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## Real Property Depreciation Recapture: An Ineffectual Reform of the Tax Laws

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## Real Property Depreciation Recapture: An Ineffectual Reform of the Tax Laws

### I. INTRODUCTION

This note stems from a belief that an asymmetrical body of tax laws is a challenge to the legal profession which, by training, experience and tradition, is well situated to spur and guide reform. It is my intention to outline the story of but one section of the Internal Revenue Code: why it was proposed, what it sought to do, how it underwent modification by an unsympathetic congressional committee, and how it was finally enacted as a superficial compromise with the underlying asymmetry of our tax laws. In short, what follows is an appended bar in the organ theme entitled "A Requiem in Honor of the Departing Uniformity of the Tax Laws."<sup>1</sup>

The plan is not to describe in depth the technical operation of an Internal Revenue Code section;<sup>2</sup> but rather, to describe and illustrate in some measure how the tax laws bestow certain special benefits upon a particular economic group—*i.e.*, real estate investors. The plan further is to explore the efforts of the United States Treasury toward reform of the law and to criticize and evaluate Congress' response: section 1250 which was enacted in 1964. Finally, relevant economic principles will be surveyed in the hope that a few helpful guidelines can be suggested for future efforts at reform.

### II. BUILDING A FORTUNE ON TAX SHELTERED REAL ESTATE

Mr. Paul Anderson, tax attorney and member of the San Francisco Bar has written:

Real estate presents a number of important tax advantages that make it an extremely desirable investment for the purposes of capital growth. The most important of these advantages are in the areas of depreciation, equity financing, and tax-free exchanges. By a shrewd combining of these advantages, a personal estate may be built up more rapidly in real estate than in any other type of investment property (save perhaps in more risky oil investments).<sup>3</sup>

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1. From the title of Professor William Cary's concerned and thoughtful article, *Pressure Groups and the Revenue Code: A Requiem in Honor of the Departing Uniformity of the Tax Laws*, 68 HARV. L. REV. 745 (1955). For an historical discussion of the American tax system's evolution and a persuasive appeal to the legal profession for its future guidance, see PAUL, *TAXATION IN THE UNITED STATES* (1954). See also STERN, *THE GREAT TREASURY RAID* (1965), for another view of the tax law asymmetry.

2. There is an overabundance of literature now existent on the technical operation of the depreciation recapture sections. See note 40 *infra*, and the appended bibliography.

3. ANDERSON, *TAX FACTORS IN REAL ESTATE OPERATIONS* 1 (2d ed. 1965).

In the hearings on the Revenue Act of 1962 before the Senate Committee on Finance, Treasury Secretary Dillon outlined how these tax advantages are used:

Under present rules depreciation at accelerated rates applies not only to the taxpayer's investment, but also to the amount of mortgage indebtedness to which the property is subject. Since the acquisition of real estate is usually heavily financed by mortgage indebtedness, accelerated depreciation often provides deductions far in excess of the income from the property. In such cases the investor is able, because of the depreciation deduction, to amortize the principal of the mortgage, to obtain a nontaxable cash return of 10 to 12 percent or more on his equity investment, and even to wipe out tax on other income at top bracket rates. When the depreciation deductions cease to produce such spectacular results, the property is frequently sold. Thus the excess depreciation, having been charged against income taxable at ordinary rates, is recouped and taxed only as capital gains.<sup>4</sup>

Much has been written on the foregoing possibilities as well as on others more subtle though perhaps less dramatic.<sup>5</sup> The sophisticated small real estate investor<sup>6</sup> should, by now, be well aware of the principles used, while the large investor has probably been using them for years.<sup>7</sup>

The more significant economic features of investment in real estate and the related tax shelter advantages can be grouped under the four following headings: leverage, depreciation, maintenance and disposition. To illustrate the financial principles involved and the tax favoritism granted by present law, a hypothetical real estate investment project will be described and analyzed. Although it is assumed that the hypothetical project is owned by an individual, the principles demonstrated extend to most other forms of ownership. Consequently, under a fifth heading some of the problems and advantages of the alternative ownership forms for a real estate investment will be discussed briefly.

#### A. Leverage

The term "leverage" in real estate financing refers to the ratio of

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4. *Hearings on H.R. 10650 Before the Senate Committee on Finance, 87th Cong., 2d Sess., pt. 1, at 88 (1962)* [hereinafter cited as *1962 Senate Hearings*].

5. The more detailed recent treatments are ANDERSON, *supra* note 3; CERF, *REAL ESTATE AND THE FEDERAL INCOME TAX* (1965); PRENTICE HALL, EDITORIAL STAFF, *ENCYCLOPEDIA OF TAX SHELTER PRACTICES* 710-82 (1963) [hereinafter cited as *ENCYCLOPEDIA OF TAX SHELTER PRACTICES*]. A helpful manual on both and financial planning of real estate transactions is CASEY, *REAL ESTATE DESK BOOK* (1964). The appendix of tables in the manual is useful for analytical computations similar to the ones that will be set out here.

6. His sophistication may be the product of his own efforts or simply the result of his wisdom in heeding his tax advisors, who are barraged with literature on tax shelter practices. That literature has a very special place for real estate tax rules.

7. See the examples cited in *ENCYCLOPEDIA OF TAX SHELTER PRACTICES* at 715-17.

creditor's equity to owner's equity. Though not often attainable, an ideal ratio would be 1 to 0, and would depend for its existence upon an investor having a prime personal credit rating. More prevalent, however, is the highly favorable ratio of building and improvement cost to land cost. That is, the investor owning the land outright mortgages the whole property for an amount equal to the cost of buildings and improvements. Experienced real estate investors, who know how to design a physical structure and its resultant economics of operation to an institutional lender's satisfaction, will frequently obtain creditor financing for all costs of improvements. Such an investor would expect the annual net cash flow from his project to be from ten to thirty-five per cent of his own cash investment, even after amortization of the mortgage principal.<sup>8</sup>

The hypothetical investment project illustrates this kind of leverage. Its owner has bought unimproved land for 200,000 dollars and has borrowed 1,000,000 dollars with which to erect an apartment house. Table 1 shows his amortization schedule for a six per cent interest-bearing mortgage note which is payable in twenty equal annual installments of 87,190 dollars.

TABLE 1  
MORTGAGE AMORTIZATION SCHEDULE

End of Year	Interest Paid	Principal Paid	Balance Unpaid
1	60,000	27,190	972,810
2	58,370	28,820	943,990
3	56,640	30,550	913,440
4	54,810	32,380	881,060
5	52,860	34,330	846,730
6	50,800	36,390	810,340
7	48,620	38,570	771,770
8	46,310	40,880	730,890
9	43,850	43,340	687,550
10	41,250	45,940	641,610
11	38,500	48,690	592,920
12	35,580	51,610	541,310
13	32,480	54,710	486,600
14	29,200	57,990	428,610
15	25,720	61,470	367,140
16	22,030	65,160	301,980
17	18,120	69,070	232,910
18	13,970	73,220	159,690

8. *Id.* at 713.

19	9,580	77,610	82,080
20	4,920	82,080	-0-
	<u>743,610</u>	<u>1,000,000</u>	

While this investor owns and operates the project, its gross receipts stream will be reduced by annual mortgage payment commitments of 87,190 dollars, of which the interest portion is tax deductible. Essentially, then, for a cash outlay of only 200,000 dollars, through leveraging the investor has become entitled to the gross receipts stream from an asset costing 1,200,000 dollars. This cash stream is reduced, of course, by partially tax deductible mortgage note payments.

A second important feature of real estate leverage is pyramiding, the key to which is the investor's rising ownership interest. As the years pass, the owner makes his annual mortgage principal payments, thereby increasing his equity in the project. For example, at the end of the fifth year, owner's equity has increased from 200,000 dollars (initial cash investment) to 353,270 dollars (200,000 dollars plus 153,270 dollars, the sum of the first five principal payments). If market value of the apartment house should increase along with the equity, the investor can put his dualistically increased ownership interest to work by refinancing the mortgage to, or beyond, its original amount. This step need not increase annual debt-service cash requirements, though it will increase the total number of remaining periods subject to a debt burden. If market value has neither risen during a five year period nor significantly declined, the investor might refinance his mortgage to its original amount of 1,000,000 dollars, thereby obtaining cash proceeds of 153,270 dollars. Because this new mortgage principal would probably have to be repaid in the remaining fifteen years of the original mortgage term, he would have to show the mortgagee that the project's gross receipts stream could sustain the burden of increased annual mortgage payments (the annual payment required to amortize a six per cent, fifteen year, 1,000,000 dollar mortgage loan would be 102,970 dollars). Under whatever conditions he obtains refinancing, the investor can use the proceeds to buy more land upon which another willing creditor will erect a new building. Pyramiding of real estate holdings thereby results.

Lender attitudes make these leveraging techniques particularly well suited to investments in new store and office buildings, shopping centers, apartment houses, motels, and any commercial or industrial real estate development to be tenanted under a long-term lease by a financially responsible enterprise.

