment in real estate. These incentives stemmed from the interaction of the accelerated depreciation deduction and the capital gains provisions that allowed the investor to convert ordinary income into capital gains to the extent that the recapture provision did not operate,[13] and formed what colloquially has been called the "real estate tax shelter."[14]

A. The Impact of the Pre-1970 Tax Shelter on the Level of Investment in Housing

The pre-1970 real estate tax shelter did reduce the tax liability of persons in high tax brackets and resulted in a significant drop in Treasury revenue. A limited Treasury study, for example, found that of thir-

13. HOUSE COMM. ON WAYS & MEANS, TAX REFORM ACT OF 1969, H.R. REP. NO. 413, 91st Cong., 1st Sess., pt. 8, at 2655 (1969). In computing the annual depreciation deduction, the investor was and still is, under certain circumstances, entitled to use one of 3 formulas to amortize the cost of his investment. *See* note 33 *infra*. The first method, the annual straight line depreciation allowance, is computed by dividing the basis of the property, less its estimated salvage value, by the asset's estimated number of years of useful life—the same fixed amount being deducted each year. A second method, the sum of the years-digits formula, consists of a changing fraction that is applied to the basis of the property to compute the annual depreciation deduction. The numerator of the fraction is the number of years remaining in the life of the asset, and the denominator is the sum of the numbers representing the useful life of the property. When multiplied by the basis, the result is a larger depreciation deduction in early years of the asset's useful life. The other method of accelerated depreciation, the double declining balance method, is computed by applying a percentage twice the straight line rate to the unrecovered basis of the property each year. Prior to the enactment of the Tax Reform Act, the use of the double declining balance and the sum of the years-digits was limited to new property with a useful life of at least 3 years. The Internal Revenue Service permitted the use of a 150% declining balance method for used property. Treas. Reg. § 1.167(a)-1 (1964). The benefits of accelerated depreciation are somewhat mitigated by the recapture provisions of § 1250 of the Internal Revenue Code. Section 1250 provides that on the disposition of § 1250 property the applicable percentage of the lesser of (1) the excess of accelerated depreciation deductions over straight line depreciation, or (2) the excess of the amount realized over the adjusted basis shall be treated as ordinary income. The applicable percentage varies from 100% recapture to zero, depending upon the nature of the use of the property and the time the property has been held by the taxpayer. INT. REV. CODE OF 1954, § 1250. *See* note 34 *infra*.

14. "The present tax treatment of real estate has been used by some high-income individuals as a tax shelter to escape the payment of taxes on substantial portions of their economic income. Because accelerated depreciation usually produces a deduction in excess of the actual decline in the usefulness of property, economically profitable real estate operations are normally converted into substantial tax losses, sheltering from income tax such economic profits and permitting avoidance of income tax on the owner's other ordinary income, such as salary and dividends. Later the property can be sold and the excess of the sale price over the remaining basis can be treated as a capital gain to the extent that the recapture provisions do not apply." STAFF OF THE JOINT COMM'N ON INT. REV. TAXATION & THE COMM. ON FINANCE, 91ST CONG., 1ST SESS., SUMMARY OF H.R. 13270, THE TAX REFORM ACT OF 1969, at 90-91 (Comm. Print 1969) [hereinafter cited as SUMMARY OF H.R. 13270].

teen high-income individuals filing tax returns in 1966, the tax shelter allowed nine to pay no taxes and two others to report less than 25 dollars income.[15] The Treasury revenue lost as a consequence of the real estate tax shelter amounted to about 800 million dollars, and a breakdown of the loss shows the kind of investment that profited by it. For example, the real estate tax shelter did not operate to encourage the construction of residential property. Instead, this virtual tax subsidy encouraged investment in commercial and industrial development more than in housing construction, investment in high-income rather than in low-income housing, and investment in used as opposed to new housing.[16]

In light of the relative strength of each real estate investment market, it is not surprising that investment in commercial and industrial construction and semi-luxury or luxury highrise housing construction accounted for most of the lost Treasury revenue. Commercial buildings and luxury or semi-luxury highrise housing are more profitable, are more likely to appreciate in value, and are subject to a lower risk of loss than moderate-income, and particularly low-income, housing. Current market indicators suggest that new commercial and luxury housing construction will continue to attract investors,[17] while the investment market in low-income housing will remain relatively weak. The cost of materials, labor, and capital to construct or rehabilitate is high throughout the industry,[18] and low-income families cannot afford rents that yield a rate of return competitive with the rate that can be earned on new buildings devoted to other uses.[19] Moreover, vandalism and tenant neglect inflate maintenance costs; high vacancy rates, tenant turnover, and rent skips make the income flow uncertain; and potential buyers'

15. COMM. ON WAYS & MEANS & COMM. ON FINANCE, U.S. TREASURY DEP'T, TAX REFORM STUDIES AND PROPOSALS, 91st Cong., 1st Sess., pt. 3, at 443-44 (1969) [hereinafter cited as TREASURY REPORT]. In another study conducted by the Treasury Department, it was found that a group of passive investors in real estate had average salaries of $140,000, reported real estate deductions of $77,500 in excess of real estate income, and as a result paid taxes on only 53% of what otherwise would have been their taxable income. *Id.* at 444.

16. *Id.* The Treasury Department found that the excess of accelerated depreciation over straight line depreciation alone accounted for about $750,000,000 of the $800,000,000 lost. Industrial and commercial buildings accounted for $500,000,000 of this amount. Older housing, undergoing its second, third, or fourth round of depreciation write off, accounted for another $100,000,000. Recently constructed, semi-luxury highrise housing accounted for another $100,000,000. Low- and moderate-income housing construction accounted for only $50,000,000 of the $750,000,000 loss. *Id.* at 442.

17. *See* P. WENDT & A. CERF, REAL ESTATE INVESTMENT ANALYSIS AND TAXATION 164-222 (1969).

18. 2 THE REPORT OF THE PRESIDENT'S COMM. ON URBAN HOUSING: TECHNICAL STUDIES 43-50 (1968); Petro, *Unions, Housing Costs, and the National Labor Policy*, 32 LAW & CONTEMP. PROB. 318 (1967).

19. *See, e.g.*, Note, *supra* note 2, at 1295. *See also* R. MUTH, *supra* note 10, at 115-35.

fears of being locked into an unprofitable investment make resale difficult.[20] Finally, because of this large element of risk, mortgage financing for investment in low-income housing is difficult to obtain from sources other than federal subsidy programs.[21] When funds are available from conventional sources, the borrower must pay high interest rates and advance a large proportion of the purchase price in cash.[22]

Additionally, the housing market also failed to make a net expansion because investment in used housing under the tax structure before 1970 seemed more attractive than investment in new housing construction, for a number of reasons. First, used housing is less expensive to purchase than is new housing. The price differential is attributable to the inflation in the cost of material, land, and labor.[23] Secondly, investment in used housing is not as great a risk as is investment in new housing. Used housing has a past rental record from which future revenues can be projected, but new housing does not earn income until it has been built and rented, which sometimes can be as many as three years after the commencement of construction.[24] Thirdly, accelerated depreciation rules, although structured to favor investment in new housing, have diverted capital into used housing. Under the pre-1970 Internal Revenue Code investors in new housing were entitled to an allowance for depreciation in an amount equal to 200 percent of the declining balance, while investors in used housing were entitled to deduct only an amount equal to 150 percent of the declining balance.[25] This difference in the percentages supposedly was to be the additional incentive needed by developers to build new housing, but unfortunately, the incentive was largely nullified because used buildings were entitled to shorter useful lives, and therefore could be amortized over a shorter period of time.[26] The preference was further undermined because purchasers of used

20. G. Sternlieb, The Tenement Landlord 104-20 (1966).

21. *See, e.g.*, note 8 *supra* and accompanying text.

22. G. Sternlieb, *supra* note 20.

23. *See* materials cited note 18 *supra.*

24. *Hearings on H.R. 13270 Before the House Comm. on Ways & Means*, 91st Cong., 1st Sess. 2762 (1969) (remarks of Jenard M. Gross) [hereinafter cited as *1969 House Hearings*].

25. Int. Rev. Code of 1954, § 167, *as amended*, Tax Reform Act of 1969.

26. Rev. Proc. 62-21, 1962-2 Cum. Bull. 418. Used buildings commonly receive a shorter useful life than new buildings, permitting the write off of investments in used buildings at a faster rate than new buildings. For example, one-half of an investment of $100,000 in a used apartment with a 30-year life, utilizing the 150% declining balance method for the first 11 years and the straight line method thereafter, as permitted by Rev. Rul. 57-510, 1957-2 Cum. Bull. 153, could have been written off in less than 14 years, whereas one-half of an investment of $100,000 in a new apartment with a 50-year life, utilizing the 200% declining balance method, would have taken 17 years to be written off completely. Sporn, *Some Contributions of the Income Tax Law to the Growth and Prevalence of Slums*, 59 Colum. L. Rev. 1026, 1041 (1959).

buildings were not tied to any specific set of construction figures, and were free to allocate a larger proportion of their purchase price to depreciable buildings.[27] The cumulative effect of the shorter useful life and the ease with which costs could be allocated to the used building more than offset the incentive to invest in new rather than old housing.[28]

Consequently, the tax disincentive that rewarded investments in used as opposed to new housing was not conducive to a policy of supplementing the existing stock of housing with new accommodations; nor was it conducive to a policy of upgrading and maintaining the existing stock of housing. Also, an ever expanding population and continued migration to urban areas has increased the demand for residential housing at a rate that presently cannot be met.[29] The disincentive for construction, in turn, contributed to the growing shortage of adequate housing, increased the demand for dwellings, inflated rents, and ultimately encouraged slumlords to carve up buildings for low-income tenants into smaller units or to force the tenants to double up in single units. Because of increased use, the buildings were more expensive to maintain and repair, and the housing stock deteriorated more rapidly.[30] The shortage

27. One study suggests that landlords are likely to err generously in their own favor when allocating the cost between land and buildings. Sporn, *supra* note 26, at 1045; *see* Groves, *Empirical Studies of Income-Tax Compliance*, 11 NAT'L TAX J. 291, 292, 296 (1958). The purchaser is not entirely free from regulations, however, in making his allocation. Treas. Reg. § 1.167(a)-5 (1956) provides: "In the case of the acquisition on or after March 1, 1913, of a combination of depreciable and nondepreciable property for a lump sum, as for example, buildings and land, the basis for depreciation cannot exceed an amount which bears the same proportion to the lump sum as the value of the depreciable property at the time of acquisition bears to the value of the entire property at that time." *But see, e.g.*, NAT'L COMM'N ON URBAN PROBLEMS, U.S. LAND PRICES—DIRECTIONS AND DYNAMICS, RESEARCH REP. NO. 13 (1968) (prepared by M. Bach), which suggests that a larger proportion of the value of acquired used property is likely to be attributable to land because of the high rate of inflation attributable to a geographic shortage. Consequently, purchasers would seem to be limited in the amount that they can allocate to buildings.

