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Residential Property

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RESIDENTIAL PROPERTY

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I would like to begin by looking at residential real estate as a tax shelter. The first and most important aspect is, of course, depreciation.

From 1954 through 1969 all real estate with a useful life of more than three years whose original use commenced with the taxpayer was eligible for the double declining balance method of depreciation.[1] Owners of used realty could use a maximum depreciation rate of 150% declining balance method.[2] In 1969 the Treasury Department stated in its tax reform proposals that accelerated depreciation was never intended to benefit real estate, but came along inadvertently when depreciation was liberalized for machinery and equipment.[3] Congress accepted this, and the 69 Reform Act substantially reduced the depreciation benefits for real estate.

DEPRECIATION

In order to determine what depreciation methods are available for property acquired after July 25, 1969, real estate must be classified in five categories which are: (1) new residential, (2) new commercial, (3) used residential, (4) used commercial, and (5) rehabilitation expenditures for low income housing.

First, as to new property. New residential rental property is still eligible for the double declining balance and the sum of the years digits methods.[4] New commercial property can be depreciated at a maximum rate of 150% declining balance.[5] Used residential rental property having a useful life of 20 years or more may be depreciated at a 125% declining balance method.[6] All other used realty must be depreciated on the straight line method.[7]

Since residential property is entitled to more favorable depreciation treatment than commercial property, let's look for a minute at the definition of residential property. Property will be treated as residential rental property if 80% or more of the annual gross rental income from a building is rental income from dwelling units.[8] The test is an annual one and the building may qualify one year and not the next.

A dwelling unit is defined as a house or apartment used to provide

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1 I.R.C. § 167(c).

2 Treas. Reg. § 1.167(b)-(o)(b).

3 TREASURY DEPARTMENT, TAX REFORM STUDIES & PROPOSALS, JOINT PUBLICATION, 91st Cong., 1st Sess. 445 (1969).

4 I.R.C. § 167(j)(2).

5 I.R.C. § 167(j)(1)(B).

6 I.R.C. § 167(j)(5).

7 I.R.C. § 167(j)(4).

8 I.R.C. § 167(j)(2)(B).

living accommodations, but does not include a unit in a hotel, motel, inn or other establishment if more than one-half of the units are used on a transient basis.[9] The Proposed Regulations require that a dwelling unit contain a kitchen and sleeping accommodations.[10] This definition is not entirely satisfactory in that it does not require bathroom facilities be available, nor does it make clear that efficiency apartments where the kitchen and the bed are in the same room qualify. It is believed that the final regulations will not contain a facilities test.

The regulations further provide that a dwelling unit will generally be considered to be on a transient basis if the normal rental term is less than thirty days.[11] In some states tenants renting units without a lease are tenants at will. Unless the regulation is changed, landlords will have to require a lease from such tenants.

If an owner occupies part of a building, the gross rental income includes the rental value of the portion occupied by the owner.[12]

If a building is planned as a combination residential and commercial structure, as for example a building in which the ground level floors are commercial and the upper floors residential, the property may not meet the 80% gross rental from dwelling units requirement. In such a case, it may be worthwhile to divide the ownership in order that the owner of the residential portion may take double declining balance depreciation.

Any realty not meeting the 80% rental test is subject to the more stringent depreciation methods of 150% declining balance for new property and straight line depreciation for used property.

DEPRECIATION RECAPTURE

In addition to limiting the circumstances when accelerated depreciation is allowable, Congress also tightened up the depreciation recapture rules for real estate which is disposed of after 1969. Prior to the 69 Reform Act, all real property was subject to the same recapture rules. If property was sold within a year of acquisition, then all depreciation taken was subject to recapture, even if the straight line method was used. In the case of real property which had been held for more than a year, the excess of accelerated depreciation taken over straight line was subject to 100% recapture unless the property was held for more than 20 months. For each month the taxpayer held the property beyond 20 months, the depreciation subject to recapture was reduced by 1% per month, so that any property held for ten years was free of recapture.[13]

Depreciation on real property taken after 1969, regardless of when

[9] I.R.C. § 167(k)(3)(C).
[10] Prop. Treas. Reg. § 1.167(k)-3(c)(1).
[11] Prop. Treas. Reg. § 1.167(k)-3(c)(2).
[12] Prop. Treas. Reg. § 1.167(j)-3(b)(4).
[13] I.R.C. § 1250(a)(2), (b)(1).