### B. Depreciation

As indicated by Secretary Dillon's comments, accelerated depreciation allowances tend to protect a part or all of a real estate investment project's cash flow from taxation. The property's total basis, that is, the sum of the creditor's equity and the owner's equity, less the portion thereof attributable to land, is subject to tax deductible depreciation. Accelerated depreciation on new real property may be computed by the double declining balance method, or by any other reasonable method not producing in the first two-thirds of the asset's life deduction in excess of those permitted under the double declining balance method.<sup>9</sup> Depreciation of used real property may not be accelerated beyond the limits of the one hundred fifty per cent declining balance method.<sup>10</sup> The most commonly used methods of depreciating real estate are probably sum of the years' digits, double declining balance, one hundred fifty per cent declining balance, and straight line.<sup>11</sup> A less commonly used method but one having some unusual implications is the sinking fund method.<sup>12</sup> Figure 1 compares

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9. INT. REV. CODE OF 1954, §§ 167(a)-(b).

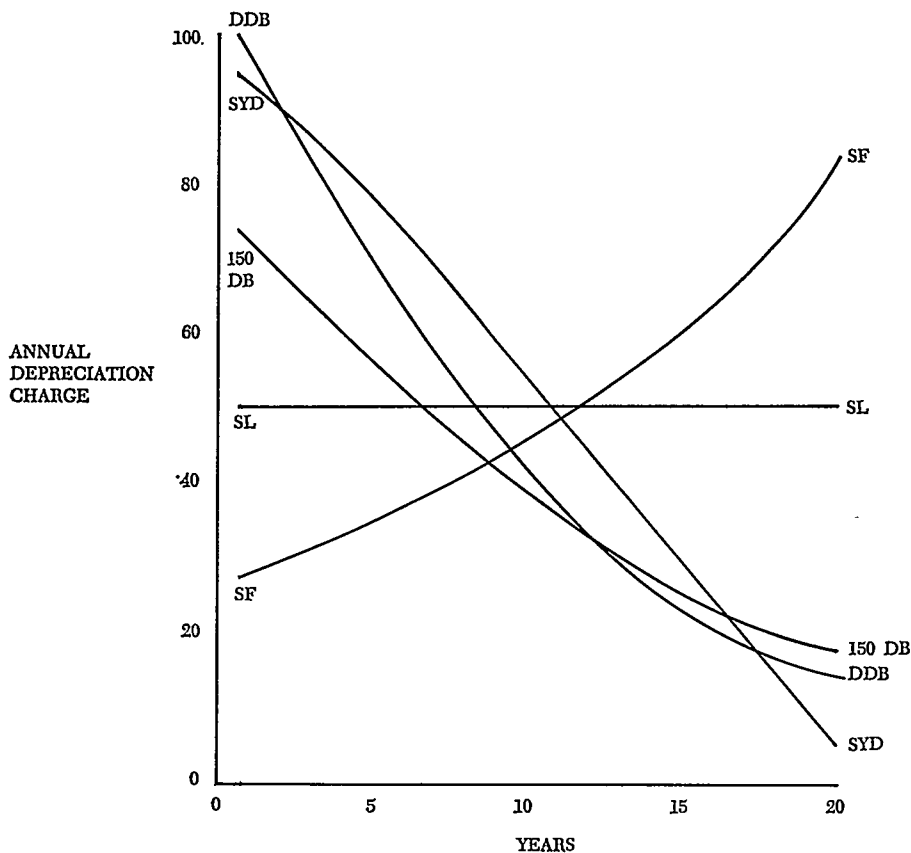
10. INT. REV. CODE OF 1954, § 167(c), and Treas. Reg. § 1.167(b)-O(b), delimiting reasonableness of methods applied to any property subject to depreciation under § 167(a).

11. Straight line depreciation is computed by dividing asset life into depreciable basis; the quotient is the recurring annual depreciation charge. For example, annual straight line depreciation for a depreciable basis of \$100 and a five-year asset life is \$20 (\$100 divided by 5). Declining balance depreciation results from a constant rate applied to the undepreciated remainder of the asset's basis and the constant rate used is some multiple of the straight line rate. The method called double declining balance, or 200% declining balance, uses a constant rate which is double the straight line rate. In the foregoing example the straight line rate is 20%. Thus the double declining balance rate is 40%. The first year's depreciation would be \$40 (40% of \$100); the next year's would be \$24 (40% of \$60, the \$60 being the undepreciated remainder, \$100 minus accumulated depreciation of earlier periods amounting to \$40). The 150% declining balance method applies a rate one and one-half times the straight line rate. In the example it would be 30%. The sum of the years digits method applies a sliding rate to the asset's original depreciable basis. The sliding rate is a fraction, the denominator of which is the sum of the digits of the years of asset life, and the numerator of which is the number of years of remaining life at the beginning of the year for which depreciation is being computed. The denominator does not change but the numerator is smaller each successive year. In the example, the denominator is 15 (1+2+3+4+5) and the numerator for year one is five, for year two it is four, and so on. Depreciation in year one would be \$33 (5/15 times \$100), in year two, \$27 (4/15 times \$100), and so on.

12. Treas. Reg. § 1.167(b)-4(a) specifically mentions use of the sinking fund method as being permissible whenever use of the double declining balance method would be. Lest the name be misleading, it should be emphasized that no cash fund is set aside when this method is used. It is merely another way of calculating annual depreciation charges. To compute sinking fund depreciation for the first year, refer to a table of the compound amount of 1 per period (or as it is sometimes called, amount of annuity of 1 per period), choose a rate of interest, and find a factor in the table opposite the number of years of the depreciable asset's life. Dividing this factor into the depreciable basis produces a dollar amount which becomes the first year's depreciation charge. For

these methods graphically. For each method of depreciation, a continuous curve is plotted through points representing annual depreciation of an asset costing 1,000 dollars and having a twenty-year life.<sup>13</sup>

FIGURE 1. DEPRECIATION CURVES



example, if the asset life is 15 years and the rate of interest is 6%, the factor from the table is 23.2759699. Dividing this into a depreciable basis of \$1000 gives a first year depreciation charge of \$42.97. Depreciation for any subsequent year is this \$42.97 plus an amount equal to 6% of total depreciation accumulated at the beginning of the year. In the second year of the example, depreciation would be \$45.55 (\$42.97 plus 6% of \$42.97), while in the third year it would be \$48.28 (\$42.97 plus 6% of \$88.52, the sum of the prior depreciation taken which was \$42.97 and \$45.55). The annual principal payments column of a mortgage amortization schedule for \$1000 at 6% interest would reflect the same numerical information since its computation is identical to computation of sinking fund depreciation charges. An informative article on the usefulness of the sinking fund method is Parish, *A New Concept of Real Estate Depreciation*, 41 TAXES 598 (1963).

13. For straight line and sum of the years digits, zero salvage value is assumed. However, taking salvage value into account merely drops these two curves vertically without affecting their shapes. Sinking fund depreciation is computed under 6% rate of interest. A lower rate of interest would cause the curve to begin at a higher level but rise rapidly without reaching as high a final peak.

To increase depreciation early in the property's life, the investor may segregate the cost of such non-structural components as heating and air conditioning apparatus, plumbing, electrical wiring, elevators and paving. These components may be depreciated over a much shorter life span than may the structural frame of the building. The larger the proportion of the property's cost arising from non-structural components, the greater is the accumulation of permissible depreciation deductions early in the asset's life.

Table 2 shows double declining balance depreciation over the first ten years of the hypothetical investment project's operation. The 1,000,000 dollar cost of the apartment house was expended ninety per cent for the building and ten per cent for the various non-structural components. The former has an estimated useful life of forty years while the latter has a life of only fifteen years.

TABLE 2  
DOUBLE DECLINING BALANCE DEPRECIATION

End of Year	Building		Non-Structural Components		Total	
	Annual	Cumulative	Annual	Cumulative	Annual	Cumulative
1	45,000	45,000	13,330	13,330	58,330	58,330
2	42,750	87,750	11,560	24,890	54,310	112,640
3	40,590	128,340	10,010	34,900	50,600	163,240
4	38,610	166,950	8,680	43,580	47,290	210,530
5	36,630	203,580	7,530	51,110	44,160	254,690
6	34,830	238,410	6,510	57,620	41,340	296,030
7	33,120	271,530	5,650	63,270	38,770	334,800
8	31,410	302,940	4,900	68,170	36,310	371,110
9	29,880	332,820	4,250	72,420	34,130	405,240
10	28,350	361,170	3,670	76,090	32,130	437,260

The table shows that under these rapid depreciation methods this project is 43.7 per cent depreciated in the first one-fourth of its life.

The next two tables demonstrate why accelerated depreciation methods are preferred by real estate investors. Briefly stated, the reason is maximization of cash throwoff, a term meaning the net spendable cash produced by operations. Table 3 shows cash throwoff for each of the first ten years of the hypothetical project's operation. It was computed as follows: assuming annual gross rentals of 150,000 dollars and annual operating expenses of 45,000 dollars, the project's annual operating income would be 105,000 dollars. The annual depreciation charge and the interest portion of the annual mortgage payment was deducted from this operating income to arrive at net



taxable income, or loss. Tax was computed thereon at 1965 rates under the assumption that this investor has an annual taxable income from other sources of 40,000 dollars.

To reflect more accurately the total economic advantage of the depreciation tax shelter, the net taxable loss was subtracted from this other taxable income of 40,000 dollars. The resultant tax saving is included as part of the cash throwoff of *this project to this taxpayer*. Both tax savings and losses are incremental amounts. That is, tax on 40,000 dollars was computed, tax on income after including income or loss from this project was computed, and then the difference in the total tax bill was shown as tax incurred or saved by this project. For computational simplicity income averaging was ignored. Then to arrive at net spendable cash from operations, the non-cash provision for depreciation was added back to taxable income, and the cash outlays for taxes and non-deductible mortgage principal payments were subtracted.