28. *See, e.g.*, Sporn, *supra* note 26, at 1040.

29. One estimate of the need to build new standard units and to upgrade substandard units for the 10-year period 1968 to 1978 found that 13,400,000 units would be required to meet the demand of new household formations, 4,600,000 units to maintain an adequate level of vacancies and replace standard units removed from the housing inventory, and 8,700,000 to upgrade substandard units—a total of 26,700,000 units needed. TEMPO 27 (1967) (report prepared for the President's Committee on Urban Housing: Technical Studies). *See also* A DECENT HOME, *supra* note 6, at 8-9.

30. A 1960 study found that poverty pockets in large metropolitan areas—over 250,000 population—accounted for 58% of all substandard units with structural or plumbing deficiencies and 39% of all overcrowded units that averaged more than one resident per room. NATIONAL COMM'N ON URBAN PROBLEMS, HOUSING CONDITIONS IN URBAN POVERTY AREAS, RESEARCH REP. NO. 9, at 5 (1968) (prepared by A. Manvel). The growth formation of slums has been the subject of a long and vigorous debate. *See generally* L. GREBLER, HOUSING MARKET BEHAVIOR IN A DECLINING AREA (1952); C. RAPKIN, THE REAL ESTATE MARKET IN AN URBAN RENEWAL

of sites and the favored tax treatment afforded used housing further inflated the cost of land for new construction.[31] To make matters worse, the accelerated depreciation provisions discouraged investors from maintaining overutilized buildings. An investor that chose to maintain his property adequately was faced with a threat to his profit, since well-maintained property was subject to a longer period of write off because it was likely to last longer.[32] Real estate operators—particularly operators of dwellings in declining areas, therefore, neglected financially feasible maintenance and repair expenditures to avoid losing the closely bunched depreciation deductions to which they were otherwise entitled.

To summarize, prior to the Tax Reform Act of 1969 there were a number of separable, yet related reasons why the real estate tax shelter contravened national housing policies. First, the incentive to invest in new housing construction was about the same as that in other real estate investments such as retail establishments, office buildings, and industrial plants, although the need to stimulate housing was greater. Secondly, the fact that the allowable period for depreciation was dependent upon the quality of maintenance penalized the investor who maintained his building, and operated as a disincentive for rehabilitation. Thirdly, the advantage enjoyed by investors in used property in allocating costs to depreciable buildings, operated to deter the reconstruction of delapidated sections of the city. In addition, by thus inflat-

AREA (1959); Cooney, *How to Build a Slum*, NATION, Feb. 14, 1959, at 40-41; McGehee, *Biography of a Tenement*, NATION, Mar. 23, 1964, at 293-96; McGuire, *Building Regulations Aren't Enough*, AMERICAN CITY, Sept. 1962, at 302-03; Seligman, *Enduring Slums*, FORTUNE, Dec. 1957, at 144; Sporn, *Empirical Studies in the Economics of Slum Ownership*, 36 LAND ECON. 333 (1960); Walker, *Tax Responsibility for the Slum*, 26 TAX POLICY 36 (Oct. 1959).

31. "The mutually reinforcing tendencies of the site shortage and present depreciation provisions in raising the overall development costs of new housing are obvious: while the former induces, or forces builders to consider, the location of new housing on sites that are already developed, the latter by increasing the profitability of operating the existing improvements, raises the price at which such sites can be acquired." Sporn, *supra* note 26, at 1042. In addition, Treasury Regulations prohibit the inclusion of the cost of demolition in the computation of the basis of the depreciable building. The regulations provide that if land with a building is purchased with an intent to demolish the building, then the entire purchase price is allocable to the basis of the land. Treas. Reg. § 1.165-3(a)(1) (1960).

32. Expenditures for repair of buildings are either deductible or written off over a period of time. Expenditures that only maintain property are deductible as current expenses, whereas expenditures that increase the value of property are capitalized, added to the basis of the property, and, as such, are depreciable. Treas. Reg. § 1.162-4 (1958). Expenditures for low-income properties are likely to be classified as improvements since they usually will prolong the life of the property. Levy v. Commissioner, 212 F.2d 552 (5th Cir. 1954); Buckland v. United States, 66 F. Supp. 681 (D. Conn. 1946). Even if the expenses were deductible, however, the period in which the original investment could be written off would likely be extended. *See also* Blum & Dunham, *Income Tax Law and Slums*, 60 COLUM. L. REV. 447-51 (1960); NATIONAL COMM'N ON URBAN PROBLEMS, *supra* note 2, at 34-35; Sporn, *supra* note 26, at 1037.

ing the investment value of used buildings, the real estate tax shelter not only diverted funds away from new construction, but made it almost financially impossible to purchase land in the central city to build new housing.

B. *The Change in Real Estate Investment Provisions Made by the Tax Reform Act*

The objections to the pre-1970 Internal Revenue Code stimulated the framers of the Tax Reform Act to draft the provisions affecting real estate investment to correct their socially counterproductive character. To reduce tax avoidance by those wealthy enough to take advantage of the real estate tax shelter, the rate of accelerated depreciation permitted for certain investments was lowered,[33] the period during which depreciation will be recaptured was extended,[34] and the alternative tax on capital gains was increased.[35] Moreover, a minimum tax was imposed on tax preference items over a certain amount,[36] and the quantity of

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33. The Tax Reform Act, by amending § 167 of the Internal Revenue Code, substantially reduced the benefits of accelerated depreciation for real estate investments other than new residential construction. Newly constructed, nonresidential buildings used in a trade or business or held for the production of income are eligible for 150% accelerated depreciation instead of the 200% previously permitted. INT. REV. CODE OF 1954, § 167(j)(1). Used, nonresidential buildings are restricted to straight line depreciation or its equivalent. *Id.* § 167(j)(5). The most rapid methods of depreciation, the 200% declining balance and the sum of the years-digits method, are reserved for new, residential, rental property. *Id.* § 167(j)(2).

34. The Tax Reform Act amendments to § 1250 altered the terms for recapture of the excess of accelerated over straight line depreciation for the property if sold after December 31, 1969, but only to the extent of depreciation taken after that date. *Id.* § 1250(a). In the case of most residential rental property held 100 months or less, the excess is to be recaptured 100%; thereafter the recapture rate is to be reduced 1% for each full month property is held beyond the full 100 months. *Id.* § 1250(a)(1)(C)(iii). In the case of all other depreciable real property, the excess depreciation is to be recaptured 100% with no time limit. *Id.* § 1250(a)(1)(C)(v). For a discussion of the recapture provisions relating to qualified, low-income housing see note 38 *infra*.

35. The Tax Reform Act did not eliminate the special capital gains tax. Under new § 1201, as was the case under the pre-1970 section, one-half of net, long-term capital gains is included in taxable income and taxed at regular rates. *Id.* §§ 1201-02. Moreover, the taxpayer still has the option of paying the alternative tax, which in effect sets the maximum rate to be paid on capital gains. *Id.* § 1201. In the case of individual taxpayers the rate is still 25% for the first $50,000 of capital gains; any excess, however, is subject to higher minimum rates, increasing to 32.5% for taxable years beginning between December 31, 1970, and January 1, 1972. *Id.* §§ 1201(b)-(c). In the case of corporate taxpayers, the alternative rate has been raised to 30% on all capital gains. *Id.* § 1201(a). In spite of the rate increase high-income taxpayers can still convert ordinary income into capital gains and apply the lower alternative rate, although they must pay a higher rate than before adoption of the Tax Reform Act.

36. The new section on minimum tax for tax preferences imposes a limit on the amount of income that an individual or corporation may shelter from taxes. Sections 56-58, added to the Internal Revenue Code by the Tax Reform Act, impose an additional tax of 10% on items of tax preference in excess of $30,000 and federal income taxes paid. *Id.* §§ 56-58. Items of income that

interest that could be deducted was limited.[37] The drafters of the Tax Reform Act, cognizant of the need to stimulate housing in general and low-income housing investment in particular, reserved a higher rate of accelerated depreciation for housing investments, with the highest rate reserved for residential rental property; they also provided a shorter period of recapture for residential rental property, with the shortest recapture period reserved for qualified, low-income housing.[38] In addi-

receive tax preferences include: (1) The excess of accelerated depreciation over straight line depreciation on real property; (2) the excess of accelerated depreciation over straight line depreciation on personal property subject to a net lease; (3) the excess of amortization of certified pollution control facilities over straight line depreciation; (4) the amount by which the fair market value of a share of stock at the time of exercise exceeds the price of a qualified stock option; (5) the amount by which the addition to reserve for bad debts of financial institutions exceeds the amount that would have been allowable had they been computed on the basis of actual experience; (6) the excess percentage depletion allowable over cost depletion; and (7) the excluded 50% of long-term capital gains. In addition, investment interest in excess of net investment income, although an out-of-pocket expenditure, was included in the list of limited tax preferences until the provision limiting interest deductions becomes operative. *Id.* § 57. Moreover, §§ 57-58 may indirectly deprive the investor of the benefits of § 1348, the maximum tax on earned income. Section 1348 sets a maximum tax to be paid on earned income. In essence it is a relief provision that establishes a maximum tax that will decline to 50% in 1972. Tax preferences, as defined in § 57, in excess of the $30,000 exemption reduce taxable income eligible for the maximum tax. INT. REV. CODE OF 1954, § 1348(b)(2). As a consequence, the tax preference items operate to convert earned income into unearned income subject to the higher ordinary rates. *See generally* Caso, *Income Items*, N.Y.U. 28TH INST. ON FED. TAX. 1, 17-24 (1970). Thus, the tax cost of accelerated depreciation, for example, not only includes the minimum tax on tax preferences, but also includes the increase in taxes that results from the earned income being transformed into unearned income by operation of the maximum tax provisions; to this extent the maximum tax reduces the desirability of real estate investments for investors in search of a shelter for their earned income.