the property was acquired, is subject to changed recapture rules. For property sold within 12 months of its acquisition, the Reform Act retained the rule that all depreciation is subject to recapture.[14] In the case of property held for more than 12 months, however, the general rule now is that all post-69 depreciation allowances in excess of straight line are subject to complete recapture, regardless of how long the property was held.[15] Any gain recognized on the sale of real property is first applied against the post-69 additional depreciation, and if the gain exceeds the post-69 additional depreciation, the remainder is available for whatever pre-1970 depreciation is subject to recapture.[16]

For example, if real property with an adjusted basis of $5,000 is sold in 1971 for $7,000, the $2,000 gain would first be applied against post-1969 additional depreciation. If additional depreciation of $500 had been taken after 1969, it would all be recaptured, and the remaining $1,500 of gain would be applied against the pre-1970 additional depreciation, subject of course to decreased recapture for property held beyond 20 months.

Congress provided, however, a separate recapture provision for residential real estate. Both new and used residential property is subject to a recapture rule which is neither as harsh as the new general recapture rule nor as lenient as the pre-1970 recapture rule. The recapture of post-69 depreciation on residential property is reduced by one percentage point for each full month the property was held beyond 100 months.[17] Consequently, there will be no recapture on residential property disposed of after 16 years and 8 months.

There is a special recapture rule for FHA 221(d)(3) and 236 limited rental housing projects. Post-1969 depreciation on such projects is recaptured in the same manner as pre-69 depreciation whereby the amount recaptured decreases by one percentage point per month after 20 months.[18] This same favorable recapture rule applies to limited rental housing projects which are financed by a state or local government agency.[19]

REHABILITATION EXPENDITURES

Congress in 1969 resolved to encourage the rehabilitation of low income housing and carved out a whole set of favorable depreciation rules as an incentive. Taxpayers may elect to depreciate rehabilitation expenditures for low cost housing on the straight line method using a useful life of sixty months with no salvage value.[20]

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[14] I.R.C. § 1250(a)(1), (b)(1).
[15] I.R.C. § 1250(a)(1)(C)(v).
[16] I.R.C. § 1250(a)(2)(A).
[17] I.R.C. § 1250(a)(1)(C)(iii).
[18] I.R.C. § 1250(a)(1)(C)(ii).
[19] *Id.*
[20] I.R.C. § 167(k).

An example will show how great the tax benefits are when rehabilitation expenditures are coupled with federal financing, such as an FHA 236 loan. If rehabilitation expenditures total $1,000,000, FHA will insure a mortgage of $900,000 and the investor will contribute the remaining $100,000. During each of the first five years the investor can take a depreciation deduction of $200,000. If he is in the 50% tax bracket, he will save $100,000 each year, all for his initial cash outlay of $100,000.

To qualify for this fast-write-off the expenditures must meet detailed statutory requirements. The expenditures must be for the "rehabilitation of dwelling units" to provide "low income housing" for families and individuals of "low or moderate income." [21] Rehabilitation expenditures do not include the cost of the acquisition of a building, which must be depreciated under the regular depreciation rules, and separate accounts will have to be maintained.[22]

Distinguishing rehabilitation expenditures from new construction may present problems. The proposed regulations provide that the expenditures will generally be considered to be for rehabilitation if the foundation and outer walls of the existing building are retained.[23] This requirement seems somewhat harsh since sound rehabilitation often requires that one or more of the outer walls be replaced. Any enlargement of the total area occupied by the dwelling units in the rehabilitated area will be treated as new construction, rather than rehabilitation.[24] The regulations do provide, however, that expenditures for related common facilities such as a garage, sidewalk or parking lot are not considered enlargement of a building and therefore qualify as rehabilitation expenses.[25]

The definition of dwelling units is the same as that discussed earlier in connection with residential housing.