TABLE 3  
ANALYSIS OF CASH THROWOFF  
UNDER DOUBLE DECLINING BALANCE DEPRECIATION

Year	Operating Income	Interest Paid	DDB Depreciation	Taxable Income or (Loss)	Tax Incurred or (Saved)	Principal Paid	Net Spendable Cash
1	105,000	60,000	58,330	(13,330)	( 5,519)	27,190	23,329
2	105,000	58,370	54,310	( 7,680)	( 3,346)	28,820	21,156
3	105,000	56,640	50,600	( 2,240)	( 1,008)	30,550	18,818
4	105,000	54,810	47,290	2,900	1,392	32,380	16,418
5	105,000	52,860	44,160	7,980	3,910	34,330	13,900
6	105,000	50,800	41,340	12,860	6,376	36,390	11,434
7	105,000	48,620	38,770	17,610	8,893	38,570	8,917
8	105,000	46,310	36,310	22,380	11,421	40,880	6,389
9	105,000	43,850	34,130	27,020	13,941	43,340	3,869
10	105,000	41,250	32,020	31,730	16,532	45,940	1,278
	<u>1,050,000</u>	<u>513,510</u>	<u>437,260</u>	<u>99,230</u>	<u>52,592</u>	<u>358,390</u>	<u>125,508</u>

If this investor feels that the market value of his apartment house will not decline below his original cost (and probably in today's market many investors so assume, at least for the first ten-year period) then the true index of this project's profitability is the sum of the last two columns of Table 3, mortgage principal paid (an amount redeemable if the project can be sold at a price equal to or exceeding cost) plus cash throwoff. Thus profitability is not measured by taxable income, the annual increase of which tends to bear an inverse

relation to the annual decrease in the sum of principal paid and cash throwoff. Parenthetically, one might remark upon the curious nature of a law designed to tax income progressively where the measure of the tax may be inversely related to profits.

Table 4 shows this project's cash throwoff under various methods of depreciation. For the um of the years digits depreciation and for straight line depreciation, the apartment house's salvage value is assumed to be zero; the sinking fund annual depreciation charge is computed under a six per cent rate of interest assumption.

TABLE 4  
COMPARISON OF CASH THROWOFF  
UNDER VARIOUS METHODS OF DEPRECIATION

Year	Double Declining Balance	Sum of the Years Digits	150 Declining Balance	Straight Line	Sinking Fund
1	23,329	22,624	17,210	9,860	( 458)
2	21,156	21,202	15,320	8,996	( 1,021)
3	18,818	19,707	13,375	8,079	( 1,649)
4	16,418	17,990	11,445	7,109	( 2,315)
5	13,900	16,149	9,452	6,076	( 3,027)
6	11,434	14,170	7,438	4,963	( 3,778)
7	8,917	12,080	5,398	3,764	( 4,571)
8	6,389	9,902	3,286	2,494	( 5,411)
9	3,869	7,533	1,125	1,141	( 6,309)
10	1,278	5,128	( 1,032)	( 289)	( 7,256)
	<u>125,508</u>	<u>146,485</u>	<u>83,017</u>	<u>52,193</u>	<u>(35,795)</u>

The difference in any year between the amounts of cash throwoff resulting from the use of one depreciation method or another is solely attributable to a difference in income taxes incurred. In year one, for example, this project owner's tax bill when he uses the straight line depreciation method is 13,469 dollars greater than it is when he uses the double declining balance method. This amount is the difference in cash throwoff for the year (23,329 dollars minus 9,860 dollars). The reason, of course, is that depreciation is a non-cash item which is tax deductible.

Inspection of Table 4 reveals that cash throwoff over ten years is greatest under sum of the years' digits depreciation, assuming no salvage value. Of the four most commonly used depreciation methods (the first four from left to right), cash throwoff is least under straight line depreciation (146,485 dollars versus 52,193 dollars). Use only

of the sinking fund method will create a necessity for the investor to contribute more cash to his project each year for the first ten years. In later years, however, under all the other methods, cash from outside sources will eventually be required. This is due both to declining annual depreciation charges and to declining annual interest deductions. Obviously, many investors who must nurture a project with cash are much more likely to turn toward another project which will for some years produce an annual cash throwoff. Such an investor will probably sell this project or at least refinance its mortgage. Nevertheless, the latter will not affect the decline in annual depreciation charges where sale and reinvestment of the proceeds would produce new and higher depreciation allowances.

From Table 4 emerges a forceful conclusion, and one well recognized by investors or their advisors. To maximize depreciation deductions over the taxpayer's anticipated holding period (which is not necessarily the project's life) is to maximize the sum of annual cash throwoffs by minimizing taxes. Consequently, much literature has evolved on the esoteric methodology of depreciation.<sup>14</sup> Determinations of estimated useful lives and of estimated salvage values deserve special mention because of their pervasiveness. While the selection of an estimated useful life is common to all methods of depreciation, no selection of an estimated salvage value is necessary if the taxpayer uses a declining balance method of depreciation because it already has an arithmetically built-in salvage factor. Since the lesser the life and the salvage value, the greater the depreciation, taxpayer estimates tend to be low while Treasury estimates tend to be high. Therefore, much administrative and judicial effort inevitably is spent on resolving these factual questions.<sup>15</sup>

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14. An example is literature on the year to switch to straight line depreciation. INT. REV. CODE OF 1954, § 167(e)(1) permits a taxpayer, whenever he so chooses, to switch from one of the accelerated methods to the straight line method for depreciating the undepreciated remainder of an asset basis. Figure I has illustrated that annual rapid depreciation charges decline below annual straight line depreciation charges about midway in the asset's life. A little later in the life, they tend to decline below what straight line charges on the undepreciated balance would be. Thus to maximize depreciation, the taxpayer should switch methods at that time. Tables showing the year to switch methods according to length of asset life can be found in Richs, *Year to Switch to Straight Line Depreciation*, 39 ACCOUNTING REV. 685 (1964). On switching with respect to group properties, see Greene, *Changing from Declining Balance to Straight-Line Depreciation*, 38 ACCOUNTING REV. 355 (1963).

15. Administrative effort is made at two levels, one being the audit and enforcement level while the other is what might be called the rule promulgation level. Issuing from the latter, Bulletin "F" and its successor, *Depreciation Guidelines and Rules*, Revenue Procedure 62-21, 1962-2 COM. BULL. 418, are attempts to deal with the life determination problem. An article co-authored by Mortimer M. Caplin, Commissioner of Internal Revenue from 1961 to 1964, reviews some of the administrative difficulties arising in this area. Caplin & Klayman, *Depreciation—1965 Model*, J. ACCOUNTANCY, April 1965, p. 34. Over two hundred examples of judicial resolution of life determination disputes

### C. Maintenance

Constant maintenance and repair expenditures to preserve property value and useful life can prevent the deterioration that depreciation allowances theoretically represent. Such casual but regular expenditures are also deductible from ordinary income. What is here referred to is the value enhancement created by a process over time. Value is a function of income expectations which such a policy can influence, for example, by shaping tenant goodwill and its derivative, occupancy rate. But any *single* expenditure significantly enhancing value or arresting deterioration must be capitalized.<sup>16</sup> To the extent that a systematic policy of maintenance increases the value of the building, or prevents its deterioration, deductions from ordinary income are converted into potential capital gains.<sup>17</sup>

### D. Disposition

As Secretary Dillon pointed out, once the spectacular depreciation-sheltered portion of the cash flow begins to subside, the real estate investor may dispose of his property. He will seek preferential taxation of his gain, or perhaps, he will be able to have his gain completely unrecognized. Gain on the sale of real estate held for over six months is taxed at capital gains rates if the property is held for use in a trade or business, for use as a personal residence, or for the production of income or for investment. Only gain on real estate held by a dealer for sale to customers in the ordinary course of business is taxed as ordinary income. Capital gains are taxed at a maximum of twenty-five per cent, while ordinary income might be taxed as high as seventy per cent. Furthermore, gains on dispositions of real property may go unrecognized in a number of situations. Generally, section 1034 grants the seller of a personal residence a tax-free rollover if he buys a new residence within a specified time at a cost equal to the selling price of the old. Under the section 1031 like-kind exchange rules, an exchange of one parcel of real property for another is tax free, no matter how divergent their uses might be. Neither gain nor loss is recognized, though basis carries over. Section 1031, however, is not

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have been collected in a table showing type of building, useful life as chosen by a court, and case citation. 4 P-H 1966 FED. TAX SERV. ¶ 14159D.