37. Individual taxpayers may deduct without limit all interest paid or accrued during the taxable year beginning before January 1, 1972. SUMMARY OF H.R. 13270, *supra* note 14, at 43. The taxpayer may set off against his other income the interest expense he has paid to purchase an investment that produces a small return, thus reducing his taxable income, and converting it into capital gain. *Id.* at 43-44. The taxpayer must include, however, the interest in totaling the tax preferences. *See* note 36 *supra*. After December 31, 1971, however, individual taxpayers may deduct only 50% of the amount by which their investment interest exceeds the sum of (1) $25,000 ($12,500 in the case of a separate return filed by a married taxpayer), (2) the amount of taxpayer's net investment income, and (3) the amount of the taxable capital gain. A carryover of the disallowed 50% of the interest in excess of the above figure will be permitted, however, to offset investment income and capital gains in subsequent years, subject to the same basic limitations. INT. REV. CODE OF 1954, § 163(d). This section limits the deduction for interest on funds borrowed for investment purposes only. It is not applicable to interest incurred in a trade or business. The theory underlying this distinction is that investment interest is a controllable expense and therefore can be used to mismatch income and the expense of earning that income. SUMMARY OF H.R. 13270 *supra* note 14, at 56. The bill as passed does include a provision excluding construction from the application of the limitation on interest deductions. INT. REV. CODE OF 1954, § 163(d)(4)(D).

38. *See* INT. REV. CODE OF 1954, § 167(j)(2). The excess of accelerated over straightline depreciation of qualified low-income residential housing held 20 months or less is to be recaptured 100%; thereafter the recapture rate is to be reduced 1% for each full month the property is held beyond the 20 months if the property is constructed, reconstructed, or acquired by January 1, 1975. *Id.* § 1250(a)(1)(C)(ii).

tion, two special provisions were added to the Internal Revenue Code to increase the yield on certain low-income housing projects. The first provides the investor in qualified low-income housing projects the opportunity to defer the payment of taxes upon the sale of the property if the investor sells to a qualified purchaser and repurchases another low-income project within a certain period.[39] The second provision authorizes the investor who purchases and rehabilitates old buildings to write off rehabilitation expenditures if the property is used to house low-income families.[40]

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39. INT. REV. CODE OF 1954, § 1039. Section 1039 allows the investor in a qualified low-income housing project to defer his taxes if within a specified period he constructs, reconstructs, or acquires another qualified housing project. To qualify, certain requirements must be met. First, the sale and purchase must be of a qualified housing project defined as one insured under §§ 221(d)(3) or 236 of the National Housing Act, and one in which the owner is limited in the rate of return he may earn and in the rent he may charge the tenants. INT. REV. CODE OF 1954, § 1039(b)(1). Secondly, the sale must be to the tenants or occupants of the project, or to a cooperative or other nonprofit organization formed for the benefit of the tenants or occupants of the project. *Id.* § 1039(b)(2). Thirdly, the reinvestment must be made within the period beginning one year before the disposition and ending one year after the close of the first taxable year in which the gain is realized. *Id.* § 1039(b)(3)(A). If the disposition meets these qualifications, the gain is recognized only to the extent that the net amount realized on disposition exceeds the cost to construct, reconstruct, or acquire the new project. *Id.* § 1039(b)(4). The basis of the new project is its cost reduced by an amount equal to the amount of gain not recognized because of the application of § 1039. *Id.* § 1039(d). The recognition of the gain therefore is deferred until the investor decides not to reinvest in a qualified low-income housing project.

40. A special rule for the amortization of expenditures to rehabilitate low-income rental housing was one of 2 inclusions in the Tax Reform Act designed to upgrade the quality of low-income housing. Section 167(k) is brief and categorical; it allows investors to write off rehabilitation expenditures over a 60-month period. INT. REV. CODE OF 1954, § 167(k). To qualify, certain requirements must be met: (1) expenditures must be to rehabilitate buildings, not to acquire the building or land; (2) rehabilitation expenditures must be for low- and moderate-income tenants; and (3) the aggregate rehabilitation expenditures within 2 consecutive years, must range between $3,000 and $15,000 per unit. These standards pose problems of interpretation. "Rehabilitation" is not easily distinguishable from renovation and remodeling. The limitation to "low-income housing" does not define the maximum income levels allowed for tenants. Although the maximum and minimum dollar requirements provide some idea of what constitutes rehabilitation, there is no indication of what housing and what individuals will benefit. A level of income eligibility that is too low will discourage private investors from taking advantage of the provisions. A level of income eligibility that is too high may inure only to the benefit of those whose incomes fall just below the limit, since the economic value of the write off for different income-level consumers is measured by the after tax rate differential. Nevertheless, since § 167(k) directs the Secretary of the Treasury, in determining eligibility under § 167(k), to make his decision in a manner consistent with the policies of the Housing and Urban Development Act of 1968, the standards should be narrowed significantly. Note, *supra* note 9, at 963-71. The advantage of this provision is that it permits taxes on other income to be deferred through the overstatement of rehabilitation expenditure deductions. In part, however, the extent of the tax benefit is determined by rules that define when deferred taxes are to be repaid. Upon the sale of the property the amortization taken under § 167(k) is treated like the excess depreciation of residential rental housing and recaptured as ordinary income to the same extent. The amount recaptured, if the property is held less than one year, includes the entire amount of the rehabilitation expenditures.

When taken together, the real estate provisions of the Tax Reform Act may have reduced the tax subsidies previously given to all real estate investment more than they reduced the tax subsidies for new, particularly low-income, housing construction. It does not necessarily follow, however, that the Tax Reform Act actually will cause investors to divert resources into new, particularly low-income, housing, or into rehabilitating low-income housing. The subsidy provided by the pre-1970 real estate tax shelter has become an integral part of the real estate market. Legal constraints, traditions, and the lack of adequately trained real estate portfolio personnel have deterred many institutional investors from purchasing interests in real estate development. Although some investment companies and business corporations have entered the real estate market, individual investors—real estate investment trusts, limited partnerships, or syndicates—still provide the major portion of the equity used in housing development. Despite the risks inherent in the real estate market, high-income individuals have preferred real estate to other forms of investment because of the tax shelter.[41] Any alteration in the after-tax yield on real estate investments is likely to have repercussions throughout the investment market that may not be beneficial for housing.

III. The Effect of the Tax Reform Act on the Relative Desirability of Housing Investments

The Tax Reform Act of 1969 was enacted during a period in which the rate of all real estate construction was critically deficient.[42] Since its passage the situation has not improved, and presently there is a shortage of both residential and nonresidential buildings. The vacancy rate for residential property, for example, fell from 7.2 percent in the first quarter of 1960 to five percent in the first quarter of 1969.[43] By the spring of 1969 vacancy rates for nonresidential property similarly had fallen and ranged from two to five percent in prime-location, central city

If the property is held more than one year, however, only the excess of the § 167(k) depreciation over the depreciation that would ordinarily have been allowable is recaptured. If the property is held more than 100 months, the amount recaptured is reduced by 1% for each full month the property is rented beyond 100 full months. INT. REV. CODE OF 1954, § 1250(b)(4). Consequently, the incentive to rehabilitate that is provided by the 60-month write off of rehabilitation expenditures is negated somewhat by the inclusion of such expenditures in the computation of depreciation recapture.

41. P. WENDT & A. CERF, *supra* note 17, at 12.

42. *1969 Senate Hearings, supra* note 1, at 4922-23 (remarks of G. Hillman).

43. *Id.* at 3934 (remarks of Wallace R. Woodbury); *id.* at 3990 (remarks of Leon H. Keyserling); *id.* at 4918 (remarks of G. Hillman).

buildings.[44] During the 1961-69 period the average annual growth rate of commercial construction was 4.9 percent.[45] New housing starts rose in July 1970, but the total annual production was still only 1,585,000 units, a level of construction that has remained static since the Second World War.[46]

The reasons for the low rate of housing construction are quite apparent. The supply of mortgage money has been severely curtailed by anti-inflationary policies; the cost of labor, land, and materials has risen dramatically; and the housing market is incapable of absorbing the higher costs.[47]

A. *The Relative Desirability of Housing and Nonhousing Investments*

The Tax Reform Act provided a number of tax benefits designed to alleviate the shortage of funds available for real estate development. Investors in new residential rental property, for example, are entitled to the most accelerated methods of depreciation, including the 200 percent declining balance method; while investors in nonresidential income-producing property, however, can use no depreciation formula more accelerated than the 150 percent declining balance method.[48] If residential rental property is held for more than 100 months, the relative tax benefit is increased because the percentage of accelerated depreciation recaptured is reduced one percent for each additional month the property is held.[49] For nonresidential income-producing property, on the other hand, depreciation in excess of the straight line formula is recaptured 100 percent, no matter how long the property has been held.[50]

These changes do not increase the absolute tax benefits for most housing investments—the tax subsidy for moderate- and upper-income rental housing investments merely was reduced by an amount less than the subsidy for nonresidential real estate investments.

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44. *Id.* at 3934 (remarks of Wallace R. Woodbury). The reason for the lower vacancy rates for all property is that construction has not kept up with demand. Real estate construction has accounted for a slowly declining proportion of the gross national product (GNP) in the past 15 years. For example, real estate construction accounted for 12% of the GNP in 1955; by the second quarter of 1969 the share of the GNP attributable to both residential and nonresidential construction had dropped to 4.39%. Moreover, housing is the segment of the real estate construction industry experiencing the lowest rate of growth, even though population growth and immigration rates have increased markedly.

45. *Id.* at 3971 (remarks of Leon H. Keyserling).

46. *Id.*

47. *See* note 1 *supra* and accompanying text.