Rehabilitation expenditures must be incurred with respect to low income rental housing which is defined as buildings in which the dwelling units are held for rental by families and individuals of low or moderate income.[26] The low or moderate income requirement is to be determined by Treasury Regulations in a manner consistent with the policies of the Housing and Urban Development Act of 1968.[27] The Proposed Regulations provide that the low or moderate income requirement is met if the occupants' "adjusted income" does not exceed 150 percent of the maximum income level established as the standard for eligibility for public housing in that area.[28] The per-

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21 *Id.*
22 I.R.C. § 167(k)(3)(A).
23 Prop. Treas. Reg. § 1.167(k)-3(a)(2).
24 Prop. Treas. Reg. § 1.167(k)-3(a)(3).
25 *Id.*
26 I.R.C. § 167(k)-3(B).
27 *Id.*
28 Prop. Treas. Reg. § 1.167(k)-3(b)(2)(i).

missible income levels for each locality within the United States are published annually by the Department of Housing and Urban Development in a book entitled "Regular Income Limits for Section 235 and 236 Housing."

The "adjusted income" of the occupants of a dwelling unit is determined by "income certifications" which must be secured by the landlord from the tenant and must cover each person who proposes to live in the dwelling unit.[29] Adjusted income means the gross income for the taxable year immediately preceding occupancy less any trade or business expenses allowable as a deduction under § 162 for that year.[30] It is understood that the Treasury may amend this "adjusted income" test to conform to the more liberal FHA definition of adjusted income. This makes much more sense since otherwise tenants eligible under § 236 FHA guidelines could be ineligible under the IRS tests and vice versa.

If subsequent to his occupancy the tenant's income increases beyond the statutory limit, the rehabilitation expenditures still qualify for the 60 month writeoff.[31] The tenant income determination is an initial one time determination.

There is both a ceiling and a floor on the amount of rehabilitation expenditures qualifying for the 5 year writeoff. $15,000 is the maximum expenditure per dwelling unit and, additionally, the rehabilitation expenditures for a particular dwelling unit must total at least $3,000 over a two year period to be eligible.[32]

For example, suppose a taxpayer in four consecutive years spends $500, $1,000, $7,000 and $7,500 to rehabilitate a low income dwelling unit. The expenditure of $500 in the first year does not qualify because the total expenditure in the first two years of $1,500 is less than the $3,000 required. The $1,000 incurred in year 2 would qualify, however, since in the second and third year more than $3,000 was expended. However, only $7,000 of the $7,500 spent in year 4 would qualify because the $15,000 ceiling would be exceeded. It should be noted that the $15,000 per unit limitation is a taxpayer limitation, and not a dwelling unit limitation. A new owner may expend up to $15,000 per dwelling unit regardless of the amount of rehabilitation expenditures incurred by previous owners of the building. In other words, the $15,000 expenditure ceiling is not a limitation on the dwelling unit, rather it is a limitation on the expenditure per taxpayer on any particular dwelling unit.

Several commentators here raised the question of whether an investor who was not the owner during the rehabilitation period, but who is the first user, is within the statutory language requiring that the

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29 Prop. Treas. Reg. § 1.167(k)-3(b)(4).
30 Prop. Treas. Reg. § 1.167(k)-3(b)(3).
31 Prop. Treas. Reg. § 1.167(k)-3(b)(5), Ex. (2).
32 I.R.C. § 167(k)(2).

rehabilitation expenditures be incurred by the taxpayer.[33] The proposed regulations are silent on this point, but Assistant Secretary of the Treasury Cohen in a speech earlier this year stated that such an investor will be eligible for the five year write off.[34]

It is also believed that Treasury will rule in the final regulations that:

(1) The building being rehabilitated need not have been previously used for housing

(2) It will not be necessary to rehabilitate every unit in a building in order to qualify.

If the property is sold within 12 months after the rehabilitation expenditure was incurred, the entire writeoff will be recaptured. If the property is sold more than a year after the expenditure was incurred, only the additional depreciation is recaptured, with the recapture percentage decreasing by 1% per month for each full month the property is held beyond 100 months.[35]

The 60 month rehabilitation rule expires on July 1, 1975.[36] The Senate Finance Committee included an expiration date so that Congress would be forced to evaluate the cost and effectiveness of the provision at that time.[37]

SECTION 1039

Another incentive to the low cost housing field is Section 1039. This provision, which operates in a fashion similar to Sections 1033 and 1034, allows a tax free rollover of low income housing projects. The requirements for nonrecognition are: First, a qualified housing project is sold or disposed of in an approved disposition; Second, within the reinvestment period the taxpayer constructs, reconstructs or acquires another qualified housing project; and Third, the taxpayer elects to come within § 1039. If these requirements are met, gain will not be recognized except to the extent the proceeds of the sale exceed the amount reinvested in another qualified housing project.

