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A PRACTICAL APPROACH TO THE
SUBSIDIZED HOUSING TAX SHELTER

by Carter C. Chinnis

As a developer of small government assisted rental projects in rural areas, I have noticed for some time that the average attorney finds it difficult to advise his developer client on the problems of the tax syndications involved. Historically the tax expertise has been in the firm that represents the limited partner investors—for they put up the money and are the ones who can afford the expense of the larger firms with the sophisticated tax counsel. Thus the developer has in many instances been in a position where many of his decisions have been dictated by positions taken by counsel for the investors, and usually the matters are so time critical that the developer has little time to explore other possibilities.

The purpose of this talk is to point out some of the potential pitfalls that the developer should explore in the early stages of negotiations with the investors. Later we shall also look into some possible avenues that the small developer could examine in the fold of real estate tax shelters, which involve both government assisted and nonassisted projects.

I. THE UNIQUENESS OF THE SUBSIDIZED HOUSING SHELTER

In dealing with the real estate tax shelters of subsidized housing, it is imperative to note that this a unique type of shelter in that under the prevailing rules and regulations the only compensation that the developer can receive is from the tax losses that the project can throw off, which losses in turn are "sold" by the developer to high bracket income investors. There is no pot of gold at the end of the rainbow as there are in other tax shelters, and the economic motivation of later rewards does not exist in this type of shelter. Seldom will the developer make any money from the land involved, stringent cost certification prevented him from making a profit on the construction, and the regulations limit the distributions of project income to a point where cash flow is hardly any consideration. Thus the tax losses of the project are the developers sole compensation, and it is from these which he receives his rewards in the form of compensation from the limited partnership which is formed as the conduit of these losses to the limited partner investors.

There is no single code section that one can consult for guidance in the subsidized housing tax shelter, and many of the provisions are laboriously technical in their applications, and are a tribute to the ingenuity and imaginations of the accountant and the tax lawyer. Con-
gress has never legislated on these shelters specifically, but it has cer-
tainly acquiesced in their applications by allowing favorable treatment
in depreciation rates and recapture, and in spite of the clamor for tax
reform in 1976, real estate tax shelters of subsidized housing emerged
virtually intact under the Tax Reform Act of 1976 and the modifications
of 1978. Certainly it seems safe to say that without these tax benefits,
few rental units for the low income segment of our society would be
built—for there is no incentive to do such without them.

II. THE CRANE RULE

The heart of the real estate tax shelter is the so-called Crane Doc-
trine (U. S. vs Crane, 331 U.S. 1 (1947) in which the court estab-
lished two generally accepted and interrelated principles. The first is
that regardless of whether or not the owner of the property has any
personal liability on the mortgage, the amount of the liability is in-
cluded in the tax basis of the property acquired subject to the mort-
gage, and second, upon the sale of the property, the amount realized for
the purpose of calculating gain or loss on the sale includes any liabilities
to which the property is subject.

Thus if real estate of $100,000 is acquired by a taxpayer who pays
$10,000 cash and assumes a $90,000 mortgage for which is personally
liable, or by a taxpayer who pays $10,000 but takes subject to the
mortgage so that he is not personally liable, the tax basis in both in-
stances for the purchaser is $100,000 for purposes of computing his
depreciation and gain or loss on the sale or exchange of the property.
The assumption of this Crane doctrine is that the taxpayer will later
have to invest an additional amount equal to the mortgage in order to
retain the property, and he is given a credit in his basis for such later
investment which it is assumed he shall make. This approach also
permits depreciation at a rate consistent with the market value of the
property when acquired, and offers competitive equality with other
taxpayers who may have paid cash for their property.

Section 752 of the Code has generally been regarded as a modifica-
tion of the Crane Doctrine for determining the basis of a partner's in-
terest in the partnership. It is obvious that this landmark decision was
in the mind of the draftsman of Sub-chapter K of the Code: “A liability
to which property is subject shall, to the extent of the fair market value
of such property, be considered as a liability of the owner of the property.”

1 Section 752(a) of IRC states as follows: “Any increase in a partner's share
of the liabilities of a partnership, or any increase in a partner's individual lia-
bilities by reason of the assumption by such partner of partnership liabilities,
shall be considered as a contribution of money by such partner to the partner-
ship.”

2 IRC 752 (c).
The Regulations also reflect *Crane* in the third sentence of Reg. 1.752-1(e) which states:

"However, where none of the partners have (sic) any personal liability with respect to a partnership liability (as in the case of a mortgage on real estate acquired by the partnership without the assumption by the partnership or any of the partners of any liability on the mortgage), then all partners, including limited partners, shall be considered as sharing such liability under Section 752(c) in the same proportions as they share profits."