48. INT. REV. CODE OF 1954 §§ 167(j)(2)(A), (j)(1)(B).

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

50. *Id.* § 1250(a)(1)(C)(v).

The magnitude of the impact made by the Tax Reform Act upon housing investment yields can be illustrated by examining a hypothetical apartment project.[51] The cost of a typical apartment project is 1,000,000 dollars, and the depreciable basis of the property is approximately 825,000 dollars. The equity investment required to finance a project of this size is approximately 200,000 dollars, and the interest rate is usually seven and one-half percent plus two and one-half percent of the gross revenue. For tax purposes, a 40-year life for the building[52] with a zero salvage value, and the 200 percent double declining balance method of depreciation probably would be chosen.[53]

The Treasury Department has described what it considers to be the typical investor in real estate projects.[54] His involvement in real estate is as a passive investor, and usually as a limited partner in a syndicate or partnership. The average income from his primary business is approximately 140,000 dollars; yet, his taxable income averages just over 85,000 dollars. The primary reasons for the disparity between the earned and taxable income are the deductions attributable to the real estate investment, which usually exceed the rental income by 77,500 dollars—including a 110,300 dollar mortgage interest deduction and a 119,000 dollar depreciation deduction.

If it is assumed that the typical investor is a participant in the hypothetical project, then the rates of return that would be earned before and after passage of the Tax Reform Act can be compared. In the early life of the venture there usually will be a tax loss, although the net income, before subtracting the depreciation deduction, will be fairly substantial, exceeding fifteen percent of the gross annual income in the

51. For a complete description of the finance of a typical apartment house investment see *1969 Senate Hearings, supra* note 1, at 4073-74 (remarks of Joseph F. Sexton). *See also id.* at 4938 (remarks of G. Hillman).

52. The maximum useful life was established by Rev. Proc. 62-21, 1962-2 CUM. BULL. 418.

53. Note 13, *supra*; *see* INT. REV. CODE OF 1954, § 167(j)(2).

54. TREASURY REPORT, *supra* note 15, at 444-45.

first year and increasing every year thereafter.[55] Ordinarily, in projects of this kind, the profit is divided into two parts: (1) the cash flow; and (2) the gain realized upon sale after payment of all taxes.

1. *Cash Flow*.—The cash flow typically includes the amount of money that is freed from the investment each year. This includes minimally the difference between the cash income and expenses, less the amount by which the mortgage principal is reduced each year. When the depreciation deduction is sufficiently large, it also includes the tax on other income that is sheltered by the tax loss.

a. *Pre-1970*.—Prior to the passage of the Tax Reform Act, the tax savings attributable to the paper losses in the first few years of the project would have become progressively lower. After the seventh year, the situation would become reversed—instead of a tax shelter, the investor would incur a tax liability. Because the accelerated depreciation yielded ever-shrinking deductions between the seventh and thirteenth years, the income liability would have become progressively higher and

55.

TABLE I

TAXABLE INCOME OF THE HYPOTHETICAL VENTURE

Year	Gross Annual Income	Operating Expenses	7½%* Interest	2½% Annually	Net Income	Depreciation**	Taxable Income (Loss)
1	150,000	64,000	59,616	3,750	22,634	41,250	(18,616)
2	150,000	"	58,736	"	23,513	39,187	(15,674)
3	150,000	"	57,788	"	24,461	37,207	(12,746)
4	150,000	"	56,768	"	25,482	35,392	(9,910)
5	150,000	"	55,667	"	26,582	33,577	(6,994)
6	150,000	"	54,481	"	27,768	31,927	(4,159)
7	150,000	"	53,303	"	28,946	30,360	(1,413)
8	150,000	"	51,825	"	30,424	28,792	1,631
9	150,000	"	50,342	"	31,907	27,390	4,517
10	150,000	"	48,742	"	33,507	25,987	7,520
11	150,000	"	47,019	"	35,230	24,677	10,553
12	150,000	"	45,161	"	37,088	23,430	13,658
13	150,000	"	43,160	"	39,089	22,357	16,731
14	150,000	"	41,004	"	41,246	21,120	20,126
15	150,000	"	38,679	"	43,560	20,130	23,430
16	150,000	"	36,174	"	46,075	19,140	26,935
17	150,000	"	33,425	"	48,774	18,150	30,624
18	150,000	"	30,566	"	51,683	17,242	34,441
19	150,000	"	27,432	"	54,818	16,417	38,400
20	150,000	"	24,054	"	58,195	15,510	42,685

* Computed with the aid of monthly amortization table found in P. WENDT & A. CERF, TABLES FOR INVESTMENT ANALYSIS 250 (1966).

** Computed with the aid of table found in W. CASEY, REAL ESTATE 58, 822 (1970).

reduced the tax-free cash flow. Thereafter, the tax on the investment income would have exceeded the cash flow in ever-increasing amounts, resulting in what investors like the least—a real out-of-pocket loss.[56]

b. *After the Tax Reform Act.*—The changes brought about by the Tax Reform Act severely reduce the cash flow to the investor from a new residential building.[57] The inclusion of excess accelerated depreciation in the calculation of the minimum tax on tax preference

56. *Cf. 1969 Senate Hearings, supra* note 1, at 4918, 4920 (remarks of G. Hillman). In the hypothetical, as Table 2 illustrates, both before and after the passage of the Tax Reform Act, the excess of cash receipts over expenditures equals $11,307 per year. This figure remains constant because the total mortgage payments remain the same even though the interest and amortization portions vary from year to year. To this amount must be added the taxes on other income sheltered by the tax loss. As a result of accelerated depreciation, however, this amount decreases every year.

TABLE 2

ANTICIPATED CASH FLOW BEFORE THE TAX REFORM ACT

Year	Net Income Before Taxes	Less * Mortgage Amortiz.	Cash Flow Before Taxes	Tax Shelter**	General Income Taxes	Total Cash Flow
1	22,634	11,327	11,307	12,314		23,621
2	23,513	12,206	11,307	10,431		21,738
3	24,461	13,154	11,307	8,512		19,819
4	25,482	14,175	11,307	6,640		17,947
5	26,582	15,276	11,307	4,719		16,026
6	27,768	16,401	11,307	2,828		14,135
7	28,946	17,740	11,307	960		12,267
8	30,424	19,116	11,307		1,109	10,197
9	31,907	20,600	11,307		3,071	8,235
10	33,507	22,000	11,307		5,138	6,168
11	35,230	23,924	11,307		7,231	4,075
12	37,088	25,781	11,307		9,374	1,932
13	39,089	27,782	11,307		11,512	(205)
14	41,246	29,939	11,307		13,888	(2,581)
15	43,560	32,264	11,307		16,201	(4,894)
16	46,075	34,768	11,307		18,654	(7,347)
17	48,774	37,468	11,307		21,237	(9,930)
18	51,683	40,376	11,307		23,908	(12,601)
19	54,818	43,511	11,307		26,680	(15,373)
20	58,195	46,888	11,307		29,679	(18,372)

* *See* note 44 *supra.*

** This figure was computed by multiplying the pre-1970 marginal rate determined on the basis of assumed taxable income of $85,000 (given as average taxable income for investors by TREASURY REPORT, *supra* note 15) times the tax loss.

57. The effect of the limit on interest deductions fortunately is negligible. Since the investor is permitted to use the straight line method of depreciation in computing his investment income, it will be the rare project that does not generate income greater than the interest expense. It is unlikely, therefore,that a tax will be paid on excessive interest. *See* note 37 *supra* and accompanying text.

items has depressed income yields.[58] Because of other income, the typical investor probably will have other tax preferences that will more than offset the allowable exemption of 30,000 dollars and federal taxes paid.[59] Consequently, the entire amount of the excess depreciation deduction taken each year may be subject to the minimum ten percent tax on tax preferences. In addition, because of the operation of the maximum tax on earned income,[60] an additional amount must be subtracted from the pre-1970 cash flow.[61] In summary, the additional taxes operate like any other expense and reduce the tax shelter in the early years and increase the tax liability in the later years of the project.[62] Thus, even though the accelerated depreciation for housing construction was not changed by

58. *See* text accompanying note 70 *infra.*

59. INT. REV. CODE OF 1954, §§ 56-58; *see* note 36 *supra* and accompanying text.

60. *See* note 36 *supra.*

61. The Tax Reform Act provides that tax preferences must be from earned income and must be included in the computation of the unearned income. A higher tax rate is applicable to earned income up to the extent of excess tax preferences. The effective rate applicable to tax preferences is the difference between the earned and unearned rates, which is the equivalent of a tax of 20% on tax preferences.

62.

TABLE 3

PROJECTED CASH FLOW AFTER THE TAX REFORM ACT

Year	Pre-1970 Cash Flow	Minimum Tax	Loss of Benefit of Max. Tax	Post 1970 Total Cash Flow
1	23,621	2,062	4,125	17,433
2	21,738	1,858	3,712	16,167
3	19,819	1,658	3,316	14,844
4	17,947	1,476	2,953	13,517
5	16,026	1,295	2,590	12,140
6	14,135	1,130	2,260	10,744
7	12,267	973	1,947	9,347
8	10,197	816	1,633	7,747
9	8,235	676	1,353	6,205
10	6,168	536	1,072	4,559
11	4,075	405	810	2,859
12	1,932	280	561	1,091
13	(205)	173	346	(724)
14	(2,581)	49	99	(2,729)
15	(4,894)	0	0	(4,894)
16	(7,347)	0	0	(7,347)
17	(9,930)	0	0	(9,930)
18	(12,601)	0	0	(12,601)
19	(15,373)	0	0	(15,373)
20	(18,372)	0	0	(18,372)

the Tax Reform Act,[63] the reduction in the cash flow has been severe. It is estimated, in fact, that the minimum tax on tax preferences and the maximum tax on earned income, together will account for more than a 25 percent reduction in the after-tax cash flow during the first year of the project's life.[64]

2. *Gain Realized upon Sale.*—If the project is successful, the sales price usually will be equal to or will exceed the original cost basis. Prior to the passage of the Tax Reform Act, the tax liability from this gain was composed of two elements. A declining percentage of the excess depreciation that had been taken was recaptured and taxed at ordinary income rates; the remainder was taxed at the lower capital gains rates. Because of the interaction of the accelerated depreciation with the recapture provisions, however, the net gain on the sale after taxes varied according to the year in which the project was sold.[65]

The increase in the recapture period and in the alternative tax rate, the addition of a tax on tax preference items, and the operation of the

63. *See* note 38 *supra* and accompanying text.