A qualified housing project is defined as a low income housing project financed under Sections 221(d)(3) or 236 of the National Housing Act, wherein the owner is limited both as to his rate of return and the rents he may charge.[38] State and local low cost housing projects are not eligible for § 1039 rollover treatment.

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[33] *Rehabilitation Projects and Middle and Low Income Housing, A Panel Discussion.* N.Y.U. 29TH INST. ON FED. TAX. 1159, 1182 (1971).

[34] Tax Section of the New York Bar Association, January 28, 1971.

[35] I.R.C. § 1250(a)(1)(C)(iv).

[36] I.R.C. § 167(k)(1).

[37] I.R.C. § 1039(b).

[38] I.R.C. § 1039(b)(2).

To come within § 1039 the sale of the qualified project must be an approved disposition. An approved disposition is a sale to the tenants or to a nonprofit organization formed solely for the benefit of the tenants. The sale must be approved by HUD.[38a]

The net proceeds of an approved disposition must be reinvested within the reinvestment period. The reinvestment period begins one year before the date of the approved disposition and ends one year after the close of the first taxable year in which any part of the gain is realized.[39] The taxpayer may apply for an extension of time, but any extension is at the discretion of the Service and is not automatically granted.

If the taxpayer meets these requirements he will only be taxed on the excess of the net amount realized on the disposition over the amount reinvested in another qualified housing project.

If no gain is recognized under 1039, there will be no 1250 recapture unless the cost of the new 1250 property is less than the gain realized from the 1250 property disposed of.[40] This may occur if there is substantial 1250 gain in the property disposed of, but the acquired property contains little 1250 property, as for example, when the cost of the acquired property is primarily for land.

The practical effect of § 1039 is that it provides a means for the investor to sell the project after the tax benefits have been exhausted without immediate tax consequences. Finding an approved purchaser may prove the biggest problem, but because of the tax deferral it should be possible to sell to an approved purchaser at a lower price.[41]

CERTAIN SIDE EFFECTS

Before leaving the subject of depreciation we must consider its relationship to two new sections that were added by 69 Reform Act. First, the minimum tax on tax preference items.[42] A tax of 10% is imposed on the excess of a taxpayer's tax preference items over the sum of $30,000 plus the taxpayer's income tax liability. The amount of accelerated depreciation in excess of straight line depreciation on real property is an item of tax preference subject to the minimum tax.[43] Furthermore, no adjustment to basis is allowed by reason of the imposition of the minimum tax.[43a] Consequently, accelerated depreciation deductions on real estate can be doubly taxed, once by the minimum tax, and since the basis of the asset is not affected, again when

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[38a] *Id.*

[39] I.R.C. § 1039(b)(3).

[40] I.R.C. § 1250(d)(8).

[41] Finding a profit-motivated purchaser is almost impossible since these projects show little cash flow, and only the first user is entitled to accelerated depreciation.

[42] I.R.C. §§ 56, 57, 58.

[43] I.R.C. § 57(a)(2).

[43a] Prop. Treas. Reg. § 1.157-1(b)(c).

the property is sold at a gain. From a planning standpoint, a taxpayer whose income subjects him to the minimum tax, and who holds real property he intends to sell in the near future, may wish to switch to straight line depreciation on that property. By switching to straight line he will eliminate the preference income without suffering any material detriment since the new recapture rules in most instances now recapture 100% in additional depreciation.

Another wrinkle here is that the tax preference income does not include additional depreciation taken in the year of a sale to the extent it is recaptured in the year of sale.[44] Taxpayers subject to the minimum tax, if they have the choice, will generally want to close sales of real property before the end of their taxable year rather than early in the next taxable year.