16. Treas. Reg. § 1.162-4 (1958).

17. An interesting illustration of tax alchemy is presented in *ENCYCLOPEDIA OF TAX SHELTER PRACTICES* at 773-74. Business realty which can be sold at a profit is in need of repair. If the repair would increase the sale price by an amount equal to its cost, the owner's tax bill for the year in which he repairs and sells would be reduced by his tax bracket rate times 50% of the repair expenditure. Suppose the repair cost to be \$5000, the resultant sale price increase to be \$5000, and the taxpayer's rate bracket to be 50%: the year's tax bill is decreased by \$1250.

applicable to exchanges by dealers or residence owners. On the other hand, losses on dispositions of real estate holdings do not necessarily receive parallel treatment. A residence owner's loss is a personal expense and non-deductible, whereas, a loss incurred on property held for the production of income or for investment is treated as a capital loss.<sup>18</sup> But a loss on property held for use in a trade or business is an ordinary loss under section 1231 which may be deducted from ordinary income.<sup>19</sup> If an investor sustains a loss upon selling his realty, the crucial question of whether his operation of rental property constituted a trade or business within the meaning of section 1231 will arise. Generally, the rule applies when the owner's activities are substantial and regular rather than incidental and sporadic.<sup>20</sup> The installment sale provisions of section 453 provide another special tax treatment accorded sales of realty. The gross profit portion of installment payments on an obligation arising from the sale of realty may be taxed in the year the payments are received, provided that payments received in the year of sale do not exceed thirty per cent of the selling price.

### E. *Forms of Ownership*

In addition to the outright ownership by an individual assumed in the foregoing discussion, two significant forms of ownership are available to real estate investors: ownership by partnership or ownership by corporation. The incorporated partnership, as a corporate election under Subchapter S is sometimes called, is unavailable for real estate investments where the corporation's income from rents exceeds twenty per cent of gross receipts, a limitation imposed by section 1372(e)(5).

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18. In general, an individual's long-term capital losses are netted against long-term capital gains. An excess of losses is first used to offset short-term capital gains. Thereafter, the deduction for the year of any remaining capital loss is limited to \$1000. For years beginning after 1963, individuals may carry forward unused capital losses indefinitely. Generally, corporations may use capital losses only to offset capital gains and may carry forward such losses only for five years. See INT. REV. CODE OF 1954, §§ 1201, 1202, 1211, 1212.

19. Section 1231 gains are netted against § 1231 losses for the year. A net gain is capital gain; a net loss is ordinary loss. The rule is the same whether the taxpayer is a corporation or an individual.

20. The question is one of fact. If the owner devotes a substantial amount of time to managing a number of rental units, he is engaged in a trade or business. *Gilford v. Commissioner*, 201 F.2d 735, 736 (2d Cir. 1953); I.T. 3711, 1945 CUM. BULL. 162, 164. The courts have split on whether operation of one rental unit is sufficient. See, e.g., *Cole v. United States*, 141 F. Supp. 558 (D. Wyo. 1956) (held insufficient); *Anders I. Lagreide*, 23 T.C. 508 (1954) (held sufficient). If the property rented is unimproved, and therefore investment property, the owner is not engaged in a trade or business. *Susan P. Emery*, 17 T.C. 308, 311 (1951). On balance, it seems that courts generally resolve this factual question in favor of the taxpayer.

Although the partnership requires profit sharing, it offers an opportunity for risk sharing which may be attractive to the investor. Since a partnership is not a taxable entity, that is, its income or loss retains its character as it passes directly to each partner, the interacting principles of leverage, depreciation and capital gains are, in general, equally applicable to the partnership form or to the individual ownership form. But a partnership is an entity for many purposes, some of which may affect real estate investors.<sup>21</sup>

On the other hand, a corporation is a separate, taxable entity, which may have one or more owners. Leverage, depreciation and capital gains are generally also available to a corporation but are subject to the intricacies of corporate tax law.<sup>22</sup> First of all, tax rates on individuals and on corporations differ, the former presently ranging from fourteen to seventy per cent, the latter from twenty-two to forty-eight per cent. A corporate capital gain is taxed at no more than twenty-five per cent while an individual's capital gain is taxed either one-half at ordinary income rates, or, at most, the whole at twenty-five per cent. If the owner wants to extract his profits and capital appreciation from the corporation, he will probably incur a tax, either at ordinary income rates if the distribution is a dividend or at capital gains rates if the corporation is liquidated in a taxable transaction, though corporate liquidations are sometimes tax-free.<sup>23</sup> To encourage corporations to distribute taxable dividends, the law imposes a tax on excessive accumulation of corporate earnings.<sup>24</sup> Finally, since the tax shelter practices in real estate are associated with investment projects perhaps slated for early liquidation, either of two Code provisions might trigger unexpected taxes: the personal holding company sections<sup>25</sup> or the

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21. Other than the fact of passed-through income retaining its character, the most significant implications of the partnership form are probably in the estate planning area. For example, an individual's heir finds the depreciable asset's basis stepped up because of the original owner's death. However, the partner's heir has the undepreciable basis of his new partnership interest stepped up rather than the depreciable basis of the asset itself. See generally the partnership chapter in ANDERSON, *op. cit. supra* note 3.

22. One intricacy of corporate tax law without parallel in the taxation of individuals is found in INT. REV. CODE OF 1954, § 312(j). If a corporation is able to obtain mortgage loan proceeds in excess of the property's basis because of liberal F.H.A. guarantees, any distribution of such proceeds to the shareholders is taxed as a dividend. Therefore, the pyramiding of investments mentioned earlier may be restricted to the corporation's ownership if refinancing creates a new, federally guaranteed mortgage in excess of the property's basis. To distribute the proceeds to the individual shareholder for his own pyramiding would be to reduce substantially the monies produced by refinancing.

23. The general rule is that a corporate liquidation is like a sale of stock. INT. REV. CODE OF 1954, § 331(a)(1). But under certain circumstances, § 333 permits non-recognition of liquidation gains. See generally BITTKER, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS*, ch. 9 (1959).

24. INT. REV. CODE OF 1954, § 531.

25. INT. REV. CODE OF 1954, §§ 541-47. A closely-held corporation with 50% stock

collapsible corporation section.<sup>26</sup>

Since a corporation cannot pass losses directly to its owner, a modification of the preceding cash throwoff analysis is necessary. Operating losses early in the project's life confer no direct tax benefit upon the corporation's owner. Neither do they confer immediate tax benefit upon the corporation unless it has other income against which the losses can be offset. Net operating losses may be carried forward for only five years to offset whatever later profits arise. Thus, the prudent investor will carefully estimate early-life operating income before he chooses a depreciation method since too rapid depreciation could generate unusable tax losses.

### III. THE TREASURY AND THE CONGRESS

In his 1962 appearance before the Senate Committee on Finance, Secretary Dillon proposed that depreciation on realty and personalty be subjected to recapture. That is, to the extent that a sale of property produced gain attributable to previously allowed depreciation deductions, the gain should be taxed as ordinary income. To show the need for the proposal as it would affect real estate, Treasury exhibits<sup>27</sup> introduced before the Committee detailed various investor uses of the principles mentioned in the first part of this note. However, Secretary Dillon added, if Congress would first amend section 167 to disallow accelerated depreciation of real property, and thus get at the essence of the tax shelter, the Treasury deemed it appropriate to have a sliding scale cut-off of recapture.<sup>28</sup> He conditionally proposed that real estate depreciation subject to recapture be reduced by one percentage point for each month over six years that the property had been held by the taxpayer. At the end of a seven-year holding period, for

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ownership in not more than five individuals and with 60% of its income composed of investment type income, as defined in § 543, will generally be subject to the 70% personal holding company tax on undistributed income. If gross rents received, less depreciation, property taxes, interest and rents paid, account for more than 50% of the corporation's income, it will not be treated as a personal holding company. Otherwise, it will be. Therefore, the investor must be wary of using his real estate corporation's accumulated earnings for investments other than in rental real estate.

26. INT. REV. CODE OF 1954, § 341. Although this section is an intricate one, basically it provides that a corporation is collapsible if it is formed or availed of to produce, construct, or manufacture property with a view toward sale of the property before the taxable income it could produce is substantially realized. A shareholder disposing of his stock in such a corporation realizes ordinary income rather than capital gain. See generally BITTKER, *op. cit. supra* note 23, ch. 10. This section could, in some circumstances, mitigate against the use of the corporate form by real estate investors interested in selling a project as soon as rapid depreciation subsides. For applicability generally of § 341 to real estate investments, see ANDERSON, *op. cit. supra* note 3, at 371-74, 381-83.

27. See 1962 *Senate Hearings*, pt. 1, at 352-70.

28. *Id.* at 87-89.

example, only eighty-eight per cent of accumulated depreciation would be recaptured. After fourteen years and four months, there would be no recapture at all. This cut-off proposal was designed "to meet the assertion of real estate investors that such ordinary income treatment would operate peculiarly in the real estate area to lock them into their investments after a long period of time. . . ." <sup>29</sup> An investor is locked into his investment if, upon seeing that his paper profits will be reduced substantially by a tax bite, he elects to forego any sale that might trigger the tax.

In their testimony before the Committee, real estate investors<sup>30</sup> responded with the following arguments. First, excessive depreciation benefits are purely temporary in nature because they occur over only a part of an asset's life. Second, since real estate is a relatively illiquid investment, rates of return must be sufficiently high to attract investors. With restricted depreciation allowances and harsh recapture rules, production of new rental housing would be considerably dampened. Additionally, the lock-in effect of recapture would seriously hamper mobility of capital. In short, "technical" tax reform "will do serious harm to [these] more basic national considerations . . . ." <sup>31</sup>

For personal property, full depreciation recapture became law in the Revenue Act of 1962.<sup>32</sup> Nevertheless, the House Ways and Means Committee Report accompanying H.R. 10650 stated: "Your committee decided not to apply this treatment to buildings . . . at this time because testimony . . . indicated that this treatment presents problems where there is an appreciable rise in the value of real property attributable to a rise in the general price level over a long period."<sup>33</sup> In its report, the Senate Committee on Finance noted without further comment that it had made no change in the House bill in this regard.<sup>34</sup> As a result, the Revenue Act of 1962 contained no provision for recapture of depreciation on real property.