64. If the building were used rather than new, the reduction in cash flow would have been even greater because of the reduction in the allowable rate of accelerated depreciation from 150% to 125%.

65. TABLE 4

NET AMOUNT REALIZED ON THE SALE OF THE VENTURE BEFORE THE TAX REFORM ACT

Year	Sales Price	Capital* Gains Tax	Unpaid** Mortgage	Amount Realized
1	1,000,000	28,675	788,672	182,652
2	"	36,662	776,466	186,871
3	"	50,023	763,312	186,664
4	"	60,605	749,136	190,258
5	"	68,695	733,860	197,444
6	"	74,656	717,398	207,945
7	"	78,782	699,658	221,558
8	"	81,324	680,541	238,134
9	"	82,573	659,940	257,485
10	"	82,769	637,740	279,490
11	"	88,937	613,816	297,246
12	"	94,795	588,035	317,169
13	"	100,384	560,252	339,363
14	"	105,664	530,312	364,042
15	"	110,697	498,048	391,254
16	"	115,732	463,280	420,987
17	"	120,019	425,817	454,167

new provision setting a maximum tax on earned income drastically reduced the amount that can be realized upon the sale after payment of taxes. The extension of the 100 percent recapture period from 20 to 100 months, combined with the allowed reduction of the percentage by only one percent per month, reduced the amount realizable upon the sale of the property significantly below that which could have been realized before passage of the Tax Reform Act.[66] Prior to the Tax Reform Act,

*The computation was made in the following manner for each year:

First 2 years' depreciation	80,438	
Less straight line	41,250	
Excess Depreciation	39,188	
Excess recaptured (100% less 1% per month after 20 months)	37,620	
Times 69% (marginal effective rate for typical investor)	.69	
Recaptured Tax		25,958
Capital Gains Tax (25% of 41,250)		10,704
Total Tax Upon Sale		36,662

***See 1969 Senate Hearings, supra* note 1, at 3934 (remarks of Wallace R. Woodbury).

66. TABLE 5

NET AMOUNT REALIZED
ON THE SALE OF THE VENTURE
AFTER THE TAX REFORM ACT

Year	Sales Price	Capital Gains* Tax	Minimum Tax	Loss of Benefit** of Max. Tax	npaid Mortgage	Amount Realized
1	1,000,000	19,378	2,062	4,125	788,672	185,754
2	"	37,531	4,022	8,044	776,466	173,938
3	"	55,078	5,822	11,765	763,312	163,023
4	"	72,382	7,692	15,304	749,136	155,486
5	"	88,436	9,331	18,662	733,860	149,711
6	"	103,350	10,927	21,854	717,398	146,471
7	"	117,183	12,445	24,890	699,658	145,824
8	"	136,827	13,885	27,770	680,541	140,977
9	"	138,420	15,254	30,509	659,940	155,877
10	"	143,921	16,553	33,107	637,740	168,649
11	"	148,217	17,785	35,570	613,816	184,612
12	"	151,507	18,959	37,918	588,035	203,581
13	"	154,032	20,077	40,154	560,252	225,485
14	"	155,850	21,133	42,266	530,312	250,439
15	"	157,217	22,139	44,279	498,048	278,317
16	"	158,628	23,146	46,293	463,280	308,653
17	"	160,876	24,004	48,008	425,812	341,300

the investor in the hypothetical venture would have been able to recover his investment at any time after the fifth year.[67] The Tax Reform Act, however, has extended this period, and now the investor must wait ten years to recover his initial investment.[68]

3. *Aggregate Yield.*—Investors make their portfolio decisions on the basis of expected yields, and to increase the accuracy of their computations several measures of aggregate yield have been devised that take into account the complexities of the Internal Revenue Code.[69] The most common measure of real estate investment yield is the after-tax return on equity calculated after all cash outlays—including finance charges, and income and capital gains taxes—have been considered.

The aggregate rate of return that may be earned on the investment in the hypothetical project varies according to the year in which the property is sold, because the net amount realized upon the sale is determined, in part, by the interaction of the accelerated depreciation and recapture provisions of the Code. Prior to the passage of the Tax Reform Act, the time at which the yield would be the greatest was after the tenth year. As the following graph illustrates, if the hypothetical project were sold at cost between the sixth and the ninth years, the rate of return would have ranged between 10.220 and 10.694 percent; but if sold at the end of the tenth year, the yield would have been at its highest level, 10.713 percent.[70] Thereafter the rate gradually would have declined.

* The computation was made in the same manner as described in Table 4, note 65 *supra*. The only differences are that the alternative rate is greater and the period for 100% recapture has been extended from 20 to 100 months. INT. REV. CODE OF 1954 §§ 1201, 1250(a)(1)(C)(iii).

** These figures were computed by multiplying the excluded 50% of capital gains times the difference between the maximum rate and the effective rate on unearned income. *See* note 52 *supra*.

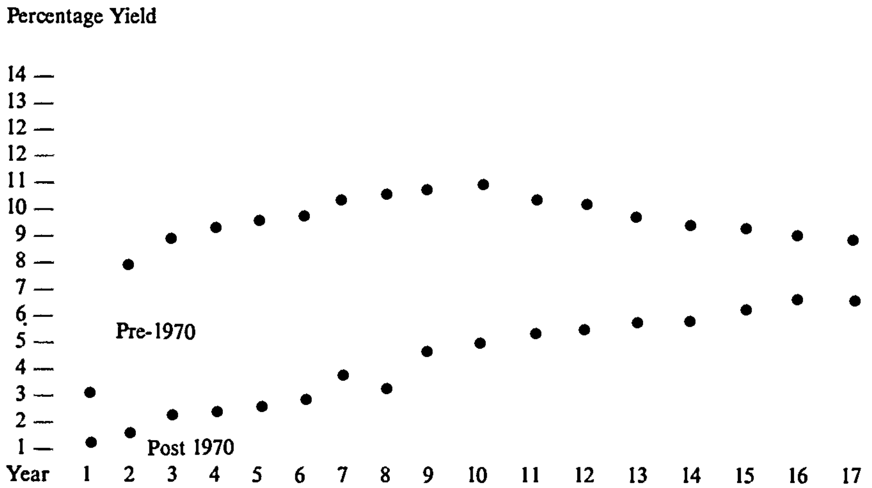
67. *See* text accompanying note 70 *infra*.

68. *See* G. STERNLIEB, *supra* note 20.

69. One method widely used as a rule of thumb is computed by dividing the first year's net income before interest and depreciation by the purchase price. Another method of computation would divide the cash down payment into the annual cash spendable. P. WENDT & A. CERF, *supra* note 17, at 25-29 (outlines formula used in computing the values in the hypothetical).

70. The Internal Revenue Service seems to concur in these calculations. *See* TREASURY REPORT, *supra* note 15, at 456.

COMPARISON OF THE YIELD BEFORE AND AFTER THE TAX REFORM ACT



The severity of the changes in the Internal Revenue Code can be demonstrated by an examination of the cumulative impact on the yield from the hypothetical project. The project's aggregate yield—the yield on (1) the tax shelter or after-tax yearly income, (2) the tax-free cash flow, and (3) the after-tax gain upon sale—prior to the passage of the Tax Reform Act would have been at its highest level of 10.713 percent if the property were sold at the end of the tenth year. Because of the Tax Reform Act this yield has been reduced to a maximum of 6.300 percent, which can be achieved only by selling the property at the end of the seventeenth year.[71]

There are limits to the reliability of conclusions drawn from any projection;[72] nevertheless the hypothetical situation illustrates the impact that the Tax Reform Act has had on rental housing investment yields.[73] A conservative estimate of the cumulative reduction in invest-

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71. *Id.*

72. The cash-flow method assumes that the cash released is reinvested at a compound interest rate equal to the discount rate, when, in fact, the rate at which cash proceeds are reinvested usually is determined by outside economic forces in effect at the time the income is received. P. Wendt & A. Cerf, *supra* note 17, at 34. Furthermore, the method requires long-term income and expense projections, for example, of rental rates and of the resale price, which are determined by the location of the real estate, its age, quality, and design, and the future prospects for the neighborhood. *Id.* at 168-71. Since these long-term projections may be highly unreliable, investors are not likely to make decisions on the basis of the results.

73. One source, moreover, has estimated that the inclusion of excess accelerated depreciation in the limited tax preference alone has reduced the yield by 20.9% to 37.4%. The longer recapture period and the higher alternative tax, according to the same source, has reduced the yield of an

ment yields brought about by the Tax Reform Act would lie between 20 and 40 percent,[74] undoubtedly dampening enthusiasm for investment in moderate- and upper-income rental housing.

B. The Relative Desirability of New and Used Housing Investments

Population growth, demographic trends, and the projected decay of existing housing forecast a need for 26 million new or renovated housing units in the next decade,[75] or an average of 2,600,000 new and rehabilitated units each year. This will necessitate an increase of 1,000,000 units over the current rate of 1,500,000 new housing units produced per year.[76]

To induce expansion of the housing construction industry and to correct the bias in favor of investment in old as opposed to new housing,[77] the Tax Reform Act increased the differential in accelerated depreciation rates. Developers of new residential rental property are now permitted to use the 200 percent double declining balance method,[78] but investors in used residential rental property are limited to the 125 percent declining balance method, which is a reduction from the 150 percent permitted previously.[79]

Admittedly, the depreciation deduction plays an important role in determining the effective yield on real estate investment, but it does not follow that a higher rate for new as opposed to used housing will redirect a significant amount of capital from used into new housing construction.[80] The used and new housing markets are interrelated, and any reduction in the profit of used housing is likely to be reflected in the resale price of new housing. In any bargain situation some of the change in one party's profit inevitably will be transferred to the other through

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investment in residential income housing by a minimum of 2.0% and a maximum of 13.1%. These figures are a low estimate of the impact of the changes on yield. They do not include, for example, the effect of the change that restricts a subsequent user to 125% accelerated depreciation. *1969 Senate Hearings, supra* note 1, at 4922 (remarks of G. Hillman).