Although excess depreciation on § 1250 property is a tax preference item, accelerated depreciation on § 1245 property is a tax preference item only if the property is subject to a net lease.[45] Not all real estate is § 1250 property, and component depreciation may be advisable if the taxpayer is subject to the minimum tax. Two additional benefits of component depreciation are: (1) The useful life of the components is normally shorter than that of the building, and they can therefore be depreciated over a shorter period, and (2) if new commercial property is involved, the 1250 property is limited to 150% declining balance, while the non § 1250 components (such as elevators and individual air conditioning units) may be depreciated on 200% declining balance.

Earlier this year, the court held in *Harsh Investment Corp. v. United States*,[46] that component depreciation is available for used real estate. Previously the Service had ruled that component depreciation was not available for used buildings.[47]

There is one further complication from tax preference items. Tax preference items in excess of $30,000 reduce the amount of earned taxable income which qualifies for the maximum tax rate of 60% in 1971 and 50% thereafter.[48]

ASSET DEPRECIATION RANGE

Asset Depreciation Range or ADR was introduced on January 11, by President Nixon and then Secretary of the Treasury Kennedy. Because nothing was said concerning public hearings on the new system, Ralph Nader's group that same day filed a lawsuit asking that public hearings be held. The Treasury responded by announcing that it had fully intended, and was in fact, to hold public hearings. Reg-

[44] Prop. Treas. Reg. § 1.57-1(b)(3).
[45] I.R.C. § 57(a)(3).
[46] 323 F. Supp. 409 (D. Ore. 1971).
[47] Rev. Rul. 66-111, 1966-1 Cum. Bull. 46.
[48] I.R.C. § 1348(b)(2).

ulations incorporating the ADR system were published on the 13th of March and adopted on June 22. In the meantime, however, Senator Muskie released a confidential memorandum from Deputy Assistant Secretary of Treasury John Nolan, which concluded that Treasury probably did not have authority to implement ADR by regulation. Boris Bittker published an article in Taxes Magazine in which he contended that the Treasury Department lacked the authority to adopt ADR, and lawsuits challenging the authority of Treasury were filed by several groups, including Ralph Nader and Common Cause. At this point, no one was really confident whether or not the ADR regulations were valid.

Fortunately, for those of us in the tax planning business, Congress authorized ADR in the 1971 Revenue Act under the new name "class life depreciation system." Congress stated that for property placed in service after 1970, the new class life system is to replace both ADR and the guideline life rules.[49] The Treasury Department is authorized to work out the details of the new class life system. Consequently, the ADR regulation 1.167(a)-11 will have to be replaced with a regulation drafted in accordance with Congress' class life system.

Congress did make it clear, however, that most of the features of ADR are to be included in the class life system.[50] It is anticipated that when the class life system regulations are promulgated they will correspond to the ADR regulations except to the extent Congress specifically prescribed otherwise.

Proceeding on that basis, the first thing to remember about the class life system is that it benefits only tangible personal property, and not real estate. With that limitation in mind, and keeping in mind that the class life system only applies to property placed in service after 1970, there are four areas in which class life may be helpful. They are:

First: Useful life may be reduced by up to 20% of the guideline life;

Second: Salvage value may be reduced by up to 10% of cost;

Third: A current deduction may be allowed for repairs that would otherwise have to be capitalized; and

Fourth: The sale of a depreciable asset at a gain may be tax free.

Let's examine each of these. First, the shorter useful life. This is the principal advantage offered by the class life system. Taxpayers are permitted to choose a depreciation period which is between 80% and 120% of guideline life as set forth in Revenue Procedure 62-21,[51]

[49] H.R. REP. No. 92-533, 92d Cong., 1st Sess. 32 (1971) (hereinafter cited as "H. Rep."). S. REP. 92-437, 92d Cong., 1st Sess. 47 (1971) (hereinafter cited as "S. Rep.").

[50] H. Rep. 30-35, S. Rep. 45-52.

[51] Treas. Reg. § 1.167(a)-11(b)(4)(i).

and the reserve ratio test has been dropped.[52] For example, suppose a taxpayer purchases $100,000 worth of office furniture which has a guideline life of ten years. Under the class life system, the taxpayer is free to choose as useful life any period between eight years and twelve years. Using an eight-year life with straight line depreciation yields a depreciation deduction in the first year of $12,500 as opposed to a $10,000 deduction under a ten-year life, an increase of 25%. The same 25% increase in depreciation would result if double declining balance depreciation rather than straight line was taken.