When the Treasury went before Congress again in 1963, its proposal remained unchanged.<sup>35</sup> What emerged from the House Committee on Ways and Means bore only a superficial resemblance. The House

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29. *Id.* at 88.

30. See 1962 *Senate Hearings*, pt. 8, at 3553-64 (statement of Emil Gould, Nat'l Ass'n of Homebuilders).

31. *Id.* at 3557.

32. Section 13 of the Revenue Act of 1962, P. L. 87-834, 87th Cong., 2d Sess. (Oct. 16, 1962), adding § 1245 to the INT. REV. CODE OF 1954.

33. H.R. REP. NO. 1447, 87th Cong., 2d Sess. 67 (1962).

34. S. REP. NO. 1881, 87th Cong., 2d Sess. 95 (1962).

35. STAFF OF THE JOINT COMM. ON INT. REV. TAXATION, 88TH CONG., 1ST SESS., SUMMARY OF THE PRESIDENT'S TAX MESSAGE OF 1963 67-68 (Comm. Print 1963).



version was enacted into law<sup>36</sup> and is presently section 1250 of the Internal Revenue Code. It provides that depreciation allowed on realty shall be recaptured to the extent that it *exceeds* straight-line depreciation.<sup>37</sup> Lest even this be too severe, Congress adopted the idea of a sliding scale reduction as originally suggested by the Treasury, though in quite a different context. Contrary to the Treasury's stipulation, section 167 was not amended to impose any new limitation upon the choice of methods for depreciating realty. Under section 1250's sliding scale, however, the one percentage point per month reduction of recapture begins not at the end of a six-year holding period, but at the end of a twenty-month period. Thus there is no recapture at all if depreciable real property is held for ten years. All depreciation allowed is recaptured, however, if the property is sold within the first twelve months.

For the hypothetical investment project discussed earlier, Table 5 shows the amount of double declining balance depreciation that would be subject to recapture under section 1250 at the end of each of the first ten years. Thereafter, there would be none at all.

TABLE 5  
ANALYSIS OF DEPRECIATION  
SUBJECT TO RECAPTURE UNDER § 1250

End of Year	Total DDB Depreciation Taken	Depreciation Subject to Recapture	
		Amount	Percent of Total Depreciation Taken
1	58,330	58,330	100
2	112,640	52,128	46
3	163,240	63,613	39
4	210,530	67,572	32
5	254,690	65,304	26
6	296,030	58,085	20
7	334,800	47,020	14
8	371,110	33,060	9
9	405,240	17,125	4
10	437,260	-0-	-0-

In the last column of the table, depreciation subject to recapture is

36. Section 231 of the Revenue Act of 1964, P. L. 88-272, 88th Cong., 2d Sess. (Feb. 26, 1964).

37. The amount of depreciation subject to recapture is not the sum of annual excesses of rapid depreciation over straight line depreciation. Rather, it is the cumulative excess. Thus if property is held until annual rapid depreciation becomes less than annual straight-line, the amount subject to recapture will begin an annual decline. See the illustration at H.R. REP. No. 749, 88th Cong., 1st Sess. A151 (1963).

TABLE 6  
ANALYSIS OF DEPRECIATION RECAPTURE AND  
RATE OF RETURN ON INVESTED CAPITAL

	Section 1250 Depreciation Recapture			All Depreciation Recaptured		
	Double Declining Balance	Straight Line	Sinking Fund	Double Declining Balance	Straight Line	Sinking Fund
Total gain	254,690	145,850	57,003	254,690	145,850	57,003
Ordinary income	65,304	—	—	254,690	145,850	57,003
Capital gain income	189,386	145,850	57,003	—	—	—
Total tax	84,713	36,463	14,251	166,799	93,280	35,084
Net sale proceeds	353,270	353,270	353,270	353,270	353,270	353,270
Less tax	84,713	36,463	14,251	166,799	93,280	35,084
Net cash realized from sale	268,557	316,807	339,019	186,471	259,990	318,186
Cash throwoff in five years	93,621	40,120	( 8,470)	93,621	40,120	( 8,470)
Tax free interest on throwoff compounded annually at 3%	6,641	2,776	( 331)	6,641	2,776	( 331)
Net cash from investment	368,819	359,703	330,218	286,773	302,886	309,385
Less return of capital	200,000	200,000	200,000	200,000	200,000	200,000
Net profit from investment	168,819	159,703	130,218	86,733	102,886	109,385
Average annual rate of return	16.88%	15.97%	13.02%	8.67%	10.29%	10.94%

shown as a per cent of total depreciation taken. This column is demonstrative of section 1250's mildness. A similar tabular analysis has led one writer to comment: "One point which cannot be over-emphasized is the relatively mild impact of section 1250. The section should not discourage any taxpayer from taking accelerated depreciation."<sup>38</sup>

The Treasury's original proposal sought full recapture of all depreciation taken on realty unless Congress restricted choice of depreciation methods. First under section 1250 recapture and then under full recapture, Table 6 compares overall rates of return on invested capital according to selected depreciation methods. These assumptions are made: The hypothetical investment property is sold at the end of five years for a total price of 1,200,000 dollars, a sum just equal to the original cost basis. Therefore, gain results only from depreciation adjustments to the cost basis. Tax is computed under the same assumptions about taxpayer income reflected in Tables 3 and 4. Again, income averaging is ignored.<sup>39</sup> Net sale proceeds are 1,200,000 dollars less the unpaid mortgage principal of 846,730 dollars, or 353,270 dollars. Net cash produced by the investment project is calculated by adding to the net sale proceeds the total cash throwoff plus 3 per cent tax-free interest compounded annually thereon. Then the average annual rate of return on the original invested capital is shown.

One may make two general observations from the information in Table 6. Section 1250 recapture does not tend to influence this taxpayer's rate of return in a manner which causes him to select the slower methods of depreciation; whereas, full recapture would tend so to do. Perhaps even more significant is a comparison of the highest rate of return under section 1250 recapture to the highest rate under full recapture. An amazing, though not unusual, seventeen per cent annual rate of return with section 1250 recapture drops only to eleven per cent with full recapture.

Section 1250 overrides several other preferential tax treatment provisions of the Code, as does the earlier enacted section 1245.<sup>40</sup>

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38. Horvitz, *Sections 1250 and 1245: The Puddle and the Lake*, 20 TAX L. REV. 285, 342 (1965).

39. The telescoping effect, to the extent it is unmitigated by the operation of income averaging rules, may aid the Treasury as against an individual taxpayer. High ordinary income resulting from a large amount of recaptured depreciation may spread over a number of tax rate brackets even with income averaging, perhaps driving the effective tax rate on this income higher than the taxpayer's effective tax rate on the depreciation deductions claimed in earlier years. However, splitting the recapture among a number of owners, as in a syndicate or real estate investment trust, tends to mitigate the telescoping effect.

40. For an illuminating, comprehensive discussion of the technical operation of these sections, see Horvitz, *supra* note 38. For another comprehensive discussion of §

Unless an exception or limitation is specified, section 1250 was intended to recapture depreciation whenever there occurs a disposition of any kind.<sup>41</sup> Even in instances where capital gain is presently unrecognized, depreciation will be recaptured, primarily because a transferee does not receive the transferor's basis. For example, a distribution of real property as a corporate dividend creates a recapture liability for the corporation, because the shareholder's basis becomes fair market value at the date of distribution. Generally, where a basis carryover is possible, ordinary income potential, that is, accumulated depreciation subject to recapture, is also carried over. For example, a donor's basis and his ordinary income potential carry over to the donee and a distributee partner receives the partnership's ordinary income potential. Though generally basis carryover is the rule, special recapture computational rules are often applied to like-kind exchanges in the year of exchange. These special rules may cause a recognition where formerly there was none if ordinary income potential would be inadequately carried over. In otherwise tax-free transfers, the passing of any boot usually causes recognition of ordinary recapture income. Where recapture would otherwise be foreclosed by a disposition, operation of section 1250 may be triggered. For example, charitable contribution deductions under section 170(e) must be reduced by any ordinary income potential. But the great leveler, death, levels ordinary income potential just as it does capital gain potential.

On balance then, it would seem that the real estate investor was treated quite gingerly by Congress. Why, one asks, especially in view of the Treasury's success with section 1245's relatively stringent rules. The House Ways and Means Committee gave this rationale for section 1250's mildness:

Your committee generally has limited the depreciation recapture to the excess over straight line depreciation because it believes that only to this extent could the depreciation taken appropriately be considered in excess of the decline in the value of the property which occurs over time. If a gain still occurs, it is believed that this is attributable to a rise in price levels generally rather than to an absence of a decline in the value of the property. The portion representing the rise in value is comparable to other

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1245, see Schapiro, *Recapture of Depreciation and Section 1245 of the Internal Revenue Code*, 72 YALE L.J. 1483 (1963). Tax Management, Inc., a division of BNA, in its portfolio series publishes a useful practitioner's manual on the technical operation of these sections: 97 T.M. *Depreciation Recapture—Sections 1245 and 1250 (1964)*. See also Fuller, *The Recapture of Depreciation*, 39 TUL. L. REV. 15 (1964); Lasseigne, *The Revenue Act of 1964: Depreciation of Real Property, Controlled Corporations and Personal Holding Companies*, 39 TUL. L. REV. 41 (1964).