74. *Id.*

75. A DECENT HOME, *supra* note 6, at 39-40. *See also* note 29 *supra*.

76. A DECENT HOME, *supra* note 6, at 40.

77. *See also id.* at 45-47.

78. INT. REV. CODE OF 1954, § 167(j)(2).

79. *Id.* § 167(j)(5)(B).

80. This statement is true because the relationship between the developer in new and the investor in used housing is one of seller and purchaser. Blum & Dunham, *supra* note 32, at 447-49. A good example of the relationship and its consequences is the following: assume a developer purchases a parcel of land for $100,000 and erects a building that costs $100,000. He invests $20,000 or 10% of his own money. Assume that before the changes made by the Tax Reform Act his sales price would have been his cost, $200,000. Assume further that before the changes, a purchaser would have invested $20,000 of his own money for a 10% after-tax return on his investment. Now

the sales price.[81] Given the nature of the housing market, the likelihood is that the change in yields produced by the wider differential will be shared proportionately through a general reduction in the resale price of new housing.

Even if the tendency to reach a new equilibrium did not exist, the beneficial effect of the wider differential provided by the Tax Reform Act would be minimal. Investors in used housing still have a greater opportunity than developers of new housing to allocate their costs to depreciable buildings and assign a shorter useful life to the depreciable portion of their investment.[82] It should be remembered that the Tax Reform Act included the excess of accelerated over straight line depreciation in computing the minimum tax on tax preference items.[83] This special tax substantially reduces the benefits of the wider differential, and when combined with the extension of the 100 percent recapture period from 20 to 100 months,[84] the remote possibility of a subsidy that would divert funds away from used housing investment into new housing construction is destroyed.

As a matter of economic policy, it seems unwise to attempt to increase the total supply of housing by reducing the profitability of one of its aspects. Since the inevitable result is the reduction of industry-wide profits, the consequence most likely will be exactly opposite from that intended.[85] If the Tax Reform Act had increased tax benefits for housing and left benefits for other real estate developments where they were, or reduced them, more funds might have been channeled into housing;[86] but the Tax Reform Act did not increase benefits for any housing except federally sponsored low-income housing projects.[87] Instead, tax benefits for other real estate in general were decreased, while benefits for housing remained unchanged or were not decreased as

assume that the reduction from 150% to 125% accelerated depreciation reduces the yield on the purchaser's $20,000 investment from 10% to 8%. To offset this reduction in profits and still earn 10% on his investment the purchaser must contribute no more than $16,000 to the purchase price.

81. For a thorough discussion of the idea that in bargain situations it is not material which party bears the cost initially because the parties will reallocate it between themselves see Calabresi, *Fault, Accidents, and the Wonderful World of Blum and Kalven*, 75 YALE L.J. 216, 223-29 (1965); Coase, *The Problem of Social Cost*, 3 J. LAW & ECON. 1 (1960).

82. *See* text accompanying note 25 *supra*.

83. INT. REV. CODE OF 1954, §§ 56-58; *see* note 36 *supra* and accompanying text.

84. INT. REV. CODE OF 1954, § 1250; *see* note 34 *supra* and accompanying text.

85. *See* notes 35-37, 71, *supra* and accompanying text.

86. *Cf.* J. VAN HORNE, THE FUNCTION AND ANALYSIS OF CAPITAL MARKET RATES 36-39 (1970).

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

much.[88] If housing were related to nothing else, the Tax Reform Act might have offered an adequate inducement for investors to purchase housing projects. Since the housing market is closely associated with other capital markets, however, the anticipated result is an overall reduction in the level of housing investments.

In summary, because the economy is not constant, changes that have an impact on the direction in which investment funds flow may occur at any time. The prospects for inflation or depression, for example, may alter the anticipated yield on common stocks dramatically and thus divert the flow of funds into or away from housing. Although the effect of the Tax Reform Act is not yet clear, statistics are available which indicate the rate of return that investors traditionally have expected on various investments.[89] This prior investment experience suggests that if the rate of return falls below the rate that investors customarily expect, either rental housing construction will decline and rents will increase, or the value of housing projects—including the value of the goods and services that go into their construction—will gradually fall. Because nontax considerations usually make housing less attractive as an investment than other real estate, the changes brought about by the Tax Reform Act probably will result in a slowdown of construction and a reduction in value of rental property, making rental housing less available than it was before the Act was passed.

C. *The Relative Desirability of Low-Income Housing Investments*

The framers of the Tax Reform Act may well have been unaware that changes in the provisions for housing investments would reduce the attractiveness of moderate- and upper-income rental housing invest-

88. For example, depreciation for used housing has been reduced from the 150% to the 125% declining balance method. INT. REV. CODE OF 1954, § 167(j)(5). Additionally, accelerated depreciation is included within the list of tax preferences and subject to a minimum tax. INT. REV. CODE OF 1954, §§ 56-58, as well as a basis for exclusion from the maximum tax on earned income. INT. REV. CODE OF 1954, § 1348; *see* notes 35-37 *supra* and accompanying text. Moreover, the new recapture provisions require that the investment be held for 100 months in order to realize some capital gains and for more than 200 months in order to receive the full benefit of the capital gains tax. INT. REV. CODE OF 1954, § 1250(a). These new rules make it almost impossible for housing to compete with the securities market for risk capital when investors may purchase and sell securities and obtain the benefits of capital gains after a holding period of only 6 months. INT. REV. CODE OF 1954, §§ 1221, 1223.

89. *1969 Senate Hearings, supra* note 1, at 407 (remarks of Joseph Sexton). The apartment industry competes with all other industries for capital funds. When readily tradable corporate bonds paying as much as 7% are available, funds that ordinarily would be invested in real estate mortgages promising an 8% return, may be diverted into corporate obligations. Since the real estate investor can get an 8% return on a first mortgage and a 10% or 11% return on a commercial real estate equity investment, he is looking for a 12% or better cash return on apartment projects. *See also* P. WENDT & A. CERF., *supra* note 17, at 16-17; *1969 House Hearings, supra* note 24, at 2762.

ment. They do seem to have been aware, however, that the supply of adequate low-income housing would not be increased unless special incentives were forthcoming. The shortage of low-income housing is so severe at the present time that incentives which treat low-, moderate-, and upper-income housing investment in the same way will not alleviate the shortage. The cost of the materials, labor, and capital needed to construct new housing is likely to remain high; consequently, for the foreseeable future, the price of new housing will not decline to a level which will allow rents that low-income families can afford. It is unlikely, moreover, that a large enough supply of adequate low-income, used housing will be generated by incentives for building middle- and upper-income housing. The filtering process in which new middle-income housing becomes used low-income housing seems to work imperfectly at best,[90] and given the magnitude of the housing shortage,[91] it is unlikely that programs that merely stimulate the construction of new middle- and upper-income housing will help low-income families.

Since 1961 Congress has realized that low-income families would be unable to share in the benefits of federally subsidized housing programs unless an additional subsidy were made available. Reacting to this realization, Congress devised a number of subsidies to stimulate privately financed rehabilitation or construction of low-income housing.[92] Section 236 of the National Housing Act,[93] enacted to increase the subsidy for the rehabilitation and construction of low-income rental housing, is now the major federal program in the area.[94] To draw more investors into the construction and rehabilitation of low-income housing

90. *See* L. GREBLER, CRITERIA FOR APPRAISING GOVERNMENT HOUSING PROGRAMS (1968).

91. *See* note 43 *supra* and accompanying text.

92. For example, Congress enacted the below-market interest rate program to induce private investment in low-income housing; Housing Act of 1961 § 101(a), 12 U.S.C. § 1715*l* (1970). This § 221 program provides below-market interest rate mortgages for qualifying sponsors either to construct new apartments or to rehabilitate old ones. *Id.* § 1715(*l*)(d)(3). *See* Note, *Government Housing Assistance to the Poor, supra* note 5, at 518-35. Congress also has devised a number of programs designed specifically to induce the rehabilitation of low-income housing. For example, the FHA is authorized to insure mortgages to finance low-income owners' costs of rehabiliation, 12 U.S.C. §§ 1709(k), 1715(k) (1970), and HUD is authorized to make outright grants in certain situations, to enable owners to rehabilitate their houses. 42 U.S.C. § 1466 (1970).

93. Housing & Urban Development Act of 1968 § 201(a), Pub. L. No. 90-448, 82 Stat. 498, 12 U.S.C. § 1715z-1 (1970).

94. As was the case under the earlier § 221(d)(3) program, certain requirements have been established to ensure that low-income families are the beneficiaries of the program. Maximum income and asset limits have been set for tenants as have maximum rents, which usually average about 20% of the tenants' income. To prevent sponsors from using the § 236 program to their sole benefit, moreover, profit limits have been established. For a description of how investors' profits can be made to exceed the maximum see Berger, Goldston, & Rothrauff, *Slum Area Rehabilitation by Private Enterprise*, 69 COLUM. L. REV. 739, 756 (1969).

financed under section 236, Congress created the National Housing Partnership.[95] The attractiveness of the section 236 interest reduction payments and the National Housing Partnership programs is dependent in part on the operation of the real estate tax shelter.

The annual yield—net cash plus tax savings—of newly constructed low-income housing projects has been reasonably attractive to investors, at least in the early years of ownership when the depreciation deductions are high.[96] Unfortunately, in later years the yield decreases rapidly along with the depreciation deductions. Furthermore, the tax consequences upon the sale of either rehabilitated or newly constructed low-income

95. Housing & Urban Development Act of 1968, Pub. L. No. 90-448, tit. ix, 82 Stat. 517 (codified at 42 U.S.C. § 3931-40 (1970)); A. DECENT HOME, *supra* note 6, at 85-86. The National Housing Partnership consists of a federally chartered, privately funded corporation organized under the District of Columbia Business Corporation Act. The corporation is authorized to form a limited partnership serving as general and managing partner with investors receiving a limited partnership share. The financial resources of the partnership consist of the investments of financial and industrial concerns in the corporation and in the limited partnership. H.R. REP. No. 1585, 90th Cong., 2d Sess. 72-74 (1968); *see* Berger, Goldston, Rothrauff, *supra* note 94, at 760-61. The profits and the tax shelter, resulting from depreciation and other deductions, are expected to pass through to each investor. In fact, as President Johnson noted in his address, "Crisis of the Cities," in February 1968, the hope was that the tax shelter would encourage investment by business in low-income housing projects by making possible "an annual cash return on investment comparable to the average earnings of American business in other manufacturing enterprises." A DECENT HOME, *supra* note 6, at 86.