In computing depreciation under ADR, salvage value is not taken into account, except that the total depreciation claimed cannot exceed the cost of the asset reduced by the salvage value.[53] Stated another way, salvage value does not affect the annual depreciation deduction other than as a limitation on the total depreciation that may be deducted over the life of the property. To return to our taxpayer with office furniture costing $100,000 and a class life of eight years, let us assume a salvage value of $25,000. During the first six years, the taxpayer could deduct $12,500 annually as depreciation, the same amount he would be allowed to depreciate if salvage value were zero. It is only in year seven when the undepreciated balance equals salvage value that salvage value affects the taxpayer's deduction for depreciation.

Of course, there may be times when a reduced depreciation deduction is desirable, as, for example, when a net operating loss is about to expire. In that circumstance, adoption of a longer useful life will be appropriate.

Another consideration is that the useful life selected is the useful life of the property for all other purposes, including the newly restored investment credit.[54] Consequently, since the investment credit is only permitted if the property has a useful life of at least three years, with the maximum credit available for property with a useful life of seven years or more, taxpayers will generally prefer to adopt a useful life as close to seven years as possible. That is, in our prior example of property which has a guideline life of ten years, the taxpayer will ordinarily use ADR to reduce the useful life by the full 20% down to eight years. On the other hand, if guideline life was eight years, although the taxpayer could under ADR reduce the useful life to 6.5 years, he is likely to elect a reduction to seven years in order to preserve the full investment. In the case of property with a guideline life of less than seven years, taxpayer will probably elect to extend the life to seven years in order to increase his investment credit. For example, a taxpayer purchasing a property with a guideline life of six years will generally benefit by electing to extend the useful life to seven years, thereby obtaining the maximum investment credit.

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[52] Treas. Dept. News Release, June 22, 1971.
[53] Treas. Reg. § 1.167(a)-11(d).
[54] Treas. Reg. § 1.167(a)-11(g)(1).

Beside the investment credit, choosing a short life may affect the taxpayer's ability to qualify for § 179 first year bonus depreciation (6 years), for accelerated depreciation (3 years), or § 167(f) salvage value reduction of 10% (3 years).

SALVAGE VALUE

The second advantage of the class life system is the salvage value tolerance of 10% of cost. The ADR regulations provided that the taxpayer's estimate of salvage value for ADR property will be accepted unless it differs from the government's estimate by more than 10%, or providing the taxpayer does not follow a practice of underestimating salvage to take advantage of the rule.[55] For example, suppose a taxpayer who purchased property for $100,000 with a true salvage value of $20,000, but who estimated the salvage value to be only $10,000. No adjustment would be made in that case unless the taxpayer followed a practice of underestimating his salvage value. If our taxpayer had also elected under § 167(f) to reduce salvage by 10%, his depreciation would be based on his entire cost of $100,000 even though there was an actual salvage value of 20%, or $20,000. This 10% safe harbor rule was intended to, and undoubtedly will, simplify the tax law by reducing the disputes between agents and taxpayers over salvage value.

REPAIR ALLOWANCE

The third beneficial class life rule is the repair allowance, which permits a deduction for costs of repairs, maintenance, rehabilitation, or improvement of property, all of which might otherwise have to be capitalized. The deductible repair allowance is determined for each guideline class of property, and is an amount equal to a specified percentage of the average basis of property in that guideline class during the year.[56] The specified percentages for each guideline class are set forth in Revenue Procedure 71-25, which was specifically approved by both the House Ways and Means Committee and the Senate Finance Committee.[57] The amount to which the percentage is applied contains all the property in that particular guideline class, and is not limited to property purchased after 1970.[58] For example, if a taxpayer had office furniture and machines purchased prior to 1971 with a cost of $75,000, and office furniture and machines purchased after 1970 with a cost of $25,000, his repair allowance would be the allowable percentage (in this case 7.5%)[59] of his total cost of

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[55] Treas. Reg. § 1.167(a)-11(d)(1)(v).
[56] Treas. Reg. § 1.167(a)-11(d)(2).
[57] H. Rep. 34; S. Rep. 51.
[58] Treas. Reg. § 1.167(a)-11(d)(2)(iii)(b).
[59] Rev. Proc. 71-25, 1971 Int. Rev. Bull. No. 28, at 62, Asset Guideline Class 00.1.