41. H. REP. No. 749, 88th Cong., 1st Sess. 104 (1963). Section 1245 was similarly intended and similarly written.

forms of gains which quite generally are treated as capital gains. Moreover, your committee believes that when the property is held for an extended period of time, gains realized on the sale or other disposition of the property are more likely to be attributable to price rises generally than to an excess of depreciation deductions.<sup>42</sup>

Quite a different reason can be inferred from this passage from "Requiem":

I next shall attempt a brief survey of some of the important economic groups in our society and how they are faring in the race for special benefits. To a large extent favored treatment is being conferred in a sporadic manner, without regard to what privileges are available to one class and withheld from another. Cases evoking sympathy and a desire to provide benefits are individually brought to the attention of Congress, and treated upon an ad hoc basis.

Those individuals who are well advised, or especially fitted by occupation, training, and background, are likely to be able to realize fully the opportunities for minimizing their tax burdens. Today the large investor probably constitutes the most important beneficiary of preferential treatment.<sup>43</sup>

The National Association of Homebuilders, "the sole national spokesman of the homebuilding industry in the United States,"<sup>44</sup> exerted substantial efforts at the 1962 and 1963<sup>45</sup> congressional hearings to defeat first, and successfully, the original Treasury proposal and then, unsuccessfully, the House version later enacted as section 1250.<sup>46</sup> There was no organized, stiff resistance to section 1245.

42. H.R. REP. No. 749, 88th Cong., 1st Sess. 102-03 (1963). The Senate Committee adopted this view, in substantially unchanged wording. S. REP. No. 830, 88th Cong., 2d Sess. 133 (1964).

43. Cary, *supra* note 1, at 763.

44. 1962 Senate Hearings, pt. 8, at 3554 (statement of Emil Gould, Chairman, Tax Studies Committee, Nat'l Ass'n of Homebuilders).

45. The organization's statement concerning the Revenue Act of 1962 is found in 1962 Senate Hearings, pt. 8, at 3553-64. See also *Hearings on the President's 1961 Tax Recommendations Before the House Committee on Ways and Means*, 87th Cong., 1st Sess., v. 2, at 1233-39 (1961) (statement of E. J. Burke, Jr., President, Nat'l Ass'n of Homebuilders) [the Hearings are hereinafter cited as *1961 House Hearings*]. Its 1963 testimony is found in *Hearings on H.R. 8363 Before the Senate Committee on Finance*, 88th Cong., 1st Sess., pt. 4, at 1983-89 (1963) (statement of W. Evans Buchanan, President, Nat'l Ass'n of Homebuilders, as presented by Leonard L. Silverman, Tax Counsel) [the Hearings are hereinafter cited as *1963 Senate Hearings*].

46. In the 1963 testimony that failed to get § 1250 modified, it is interesting to note the NAHB's proposal: "While NAHB appreciates the problems involved in this area and therefore does not quarrel with the general objectives of this section, we believe that the sliding scale should be changed so as to reduce the resulting lock-in of investment in depreciable realty." *Id.* at 1984. And, "we would see merit in this provision if the sliding scale reallocation from ordinary income to capital gain potential presently set at 1 percent per month after a holding period of 20 months was to be increased from 1 to 2 percent per month. . . . The 'lock-in' period would thus be reduced from 10 years to approximately 6 years." *Id.* at 1987.

One survey<sup>47</sup> of major corporation executives indicated that management would have been more than willing to give up recapture, or even the whole section 1231, in order to get favorable depreciation reform.<sup>48</sup> Furthermore, depreciation recapture on machinery is not uncommon in the tax laws of other industrial nations.<sup>49</sup> Senator Paul H. Douglas offered still another reason for the Treasury's failure in 1963:

The administration initially made a partial but somewhat ineffectual effort at tax reform. But when most of its proposals were rejected by the House Ways and Means Committee, they ceased to fight with any vigor except on two matters [neither of which was section 1250's mildness].<sup>50</sup>

#### IV. THE ECONOMISTS' ARGUMENTS

Two pervasive concepts of taxation, depreciation and capital gains, necessitated the legislature's real estate depreciation recapture provision. Although there is a substantial amount of economic literature on both,<sup>51</sup> there is little theoretical unanimity on either.

Obviously, were capital gains not differentiated from other kinds of income and granted preferential tax treatment, the recapture question would not arise at all. What are capital gains? Why are they treated differently? Professor Blum, in the most comprehensive article on the capital gains controversy, suggests this pragmatic view:

A capital gain in the context of an income tax is a wholly arbitrary concept created exclusively by the tax law. It is easy to be misled into thinking otherwise.

This is not to say that the tax law cannot find conceptions of capital gains to copy and expand. Rather, the difficulty is that there are too many different ones and they are inconsistent with each other. Thus the tax law struggles to incorporate such diverse notions of capital gains as unusual or non-recurring gains; gains due to market fluctuations; unexpected gains; gains accruing over long periods of time; gains not attributable to services

47. Powell, *Management Views of Tax Depreciation*, IND. BUS. REP. No. 34, 24-25, 59 (1962). Results of this study were also published in Milroy, Istvan & Powell, *The Tax Depreciation Muddle*, 36 ACCOUNTING REV. 540 (1961).

48. Acting in its administrative capacity in July, 1962, the Treasury Department contributed significantly to the depreciation liberalization that management sought by issuing *Depreciation Guidelines and Rules*, I.R.S. PUB. No. 456, Rev. Proc. 61-21 (rev. Aug., 1964). In that same year Congress liberalized salvage value rules and passed the investment credit, all as a part of the program to stimulate modernization of the economy's industrial plant.

49. See, e.g., the Treasury survey of depreciation recapture in other countries in 1962 *Senate Hearings*, pt. 2, at 928-31.

50. S. REP. No. 830, 88th Cong., 2d Sess. 164 (1964). Once again is demonstrated the political problem arising to hamper tax reform when it is inextricably linked with broad fiscal policy measures such as the 1964 tax rate reduction bill.

51. See the bibliography appended to this note.

rendered by the gainer.

More and more the law has come to depart from any non-tax conception of capital gain and to recognize frankly that a capital gain is merely some form of income taxed at a bargain rate.<sup>52</sup>

If there is then no natural economic law of capital gains, one necessarily must proceed on an *ad hoc* basis. A capital gain is what the tax law says it is. In each instance the issue is why do lawmakers call something a capital gain. The reason given by Congress for section 1250 was that gains accruing over long periods of time are apt to be due to price level changes; depreciation allowances, to the extent not "excessive," reflect "declines in value."<sup>53</sup> Therefore, except for "excessive" depreciation, these gains will be treated as capital gains. There are in this reasoning two elusive concepts, value decline and excessive depreciation. First, if property can be sold at a gain, how is it possible to reason that there has been a decline in value? The idea alluded to is that a building will physically deteriorate over a period of time. Immediately one is tempted to conclude that its value has declined. But the economist recognizes the value of a capital asset to be the present value of its discounted stream of future receipts. Expectations concerning this stream create market values. Many forces mold expectations; still others determine the building's receipt stream, only one of which is physical condition. As has been pointed out, given good management and maintenance policies, even the building's physical condition may improve with age. Management, of course, is service rendered by the gainer, something which is usually taxable as ordinary income. Another little recognized service contributed by the gainer is his entrepreneurship in directing the assembly of bricks, mortar, and labor into a building. This personal service factor alone may account for a newly erected building having value in excess of the cost of its components, including labor.

The problem encountered in formulating laws to recognize these many variables, and to tax them accordingly, is one of quantification, that is, of measurement. When the convenient spectre of inflation is involved, it is not surprising that the other variables get ignored. Fundamentally, there is not a close correlation between changes in the value of money and the price of a *specific* complex asset like a building. The price of a given building may rise quicker than the value of the dollar declines, it may rise slower, or it may not rise at all. After all, the inflation question should not be how to tax assets, but how to tax people. "If redistribution [of income and property]

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52. Blum, *A Handy Summary of the Capital Gains Arguments*, 35 TAXES 247, 262-63 (1957).

53. H.R. REP. No. 749, *supra* note 42.

by inflation is unfair, then surely taxation of inflationary gains does not move in an inequitable direction."<sup>54</sup> Nevertheless, the recapture issue is not whether to tax as ordinary income all inflationary gain even if it could be accurately identified, but whether to tax as ordinary income that portion of gain, whatever gives rise to it, attributable to past ordinary income deductions. Thus recapture is a tax benefit argument, which hardly seems inequitable when balanced against the imponderables of inflation and these other variables. The averaging law now provides a mitigation for the telescoping effect, or bunching of ordinary income into a single period, so as to prevent, generally, a tax burden in the year of recapture disproportionate to the tax benefits obtained from depreciation deductions in earlier years.

The second and even more economically elusive concept is "excessive" depreciation. Its genesis is probably the Treasury proposal which would have limited real estate depreciation to the amounts deductible under the straight-line method. From this proposal, the fathers of section 1250 probably fastened onto the notion that straight-line depreciation is normal. Consequently, accelerated depreciation must be abnormal; therefore, the difference between the two is "excessive." If this was the chain of intuitive reasoning underlying the concept, it is difficult to imagine why the sliding-scale discount feature was adopted. Probably, the creators of section 1250, noticing that the original Treasury plan had contained such a feature, adapted it for their own purposes:<sup>55</sup> in the name of inflation, recapture should be mild, and here was a moderating device which could handily be used. One also wonders what made Congress think straight-line depreciation is normal depreciation since the only evidence<sup>56</sup> presented

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54. Blum, *supra* note 52, at 256.