96. *See* notes 51-66 *supra* and accompanying text. Recall that the entire cost of the hypothetical project was $1,000,000, and the depreciable base, including the building, was $825,000. If the investor wished to qualify the project under § 236 of the National Housing Act, 12 U.S.C. § 1715z-1 (1970), the rental income probably would be decreased about $100,000 because of the rent limitations, but the interest reduction payments should be enough to raise the income to an acceptable level. The equity investment should not exceed $100,000. An operating statement for the first year of the project, assuming a 6 3/4%, 40-year mortgage probably would look something like the following:

Income (rents $100,000 + subsidy 42,600)		142,600
Cash expenses		64,000
Available for Debt Service		78,600
Debt Service		
Interest	51,600	
Principal	5,900	
Mortgage Ins. Premium	9,000	
Total Debt Service		66,500
Available for Distribution		12,100
Maximum Distribution (6% investment)		6,000
Excess to Replacement Funds		6,100

housing projects substantially diminishes the total after-tax yield.[97] The President's Committee on Urban Housing found, for example, that on sales of property held more than ten years the average annual yield of 14.4 percent was reduced by the taxes on sale to 5.6 percent.[98] Since most sponsors seek an after-tax yield of at least fifteen percent, the effect was to diminish substantially the attractiveness of investments in low-income housing.[99]

1. *Incentives for the Construction of Low-Income Housing*.—The President's Committee on Urban Housing proposed a number of measures to alleviate the harshness of the tax upon the sale of low-income housing projects. The Committee proposed two modifications, subsequently adopted in the federal housing administration regulations, that permit the sale of low-income housing projects in the most profitable early years and enable a nonprofit buyer to receive an insured mortgage large enough to allow the sponsor to recover his equity invest-

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The income tax statement for this same operation, however, probably will not show a profit. In fact, as the following statement indicates, it would provide for a substantial tax loss:

Rental Income		142,600
Less Cash Operating Expenses (deductible under § 162)	64,000	
Less Interest Expense	51,600	
Less Depreciation Deduction	41,250	
Less Mortgage Insurance Premium	9,000	
Tax Gain or (Loss)		165,850
		($23,250)

The tax loss of $23,250, like any other loss, can be used by the sponsor to offset his income from other sources. Assume that the hypothetical investor, whose income sources are outlined above, is the sponsor of the project. Since he is in the 70% tax bracket, his tax savings are $16,275. When added to the allowable cash distribution of $6,000, there is a total first year return of $22,275 or a 22.28% return on the maximum investment of $100,000.

If the investment had been larger, then the investor could have taken advantage of the rule that permits the use of the building fee as the cash contribution. *See* Berger, Goldston & Rothrauff, *supra* note 94. Rehabilitated low-income housing projects are not as profitable, however. The pre-1970 tax consequences of rehabilitation were such that few sponsors were willing to upgrade the existing stock of low-income housing. Well maintained property was subject to a longer period of write off than poorly maintained slum property, discouraging sponsors from risking their capital to upgrade existing properties. *See* note 32 *supra* and accompanying text.

97. The sponsor of a low-income project was obligated to pay the same taxes upon sale as all real estate investors. The difference between his selling price and his cost less depreciation was his profit. Depending on the length of time the property was held, a portion of the profit was recaptured and taxed as ordinary income. The remainder was taxed at capital gains rates. INT. REV. CODE OF 1954, § 1250, *as amended*, Tax Reform Act of 1969. The President's Committee on Urban Housing calculated that a § 221(d)(3) below-market interest rate project sponsored by a taxpayer in the 50% tax bracket, if held 5 years, would yield, before sale, on the average 18.5%; yet the yield after sale would average no more than 4.5%. A DECENT HOME, *supra* note 6, at 84.

98. A DECENT HOME, *supra* note 6, at 84.

99. *Id.* at 83.

ment and the taxes due upon sale.[100] These changes may have mitigated the harshness of the tax rules, but they did not correct the factors that reduce the aggregate yield. Consequently, the Committee proposed that, upon completion of the project, the sponsor should receive a tax credit, or, alternatively, that the taxable gain upon sale should be limited to the amount the sales price exceeds the original value of the project.[101]

The Tax Reform Act adopted the second alternative and added another modification to maintain the yields at the before sale levels. Under the Tax Reform Act, if a qualified housing project is sold or disposed of in an approved disposition—to the tenants of the project or to a cooperative or other nonprofit organization formed for their benefit—and the taxpayer constructs, acquires, or reconstructs another approved housing project within a certain period, his gain shall be recognized for tax purposes only to the extent that the net amount realized on the sale exceeds the cost of the new investment.[102] If the investor chooses not to sell his project to the tenants, he still is afforded special treatment, since the twenty-month recapture period for approved low-income projects has been retained.[103]

These two changes provide more favorable treatment for government subsidized low-income housing than for other kinds of housing. The investor who sells the project to his tenants probably will receive less than if he had sold to someone in search of a tax shelter, but he can defer the taxes upon the sale of his project indefinitely. If the investor prefers to sell at a higher price to another investor, the impact of the recapture rules is not as severe as if he had invested originally in higher income housing. The subsidy is decreased somewhat, however, by the inclusion of one-half of the capital gain in the list of tax preference items.[104] Nevertheless, since the tax preference rules are the same for all housing, high-income taxpayers in search of a tax shelter should prefer to invest in subsidized low-income housing projects.

100. *Id.* at 84. The Housing & Urban Development Act of 1968 enacted this recommendation, National Housing Act §§ 221(i)(1), 236(j)(3), 12 U.S.C. §§ 1715*l*(i)(1), 1715z-1(j)(3) (1970), and permits the sale of below-market interest rate and interest reduction property in the early years of use to low-income tenants.

101. A DECENT HOME, *supra* note 6, at 84-85.

102. INT. REV. CODE OF 1954, § 1039.

103. The old recapture rules for projects insured under §§ 221(d)(3) or 236 of the National Housing Act, 12 U.S.C. § 1715*l*, 1715z-1 (1970), or under similar provisions of state or local laws remain applicable. Section 1250 of the Internal Revenue Code provides for the reduction of the recapture percentage by 1% for each full month residential rental property is held beyond 100 months. Low-income housing, on the other hand, is permitted to use the old, less harsh percentage based upon a 1% reduction for each full month the property is held beyond 20 months. INT. REV. CODE OF 1954, § 1250(a)(1)(C)(ii); *see* note 38 *supra*.

104. INT. REV. CODE OF 1954, §§ 56-58.

2. *Incentives for the Rehabilitation of Low-Income Housing.*—There are approximately 6,500,000 substandard housing units in this country that will not be replaced or rehabilitated without a subsidy. To meet the nation's housing goal, the construction or rehabilitation of 650,000 subsidized units per year is needed for the next ten years, requiring an increase in output of at least one-third, costing fifteen to twenty billion dollars per year.[105] Unfortunately, this country simply does not have the business skills, trained manpower, materials, or capital to build enough new housing units to meet the nation's needs.[106] Given the other claims upon the nation's one trillion dollar economy, a total emphasis upon the construction of new housing would not be a realistic choice. Thus some special incentive for rehabilitation seems justifiable.[107]

Federal funds for the rehabilitation of low-income housing have been limited in the past, but are expected to be increased.[108] To assure that when the funds are forthcoming investments will be financially feasible, the Tax Reform Act contains provisions that reduce the impact of tax impediments to rehabilitation.

The operation of the pre-1970 tax provisions discouraged landlords from making repairs because rehabilitation of a structure usually resulted in the extension of the period of amortization and a corresponding reduction in the annual accelerated depreciation deductions.[109] The Tax Reform Act offered some relief by permitting the amortization of rehabilitation expenditures on certain low-income projects over 60 months if the straight line method of depreciation were used.[110]

105. A DECENT HOME, *supra* note 6, at 113, 120-21, 124.

106. *See also id.* at 113, 124.

107. *See generally id.* at 120-21, 124.

108. For example, the expenditures under the § 221(h) program that provided assistance for the purchase, rehabilitation, and resale of low-income housing by nonprofit organizations totaled only $7,000,000 for 73 projects. U.S. DEPT. OF HOUSING & URBAN DEVELOPMENT, HUD 3D ANNUAL REPORT 19 (1967). Sections 235 and 236 added by the Housing ~~and~~ Urban Development Act of 1968, 12 U.S.C. 1715z, 1715z-1 (1970), include rehabilitation as a goal, although they were directed primarily toward the production of new housing. Initially, Congress permitted only 25% of the first year's, 15% of the next year's, and 10% of the third year's contracts under §§ 235 and 236 to be used for the rehabilitation of existing housing. Recently, however, Congress has indicated that these percentages should be increased. U.S. DEPT. OF HOUSING & URBAN DEVELOPMENT, *supra* at 19. As the appropriations under § 236 increase, it is likely that an even larger percentage will be available to finance the rehabilitation of low-income rental housing.

109. *See* notes 29-32 *supra* and accompanying text.

110. To assure that low-income persons will be the primary beneficiaries and the quality of substandard housing will be improved, certain criteria were included in the amendments: (1) The expenditure must be between $3,000 and $15,000 over 2 consecutive years, and the building must have a useful life of 5 years or more; and (2) the rehabilitation must be of low-income rental housing. INT. REV. CODE OF 1954, § 167(k).

Considered in isolation the rapid amortization of rehabilitation expenditures appears to offset the tax deterrent to rehabilitation that existed prior to the enactment of the Tax Reform Act. The investor no longer will be penalized for rehabilitating his property by having to write off the expenditures over a period longer than the asset's useful life. The write-off period for other expenditures, of course, may be lengthened because of the improvements. Nevertheless, since a larger proportion of a rehabilitated structure's cost will be attributable to rehabilitation, this probably will not be a substantial tax disincentive.