$100,000 or $7,500. Accordingly, if the taxpayer spent during the taxable year any amount up to $7,500 on repairs, rehabilitation, maintenance or improvement of his office furniture and machines, the full amount would be deductible. If expenditures exceed the repair allowance, the excess must be capitalized.[60]

A limitation is imposed on a taxpayer who regularly acquires used property and repairs or rehabilitates it for his own use simply to take advantage of the repair allowance rule. Such property will not qualify as repair allowance property.[61]

Certain expenditures are excluded from the repair allowance and must be capitalized. These nonqualifying outlays are called excluded expenditures and fall into three categories.[62] The first class of excludable expenditures are expenditures which represent additional identifiable units of property. For example, the replacement of an existing lathe with a new lathe. On the other hand, the replacement of bearings and gears in an existing lathe would not be an excludable addition. Second, expenditures which increase the capacity of a unit by more than 25% of its original capacity must be capitalized. An example would be costs incurred in modifying a metal fabricating machine which substantially increases its output. The third excluded class is expenditures to modify an existing unit of property for a substantially different use. For example, the cost of converting a passenger ship to a cargo ship.

RETIREMENTS

Another benefit of electing class life depreciation is the treatment afforded asset retirements from class life accounts. Under the class life system, the sale of used property is not a recognizable event. Instead, the proceeds from the sale will be added to the reserve for depreciation, thereby reducing the total depreciation that may be taken on that particular account.[63] For example, if property with an adjusted basis of $1.500 was sold for $3,000, the $1,500 gain would not be recognized. But the reserve for depreciation for that particular account would be increased by the $3,000 sales price.

The only exception to this rule is when an extraordinary retirement occurs. Extraordinary retirements are quite narrowly defined, and consequently most retirements will be ordinary. Extraordinary retirement occurs when either (1) the retirement is the direct result of fire, theft, shipwreck, or other casualty, or (2) the retirement was caused by the cessation of a portion of a business *and* the basis of all the assets so retired (other than a capitalized repair) is more than

[60] Treas. Reg. § 1.167(a)-11(d)(2)(viii)(a).
[61] Treas. Reg. § 1.167(a)-11(d)(2)(v)(c).
[62] Treas. Reg. § 1.167(a)-11(d)(2)(vi).
[63] Treas. Reg. § 1.167(a)-11(d)(3)(iii).

20% of the basis in that account.[64] Any gain or loss realized on extraordinary retirements is recognized and their cost is removed from the asset account.[65]

ELECTING ADR

Well, assuming one wishes to come within the class life depreciation system, how does one go about it. Class life is elective on a year by year basis.[66] That is, class life is an annual choice; an election to use the class life system in 1971 does not require that you use class life in 1972. The taxpayer makes the class life election in the tax return for the year in which the tangible personal property was put in service.[67] The election must specify the depreciation period to be used for each account, and that same period must be used in computing depreciation in later years on those assets. Additions in each subsequent year will be subject to a new election both as to the use of the class life system, and the life to be used.

An election to use the class life system applies to all "eligible property" placed in service during that year. Eligible property must meet the following requirements:[68]

(1) It must be tangible personal property subject to the allowance for depreciation.

(2) A guideline class must be in effect for the property under Rev. Proc. 62-21.

(3) It must have first been placed in service by the taxpayer after 1970. The taxpayer does not have to be the original user, however, and used property qualifies.

Congress eliminated the requirement contained in the regulations that the property had to be used predominantly in the United States.[69]

Eligible property must then be grouped in "vintage accounts." A vintage account is defined as a "closed end depreciation account" that contains only eligible property of the same guideline class placed in service that year.[70] That is, all eligible assets placed in service in a particular year must be carried in item or multiple asset account which contains only property of a single guideline class which was put in service in that year. Thus, new vintage accounts are established each year.