55. Although the distortion of the Treasury's real property depreciation recapture proposal was probably more subtle, the proposal being more complex, elsewhere in its 1963 H.R. 8363, the House Ways and Means Committee had lifted Treasury proposals out of context so as to favor investors as an economic group. One of the administration's most eagerly sought reforms was constructive taxation of capital gains at death. To make this proposal more attractive, the Treasury packaged it with a favorable revision of capital gains rates. The proposal for taxation of capital gains at death sank without a trace in the Committee but the favorable revision of capital gains rates did not. It passed the Committee, and it passed the House. To defeat it the administration had to mount an all-out campaign. This was one of the two hard fights mentioned by Senator Douglas. The other hard fight was over the dividend tax credit, another investor-favoring measure that the administration had sought to eliminate. See Senator Douglas' commentary in S. REP. No. 830, 88th Cong., 2d Sess. 163-67 (1964).

56. In one real estate expert's words, "It seems to be accepted in the real estate industry that depreciation is measured by mortgage amortization—the amount that you have to pay off on the mortgage, by and large, is considered about equivalent to current wastage of asset." 1961 *House Hearings*, v. 2, 1247 (statement of Mark H. Johnson) (quoted in a Treasury exhibit in 1962 *Senate Hearings*, pt. 1, at 356).



in the hearings tended to indicate that sinking fund depreciation is more likely to represent "actual declines in value." Before enactment of section 1250, but after passage of section 1245, Mr. Donald Schapiro worried that windfall gains on personalty might be taxed as ordinary income via recapture.<sup>57</sup> He therefore suggested that only excessive depreciation be recaptured. His rule, however, was to define excessive depreciation as the difference between depreciation taken and sinking fund depreciation. Adopting the notion later to be used by Congress, Mr. Schapiro equated "actual decline in value" with depreciation which reflects a using-up of the asset's service life. He then persuasively stated the economic case for his recapture rule as follows:

The decline in the value of an asset in any year, which reflects the consumption of useful service life, may be measured by the loss of one year's useful service life at the end of an asset's life. A depreciable asset may be expected to generate a stream of income over its useful service life, and the present value of the asset is the discounted value of the stream of income plus the asset's salvage value. Utilization of the asset for one year reduces by one year the period during which the stream of income may be expected, but the discounting process attaches less value to the last year of the stream of income in comparison to earlier years. Since it is this value which has been exhausted, under this valuation theory the value of an asset is reduced in its early life by an amount less than straight-line depreciation. This method of depreciation is referred to as sinking fund depreciation. The best approach may be to limit recapture of depreciation deductions on all depreciable property (buildings and leaseholds as well as personal property) to the amount by which depreciation actually allowed exceeds the amount allowable under the sinking fund method (assuming for simplicity a single, perhaps 5 per cent rate of interest). This rule would deal in an economically rational manner with all taxpayers, and it would eliminate the inconsistent results which section 1245 may produce when changed economic conditions have caused substantial appreciation in value.<sup>58</sup>

If one is willing to concede the elusive concept of "actual decline in value," and, as a logical result, becomes willing to concede recapture only of "excessive" depreciation, then Mr. Schapiro's argument is far more rational than the one found in the congressional reports.<sup>59</sup> A comparison of the amounts of depreciation subject to recapture under section 1250 on the one hand, and under Mr. Schapiro's sinking fund proposal on the other, is set forth in Table 7. This table, like

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57. Schapiro, *supra* note 40, at 1507-12. He cited a case in which a ship's selling price had become inflated as a result of the Suez crisis. *Fribourg Nav. Co. v. Commissioner*, 335 F.2d 15 (2d Cir. 1964), *aff'd*, 383 U.S. 272 (1966). Professor Blum's comment mentions an unexpected or windfall gain as one of the diverse concepts of capital gains. *Fribourg* is a classic illustration of this sort of gain.

58. Schapiro, *supra* note 40, at 1509-10.

59. The congressional argument is quoted in text accompanying note 42 *supra*.

Table 5, shows double declining balance depreciation actually taken on the hypothetical investment project for each of the first ten years.

TABLE 7  
COMPARISON OF SINKING FUND RECAPTURE  
TO SECTION 1250 RECAPTURE

End of Year	Total DDB Depreciation Taken	Sinking Fund Depreciation Allowable	Depreciation Subject to Recapture		
			Sinking Fund Proposal	Section 1250	Difference
1	58,330	10,112	58,330*	58,330	-0-
2	112,640	20,831	91,809	52,128	39,681
3	163,240	32,193	131,047	63,613	67,434
4	210,530	44,237	166,293	67,572	98,721
5	254,690	57,003	197,687	65,304	132,383
6	296,030	70,535	225,495	58,085	167,410
7	334,800	84,879	249,921	47,020	202,901
8	371,110	100,084	271,026	33,060	237,966
9	405,240	116,201	289,039	17,125	271,914
10	437,260	133,285	303,975	-0-	303,975

\*Here it is assumed that all depreciation taken is recaptured if there is a sale at the end of year one, as is provided by section 1250.

The last three columns of the table show first "excessive" depreciation subject to recapture under a six per cent sinking fund proposal, next the amount under section 1250, and finally, the difference between the two. This difference is the amount of "excessive" depreciation (as defined pursuant to at least some measure of economic logic) which Congress and section 1250 leave unrecaptured. It is not inconsiderable during the crucially profitable first ten years of a tax shelter's life, as inspection of the dollar amounts in the column will reveal.

Another argument against recapture was often raised in the congressional hearings although it was not vigorously propounded in the committee reports as was the price-level argument. Investors assert a lock-in effect of recapture, which, according to Secretary Dillon,<sup>60</sup> had caused the Treasury to propose the sliding-scale cut-off. The lock-in assertion is a mobility of capital argument, aimed at tax-caused hindrances of rational economic decision making. Recapture, so goes the argument, will bias the investor against freely transferring his funds from one investment to another on their economic merits,

60. 1962 Senate Hearings, pt. 1 at 87-89.

if upon so doing, his capital<sup>61</sup> will be reduced by an increased tax bite. Thus investors, as a class, become less willing to transfer assets, and capital becomes less mobile. Although the argument is not without some economic logic, the lock-in effect has probably been vastly overrated.<sup>62</sup> As long as demand for rental housing continues to increase because of both population and income increases, capital will mobilize to build profitable rental housing. Continual increases in demand are far more powerful stimulants than recapture is a depressant.

A second reason exists for paying little heed to the lock-in argument. It fails to place recapture in the perspective of the overall tax system. The primary question to be raised is this: do our present tax laws reflect a strong underlying policy of protecting capital's mobility, of zealously guarding rational investment choice? Emphatically, they do not. Many economists reason that section 1014's basis step-up at death is the worst lock-in feature of our tax laws. This reasoning is a more realistic appraisal of why the tax law causes an investor to hold property rather than sell it. It is not his reluctance to lose part of his appreciation to the tax collector that keeps him from selling; instead, it is his sure knowledge that his economic unit, his family, can wholly avoid the tax on that appreciation when he dies. Analogous reasoning may be applied to the sliding-scale cut-off feature of section 1250 recapture. An investor, knowing that the longer he holds his real estate the lower becomes its ordinary income potential,

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61. Note that "capital" here means original capital plus appreciation thereon. To digress momentarily, the tax bite comes from the appreciation, not from original capital. If appreciation is income, why should it be taxed preferentially? A dollar is a dollar, from whatever source derived. In Professor Blum's opinion, this statement is "perhaps decisive" for non-preferential taxation of capital gains. Blum, *supra* note 52, at 266.

62. To this writer, the lock-in argument is more economic mythology than economic reason. It is not unlike another economic myth now on the wane (see *Time*, Dec. 31, 1965, cover story on Keynesian economics, pp. 64-67B), that only a balanced federal budget is sound fiscal policy. Like the balanced budget which can be desirable within certain, reasonably narrow, limits, lock-in can be a deterrent in certain investment situations, but it doesn't take much to overcome the lock-in effect. See Professor Walter Heller's careful analysis of the lock-in mythology concerning the capital gains tax, an analysis demonstrating just what a small percentage point shift in the rate of return on alternative investments is needed to overcome an investor's reluctance to shuffle his securities portfolio, thereby incurring a tax asserted to be locking him into his investment. *Hearings Before the Subcommittee on Tax Policy of the Joint Committee on the Economic Report*, 84th Cong., 1st Sess., 309-11 (1956). Another strong parallel between the lock-in myth and the balanced-budget myth is that, though vigorously urged, it is usually unaccompanied by any detailed analysis of the probable economic results and ramifications of the measures its proponent is seeking from Congress. Compare the statement of Jonathan Brown of the New York Stock Exchange to Professor Heller's. *Id.* at 307. Two unstated premises of the lock-in assertion are that any deterrent to free movement of investment funds is economically undesirable, and that investors always behave rationally in refusing to incur taxes. A challenge to these premises may be found in Blum, *supra* note 52, at 258.

will be tempted to wait out the sliding-scale. In contrast, the real estate lobby had actually used its version of the lock-in argument to urge adoption of sliding-scale cut-off of recapture in the first place. Though probably somewhat overstating his case, one commentator has estimated "as a general range of magnitudes that probably four-fifths of all capital gains accrue outside the tax system."<sup>63</sup> On the other hand, of all long-term capital gain reported by individuals in, for example, 1959, only eighteen per cent was attributable to real estate.<sup>64</sup> Thus, real estate depreciation recapture, full or partial, is unlikely to impose relatively significant immobility on the economy's capital movements. True enough, less new capital might be used for construction of new rental properties because they are less tax-favored, but the whole idea of mobility of capital anyway is that investment decisions should be made on their economic merits, not on their tax merits.