The incentive to rehabilitate is mitigated somewhat by the Tax Reform Act's requirement that the excess rehabilitation depreciation is to be recaptured to the same extent as accelerated depreciation.[111] The effect on the incentive should not be too great if the projections of revenue loss can be relied upon.[112] If the deduction taken as a result of the rapid amortization of rehabilitation were included in the list of tax preferences, however, the incentive to rehabiliate might have been substantially impaired.

To summarize, the special incentives for low-income housing construction and rehabilitation probably will operate to increase the yield sufficiently to induce investors to redirect their capital into these markets. Perhaps it is fortuitous that the subsidy has been effective for low-income housing and not for moderate- or upper-income housing investments; however, this hypothesis depends upon the way in which the housing markets—low, moderate, and upper—fit together.

IV. The Impact of the Tax Reform Act on the Interrelated Housing Market

Housing is part of a larger, complex system of urban physical design. One authority, after defining what he believed to be the most important behaviorial characteristics that must be understood before attempting urban planning[113] maintained that the manipulation of a complex system is likely to produce results counter to those expected unless the focus is expanded to consider the complete system. When this thesis is applied to the housing market, it suggests that low-, moderate-, and upper-income housing cannot be viewed in isolation, nor can new housing construction be viewed separately from the rehabilitation

111. INT. REV. CODE OF 1954, § 1250.

112. It has been estimated that the revenue loss due to rehabilitation write offs will exceed $15,000,000 in 1970 and increase to $200,000,000 by 1974. H.R. REP. No. 413, 91st Cong., 1st Sess., pt. 1, at 16 (1969).

113. J. FORRESTER, URBAN DYNAMICS 109 (1969).

of used housing. Housing markets of all kinds and for all income groups are interrelated. Programs that favor one market ultimately will affect all others, and, in turn, the reaction of the other markets will affect the one originally favored, sometimes in a negative fashion.

The Tax Reform Act takes on new significance when housing is studied as an integral part of the nation's capital structure. The interrelationship between housing and capital markets explains why the overall reduction in investment yields for both new and used moderate-income rental housing contributes to the disadvantage that housing suffers when it competes with the securities market for risk capital.[114] In the analysis of low-income housing, it was demonstrated that low-income housing investment yields have increased because of the Tax Reform Act, and that consequently, equity capital will flow into low-income housing, away from moderate-income housing and the securities market.[115] It cannot be concluded, however, that this redistribution of capital will provide adequate housing for low-income families.

The President's Committee on Urban Housing has estimated that 26,000,000 housing units will be needed between 1968 and 1978. Six million to eight million of these units will be required for low-income families; the largest need, however, is 13,400,000 units to accommodate the formation of new families. Most of the new families will be young people between the ages of 20 and 30 who can be expected to demand moderate-income rental housing. The remainder of the need will be for single family detached dwellings for middle-income families who are moving out of apartments into suburban neighborhoods.[116]

The housing costs of homeowners have always been subsidized by the Internal Revenue Code. Under the Tax Reform Act the opportunity to deduct mortgage interest payments and property taxes from individual income has been carried forward into the 1970's.[117] As a result, homeowners pay less relatively for their housing than do consumers of rental housing. Since homeowners usually are not newly formed family units, these deductions do little to help the moderate-income newly formed families.

New families of young people are the major consumers of middle-

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114. *See generally* notes 51-66 *supra*.

115. *See* notes 90-104 *supra*.

116. A DECENT HOME, *supra* note 6, at 39-40.

117. INT. REV. CODE OF 1954, § 163(a); NAT'L COMM'N ON URBAN PROBLEMS, *supra* note 2, at 27-28, 160-61; Goode, *Imputed Rent of Owner-Occupied Dwellings Under the Income Tax*, 15 J. FINANCE 504 (1960); Kindahl, *Housing and the Federal Income Tax*, 13 NAT'L TAX J. 376 (1960); White & White, *Horizontal Inequality in the Federal Income Tax Treatment of Homeowners and Tenants*, 18 NAT'L TAX J. 225 (1965).

income rental housing.[118] Since the Tax Reform Act does not treat middle-income rental housing favorably, the likelihood is that capital funds will flow away from middle-income rental housing. Investors that remain in this market probably will increase rents forcing young couples to move into less desirable housing, which puts additional pressure on the supply of housing for low-income families. At some point in the price curve young couples are willing to forego the luxury of modern apartment living and move into less expensive, older housing that previously has been occupied by large, low-income families.[119] These displaced low-income families, without incomes that can match those of the young couples, will be forced to compete for the remaining low-income units by doubling up or by living in smaller units. In the long run, therefore, despite the diversion of equity funds into low-income housing rehabilitation and construction, the effect of the Tax Reform Act may be to inflate low-income housing costs.

The Tax Reform Act not only may inflate the cost of low-income housing, but it also may reduce the purchasing power of low-income families. Housing is a part of the physical plant of the city, and, as such, its quality is determined by the overall physical quality of the city. The middle classes deserted the central cities once the areas began to decay, taking with them the tax base and leaving behind the unskilled, the aged, and the rural migrants to burden the city with an increasing demand for municipal services. Commercial and industrial enterprises likewise moved to the suburbs in search of their scattering customers and labor supply, leaving the low-income families in central cities without jobs.[120] The Tax Reform Act may have exacerbated this disjunction.

If housing were an isolated aspect of the decay of the central city, then a direct program of construction and rehabilitation would be sufficient to solve the housing crisis. Because of the mutual dependence of

118. The Department of Housing and Urban Development has estimated that new rental units constituted 31% of all new units constructed between October 1965 and March 1966. HUD also found that 72% of the tenants in new rental units were newly formed households; only 37% had lived previously in rented units. The median income of these families was $7,500. U.S. DEP'T OF HOUSING & URBAN DEVELOPMENT, HOUSING SURVEYS, pt. 1, at 7-8 (1969).

119. This proposition is correct only if housing demand is relatively inelastic. Measured in terms of a percentage of expendable income, the inelasticity of demand seems evident. Higher income individuals spend a smaller percentage of their income for housing. Moreover, few individuals spend more than 25% of their income for housing—most American families spend approximately 20%.

120. R. WOOD, 1400 GOVERNMENTS 56-63 (1961); Brazer, *Economic and Social Disparities Between Central Cities and Their Suburbs*, 43 LAND ECON. 294 (1967); Feinberg, *The Implications of Core-City Decline for the Fiscal Structure of the Core-City*, 17 NAT'L TAX J. 213 (1964); Woo Sik Kee, *Suburban Population Growth and Its Implications for Core City Finance*, 43 LAND ECON. 202 (1967).

housing quality and employment opportunities, however, the housing program built into the Tax Reform Act probably will be counterproductive since it will tend to increase the number of houses without the benefit of rational urban planning. Sufficient data is not yet available to determine the extent to which low-income projects are being located in areas that permit low-income families to reside close to employment opportunities. It is evident, however, that many communities use local zoning ordinances to exclude low-income housing projects from the newly developing portions of their communities.[121] It can be hypothesized, therefore, that low-income housing has not been and is not likely to be located where low-income families will have easy access to jobs.[122] Without work the low-income family cannot acquire adequate housing. In the short run, perhaps the number of families living in inadequate low-income housing units will be reduced by the Tax Reform Act, but over the long run the likelihood is that fewer jobs will be available for low-income families close to their homes, average incomes for low-income families will decline, and more low-income families will be unable to afford adequate housing.[123]

V. Conclusion

Housing is one of many interacting factors that make up the capital market, the physical plant of the city, and the poverty syndrome. Any attempt to increase investment yields to improve housing conditions must recognize the limitation imposed upon a linear program by other interacting variables. It is not clear that the framers of the Tax Reform

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121. For a discussion of the ingenuity of local communities in excluding low-income families from their neighborhoods see Williams, *Planning Law and Democratic Living*, 20 LAW & CONTEMP. PROB. 317, 325-31, 334 (1955). *See also* James v. Valtierra, 402 U.S. 137 (1971); Sasso v. Union City, 424 F.2d 291 (9th Cir. 1970); Ranjel v. City of Lansing, 417 F.2d 321 (6th Cir. 1969), *cert. denied*, 397 U.S. 980 (1970); Gautreaux v. Chicago Housing Authority, 296 F. Supp. 907 (N.D. Ill. 1969), *aff'd*, 436 F.2d 306 (7th Cir. 1970), *cert. denied*, 401 U.S. 953 (1971); El Cortez Heights Residents & Property Owners Ass'n v. Tucson Housing Authority, 10 Ariz. App. 132, 457 P.2d 294 (1969); Note, *Large Lot Zoning*, 78 YALE L.J. 1418 (1969).

122. For an analysis of the spatial characteristics of land uses and the income of their tenants see R. MUTH, *supra* note 10, at 139-205.

123. Even if enough low-income houses can be constructed to meet the needs of the poor, low-income families probably will be worse off. "In recent years, the costs of construction and operation of multifamily housing in center cities have increased geometrically. At the same time, as money has become increasingly tight, interest rates have also increased rapidly. The trend continues as the costs of land, labor, and money continue to rise. Land costs lead the increase at 6 percent per year, followed closely by 5 percent per year construction cost increases.

"This pattern of costs has gradually produced a situation in which new construction in our urban areas is limited to subsidized low-income units and high-income luxury apartments. The economics involved are producing a financial environment in which there is no place for the middle class in the cities." *1969 Senate Hearings*, *supra* note 1, at 4929 (remarks of G. Hillman).

Act were cognizant of these limitations, and, because of their narrow perspective, the Tax Reform Act may fall short of its stated objective to redirect investments into housing. Moreover, it is not certain that the quality of housing would be upgraded. Furthermore, an improvement in the quality of low-income housing may not necessarily benefit low-income families in the long run. Simply stated, the tax subisidies for housing embodied in the Tax Reform Act may not be as effective a tool to use in upgrading the quality of housing as the proponents of reforms had hoped. Too often, superficial palliatives are prescribed for complex social problems. Hopefully, when the role of the federal income tax in housing policy is reevaluated, greater attention will be paid to the mutual dependence of the various housing markets upon the level of activity in each that unavoidably determines the overall success of national housing programs.