The taxpayer may establish as many vintage accounts within a par-

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[64] Treas. Reg. § 1.167(a)-11(d)(3)(ii).
[65] Treas. Reg. § 1.167(a)-11(d)(3)(iv).
[66] Treas. Reg. § 1.167(a)-11(a)(1).
[67] Treas. Reg. § 1.167(a)-11(f)(1)(i).
[68] H. Rep. 32-33; S. Rep. 48-50.
[69] H. Rep. 33; S. Rep. 48.
[70] Treas. Reg. § 1.167(a)-11(b)(3)(i).

ticular guideline class as he wishes.[71] For example, a taxpayer who purchased five trucks in 1971 could choose between a minimum of one and a maximum of five vintage accounts. This flexibility affords an opportunity for tax planning as, for example, maximizing the investment credit by creating long life vintage accounts for investment credit property and short life vintage accounts for property not eligible for the investment credit.

In certain circumstances, the regulations require that property of the same guideline class be carried in separate vintage accounts. The most important limitation is that used property may not be grouped with new property in a single vintage account.[72]

Once the class life system is elected, there is a further sub-election, the repair allowance. As mentioned earlier, the repair allowance permits certain repairs and improvements to be deducted up to the computed repair allowance. The point here is that the repair allowance is not an automatic feature of the class life system; rather the taxpayer has an annual choice whether he wishes to come within it.[73] Inasmuch as election of the repair allowance sets a dollar ceiling on deductions for repairs, a taxpayer may choose not to be covered if he can substantiate a larger repair deduction under the rules of Sections 162, 212 and 263. Or if a net operating loss is expiring, the taxpayer may wish to capitalize his repair and improvement costs in order to take advantage of the net operating loss.

The repair allowance offers some flexibility in that the election is made for each guideline class.[74] Note, however, the election is total vis-a-vis each guideline class and all vintage accounts within a guideline class must be treated consistently.

One provision of the ADR regulations that was eliminated by Congress was the three-quarter year convention.[75] The three-quarter year convention would have permitted taxpayers to treat all property additions as if they had been placed in service on the first day of the second quarter of the year, thereby granting nine months depreciation for all assets placed in service during a year. Congress, while disapproving of the three-quarter convention, did give specific approval to any convention that treats assets as having been placed in service ratably throughout the year.[76] One acceptable depreciation convention is to treat all assets placed in service during the year as if they had been placed in service in the middle of the year.

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[71] *Id.*

[72] Treas. Reg. § 1.167(a)-11(b)(3)(ii).

[73] Treas. Reg. § 1.167(a)-11(d)(2)(iv).

[74] *Id.*

[75] H. Rep. 32; S. Rep. 47.

[76] H. Rep. 33, 34; S. Rep. 50.

CONCLUSION

In summary, the class life system should prove a major benefit to most taxpayers. Its principle drawback is the detailed record keeping required, but this should be offset by the certainty provided as to useful life, salvage value, and deductible repairs. The class life system is intended to be a dynamic system, and the Treasury has established an Office of Industrial Economics to collect data to be used in updating the guideline classes and lives, repair allowances, and other elements of the class life system.

The class life system is intended to apply eventually to real estate.[77] The guideline lives of Rev. Proc. 62-21 are still available in depreciating real estate for a taxpayer who elects the class life system.[78] However, the 20% reduction in useful life is not permitted for real property. In recognition of this, Congress provided that taxpayers electing class life may, if they choose, use actual life in computing real estate depreciation for the period 1971 through 1973.[79] There is a similar transition rule for so-called subsidiary assets.[80]

Both the House Ways and Means Committee and the Senate Finance Committee in the Committee Reports accompanying the Revenue Act of 1971 directed the Treasury to review the guideline depreciation lives for real property.[81] The Committee stated that if it is determined that real property lives should be shortened, then consideration should also be given toward conforming the real property recapture rules with the personal property recapture rules. Perhaps then, in the future, we will see a class life system incorporating both real and personal property, coupled with a single § 1245 recapture provision for real and personal property.

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[77] S. Rep. 49.
[78] *Id.*
[79] H.R. 10947 (Revenue Bill of 1971) § 109(e)(1).
[80] H.R. 10947 (Revenue Bill of 1971) § 109(e)(2).
[81] H. Rep. 35; S. Rep. 52.