It is this section which brings about the use of the so-called "exculpation clause" in the note representing the liability for the mortgage. This note will contain a clause with the following general language. "The security for this note is the real estate secured thereby only, and the General Partner has no personal liability therefor.

Willis, in Partnership Taxation (pp. 250-251) states that in the case of a limited partnership tax shelter, this may be the most important provision in the regulations under Subchapter K:

"In the first place, it is noted that while full recourse liabilities are allocated among the partners in the ratios for sharing losses, non-recourse liabilities are allocated in the ratios for sharing profits. This distinction may have little significance in the case of the uncomplicated general partnership. It is of major importance to the limited partnership. Limited partners do not share in partnership losses beyond their capital contributions. However, they do share in partnership profits. Therefore, limited partners, as well as general partners, may include in the basis of their partnership interests amounts of non-recourse partnership liabilities, determined in the ratios they share profits."

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3 Reg. 1.752(c); Williston, *Partnership Taxation*, p. 250. See also Rev. Rul. 75-31, 1975-1 C.B. 10, which held that a limited partnership formed under New York state law was to be treated as the owner of the project, and each limited partner of the non-recourse loan could include a portion of a loan made by the New York Housing Finance Agency in the basis of his partnership interest. See also:

S. Surrey & W. Warren, *Federal Income Taxation—Cases and Materials*, pp. 639-646 (1962). Perry, *Tax Shelters: The Crane Rule*. 27 Tax L. Rev. 525, 553, states: "Not only is there some doubt, in the light of historic administrative interpretation, as to whether the suggested revision correctly interprets Section 752, but there is no rational basis in the Code upon which to reflect a distinction between general partners and limited partners with respect to a non-recourse loan. To apportion liabilities only to the general partners is no more reasonable than to apportion liabilities only to the tallest or shortest partner or another definable group. There is no economic substance for the distinction."

4 Williston, *Partnership Taxation*, pp. 250-251. An open question is whether the total contributions which a limited partner is required to make includes a contingent liability, for example, a liability to contribute to the partnership triggered by a failure of the partnership to meet payments under a recourse liability. See Long, *Tax Shelter in Real Estate Partnership*, 36 J. Taxation 312, 314 (1972). *Staff of the Joint Committee on Internal Revenue Taxation, Tax Shelter, 83* (1976).
Thus one can conclude that *Crane* becomes of prime importance when property subject to a mortgage is depreciable, for depreciation is calculated on the tax basis of the property. Though the Code generally states that the initial basis of the property is its cost, by allowing the taxpayer to include the amount of the mortgage in his cost basis, *Crane* allows the taxpayer to take depreciation charges far in excess of his original cash contributions. It is this so-called "leverage", or the use of borrowed money, that is the heart of the tax shelter. As a consequence of the use of borrowed funds, whereby the basis for an asset is substantially increased, tax write-offs in real estate tax shelters usually exceed by several times the amount of equity which the taxpayer actually has at risk.  

III. THE FRONT ENDED DEDUCTIONS

So the developer has tax losses that are available. Usually the General Partner is said to have "syndicated or sold" his interest in the partnership to limited partner investors. The term "sale" is hardly appropriate for the transactions that occur, for if an actual sale takes place, no tax deductibility would be created by such, and the amount of the purchase price would simply be the limited partner's basis for his interest in the partnership. Thus the limited partner makes his initial contribution directly to the partnership, which in turn, compensates the General Partner for the services, tasks, guarantees, pledges, and covenants that he has made for and on behalf of the partnership. This compensation in turn creates a tax deduction for such for the partnership.  

These payments to the General Partner can thus result in immediate deductions for the limited partner investors from ordinary income, and can cover part or all of their cash investment. The nature and amount of income reported by the General Partner will be ordinary income, but by allowing the deduction of these payments by the partnership, he increases the amount of the payment the limited partners will be

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9 An excellent review of compensation for the general partner is in 22nd Annual Tax Conference, William and Mary College (1977): "How to Compensate the General Partner for Services", by Martin B. Cowan.
inclined to pay him. By taking advantage of the investors higher tax bracket, the General Partner thus increases the amount of partnership compensation to him (which is a major portion—and sometimes the entirety) of his proceeds from the "sale" of the tax shelter.