If, in the final analysis, the tax law should be neutral in its effect upon economic decision-making in real estate capital formation, reform of present depreciation provisions is needed, rather than an attempt at recapturing the "excessive" depreciation presently allowed by the Internal Revenue Code. A discussion of the depreciation policy required to prevent tax-caused decisions, along with a mathematical proof of the conclusion reached, was presented in a recent paper by one of the nation's most distinguished economists, Professor Paul A. Samuelson, who writes:

How must "income" be defined if present discounted valuations of all assets, and therefore all optimization decisions, are to be independent of the tax rate each person is subject to?

*Fundamental theorem of tax-rate invariance.* —

If, and only if, true loss of economic value is permitted as a tax-deductible depreciation expense will the present discounted value of a cash-receipt stream be independent of the rate of tax.

• • •

The only sensible definition of depreciation relevant to measurement of *true money income* is putative decline in economic value. Fast-depreciation gimmicks in the Swedish, Japanese, German, British, and American tax codes are *not* a return to just recognition of economic obsolescence. . . . They are . . . designed to undertax *money* income (and perhaps obviate the bias against capital formation inherent in taxing income rather than consumption or wealth).<sup>65</sup>

#### The Committee on Concepts and Standards of the American Ac-

63. Groves, *Taxation of Capital Gains*, 2 TAX REVISION COMPENDIUM 1194, HOUSE COMM. ON WAYS AND MEANS, 86TH CONG., 1ST SESS. (Comm. Print 1959).

64. 1963 Senate Hearings, pt. 1, at 197.

65. Samuelson, *Tax Deductibility of Economic Depreciation to Insure Invariant Valuations*, 72 J. POL. ECON. 604, 606 (1964). But see Smith, *Tax Depreciation Policy and Investment Theory*, 4 INT'L ECON. REV. 80 (1963).

counting Association has acceded to this view, which would require any standard for measurement of current income to recognize "the current cost of the expiration of asset service potential,"<sup>66</sup> that is, to recognize Professor Samuelson's putative decline in an asset's economic value. Nevertheless, the influential American Institute of Certified Public Accountants still adheres to the cost-expiration, timetable concept of depreciation reflected in the Internal Revenue Code.<sup>67</sup> Its central defense of this admittedly theoretically deficient concept is based upon a practical need for an easily applied, mechanically objective method for cost allocation. Whatever the reasons of convenience proffered for its usage, a cost allocation methodology for depreciation tax deductions tends to cause uneconomic investment decision making.

#### V. A CONCLUSION AND SOME SUGGESTED REFORMATIVE GUIDELINES

Inescapably, the real estate tax shelter still exists, and is practically unmodified by section 1250. A reform measure originally designed by the Treasury to strike at its essence, and in the process increase annual tax revenues by eighty million dollars,<sup>68</sup> was substantially rejected by the Congress which passed section 1250, a measure increasing annual tax revenues by only fifteen million dollars.<sup>69</sup>

One question raised at the time should again be posed and answered. Do our depreciation tax laws need to favor real estate development purely in the interests of economic growth and capital formation in the American economy? It is here submitted emphatically that the answer should be "no," that instead an elaborate machinery capable of pervasively influencing both growth and stability in construction is already existent, a machinery capable of being far more satisfactory and far less insensitive than the tax laws, the federal mortgage credit program. Recently, that program has undergone searching congressional studies evaluating its adaptability to achieving the goals of growth and stability in the construction sector of the economy.<sup>70</sup> Con-

66. Committee on Concepts and Standards, American Accounting Association, *Accounting for Land, Buildings, and Equipment*, 39 ACCOUNTING REV. 693, 695-96 (1964). The American Accounting Association is composed of college and university accounting teachers.

67. See COMMITTEE ON TERMINOLOGY, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, ACCOUNTING TERMINOLOGY BULLETINS, REVIEW AND RESUME No. 1, 20-25 (1961), published in ACCOUNTING RESEARCH AND TERMINOLOGY BULLETINS, FINAL EDITION (1961). See also GRADY, INVENTORY OF GENERALLY ACCEPTED ACCOUNTING PRINCIPLES FOR BUSINESS ENTERPRISES 415-21 (AICPA Accounting Research Study No. 7, 1965).

68. 1962 Senate Hearings, pt. 1, at 89. By way of comparison, full recapture of personalty depreciation under § 1245, it was estimated, would increase revenues by 100 million dollars, only twenty million more.

69. 1963 Senate Hearings, pt. 1, at 239.

70. SUBCOMMITTEE ON HOUSING, SENATE COMM. ON BANKING AND CURRENCY, 86TH

clusions there reached were (1) that the residential housing sector has been plagued by instability in the flow of capital funds and by greater cost inflation than most other sectors of the economy;<sup>71</sup> and (2) that flexible credit terms policy applied according to certain principles set out in the study can tend substantially to stabilize a high rate of growth in the construction sector, given the projected increases in demand over the next decades.<sup>72</sup> Though the study does not explicitly call for it, a depreciation tax policy economically neutral would seem a logical complement to the application of credit policy there recommended. Certainly, in view of inflationary, unstable capital formation tendencies in the sector, heavily favorable, even tempting, tax shelter practices are undesirable and unneeded.

Therefore, in descending order of economic merit, the following are ranked as guidelines for reform:

1. Restrict allowable depreciation of real estate improvements to sinking fund depreciation. This proposal is premised upon the need for tax neutrality in economic decision-making. Sinking fund depreciation would be the best timetable depreciation approximation of the probable decline in economic value of realty improvements, in view of the preceding economic analysis and of the generally accepted notions in the industry. Because of the present state of the accounting art, it is perhaps several years premature to suggest that the Internal Revenue Code ideally should reflect the valuation principles set out by Professor Samuelson and the American Association of Accountants.

2. Whatever the depreciation methodology allowable, recapture depreciation upon sale of real property to the extent that it creates gain. This proposal, though secondary to the preceding one, would tend to reduce the incidence of tax-caused investment decision-making in a sector of the economy where it is too prevalent. It also has an equitable appeal. It would not permit deductions from ordinary income to be transformed into capital gains. Note that it should really go hand-in-glove with proposal number 1, as a necessary complement.

3. Recapture depreciation to the extent that it exceeds sinking fund

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CONG., 2D SESS., STUDY OF MORTGAGE CREDIT (Comm. Print 1960). Also available is a thorough series of statistical studies on trends in capital formation sponsored by the National Bureau of Economic Research, three entries in which bear directly on the question at hand. See GREBLER, BLANK & WINNICK, CAPITAL FORMATION IN RESIDENTIAL REAL ESTATE: TRENDS AND PROSPECTS (1956); KLAMAN, THE POSTWAR RESIDENTIAL MORTGAGE MARKET (1960); KUZNETS, CAPITAL IN THE AMERICAN ECONOMY: ITS FORMATION AND FINANCING (1961).

71. See O'Leary, *Postwar Trends in the Sources and Uses of Capital Funds, 1947-57*, STUDY OF MORTGAGE CREDIT, *supra* note 70 at 209, 234.

72. REPORT ON STUDY OF MORTGAGE CREDIT, SUBCOMMITTEE ON HOUSING TO THE COMMITTEE ON BANKING AND CURRENCY, STUDY OF MORTGAGE CREDIT, *supra* note 70, at 401, 429-31.

depreciation. This is nothing more than a compromise between the views here expressed and the legislative views underlying section 1250. It is a compromise which does utilize some of the economic analysis that should be more frequently employed in this area.

4. Continue the reign of section 1250. This proposal has nothing to defend it except an observation that, on equitable grounds, it is better than to adopt the next alternative.

5. Recapture no real estate depreciation at all. This seems indefensible on any economic or equitable grounds.

To summarize, section 1250 is demonstrably mild. In its effort for tax reform, the Treasury sought a restriction to straight-line depreciation methods on real estate, and it sought imposition of ordinary tax on that part of gain from a sale of real property which was attributable to the straight-line depreciation deductions. Instead, Congress merely imposed a recapture on depreciation in excess of straight-line and even then only partially, depending on the length of the holding period. As manifested by the Committee Reports, section 1250's underlying rationale that price level movements primarily cause real property value appreciations is at best economically questionable. To whatever extent its passage was motivated by congressional feelings for mobility of capital, one can only demonstrate that those feelings are largely inchoate, but do tend to crystallize when a rationalization rather than a broad social policy is to be applied. In the spirit of Mr. Cary's "Requiem," a final comment—section 1250 does not at all brake the accelerating tendency toward preferential treatment of pressure groups and away from uniformity. The section's convolutions illustrate anew the often repeated observation that special treatment of capital gains contributes more complexity to the Internal Revenue Code than any other feature of our tax heritage.

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