The deduction problem during the initial phases of the acquisition of the investment and the construction period, as well as the compensation after the project is completed and rented, is the prohibition against any deductions for capital expenditures. In most cases the critical question is whether the expenditures by the limited partner or by the partnership is not in substance a form of capital expenditure which must be capitalized rather than deducted. While the nature of these deductions is very complex, and has been covered by several authorities, such will usually fall in the following general categories.

1. "Guaranteed Payments" made Irrespective of Partnership Income

Subdivision (c) of Section 707 stated as follows prior to the 1976 amendment:

"Guaranteed Payments—To the extent determined without regard to the income of the partnership, payments to a partner for services or the use of capital, shall be considered as made to one who is not a member of the partnership, but only for the purpose of Section 61 (a) (relating to gross income) and Section 162 (a) (relating to trade or business expenses)."

Thus prior to the 1976 amendment there was some basis for the position that a "guaranteed payment" made a partner was always deductible by the partnership. The 1976 amendment, however, specifically subjects the guaranteed payment to Section 263, which provides that no deduction shall be allowed for "any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate." This amendment thus effectively closes the use of guaranteed payments to create large front end deductions for promoter compensation, unless they are deductible as ordinary and necessary—and reasonable—under other provisions of the Code.

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7 See Shop Talk, 43 Journal of Taxation 62 (1975); IRC 263; Reg. 1.263(a); Woodward vs. Commissioner, 397 U.S. 572 (1970); Commissioner vs. Idaho Power Co., 418 U.S. 1 (1974). In addition to not being a capital expenditure, all expenses must satisfy the provisions of Sections 212 and 162 relating to ordinary and necessary business expenses.

8 Although the statute is still slightly ambiguous, a review of the Committee Report clearly concludes that guaranteed payments are deductible only if ordinary and necessary. See Senate Report, No. 94-938, 94th Congress, 2nd Sess. 94-96 (1976).
As an elective to making a guaranteed payment, it may be possible to allocate income equal to what the guaranteed payment would have been. Allocating an item of income to the General Partner removes it from the computation of partnership taxable income or loss allowable to the other partners, and it therefore has the same "bottom line" impact as a deduction. It would also not have to pass the ordinary and necessary business expense test of Section 162.

Section 707 (c) also provides a deduction for payments made to the General Partner for the use of capital. Under the 1976 amendment, however, it is clear that the ordinary and necessary language of Section 162 will apply, and as is the case of all payments made to the General Partner, the question will be asked if the guaranteed payment is in fact for the use of capital, or is a mere cover for a promoter's fee.\textsuperscript{10}

2. Supervisory and Consulting Services

Since it is clear that guaranteed payments do not automatically produce deductions, it may be expected that many partnerships will increase their efforts to claim fees for supervisory and consulting services under Sections 162 or 212. These services include the supervision of partnership affairs and rendering various consulting services about project financing, the employment of attorneys, accountants, and general contractor selection, assistance on zoning matters and tax abatement, obtaining appropriate environmental approvals, and assisting in the obtaining of the construction and permanent financing. It must be noted that some of these services could be challenged on audit for deductibility, particularly if such was rendered during the construction period.\textsuperscript{11}

3. Cash Flow Guarantees—Commitment Fees

If the operating revenues of the project should be insufficient to cover project expenses and pay the mortgage principal and interest, the project will fall into default. A major covenant of the promotor—Gen-

\textsuperscript{10} It should be noted that another feature of Sect. 702(c) as it applies to payments for use of capital is that the deductibility of such is determined under Section 162 relating to business expenses, rather than Section 163, relative to interest expenses. The restrictions on "investment interest" in Section 163(d) thus seem to be inapplicable. The Committee reports indicate that it was the legislative intention to subject all guaranteed payments to the same criteria for deductibility as payment to third parties. See Senate Report 94-938, 94th Congress 2nd Sess. 94 (1976); House Report 94-638, 94th Congress, 2nd Sess., 120 (1976). Payments to third parties for use of money would be subject to Section 163 and the restrictions on the deductibility of "investment interest." The regulations may have to settle this inconsistency.

eral Partner in almost every tax syndication is his guarantee to provide the funds to cover any operating deficits.\(^\text{12}\) Fees paid for this guarantee are deductible on the argument that the payment is in the nature of an insurance against the loss of income and possible foreclosure, and thus qualifies as a business expense under Sections 162 and 212.

A commitment fee paid to the General Partner should also be deductible if he agrees to supply at a reasonable cost funds in excess of those to be supplied by the permanent lender which might be needed to cover cost overruns, and the General Partner is in a position to fulfill that obligation.\(^\text{13}\)

Apart from the material distortion test, the main question in all of these situations, is whether in substance, the payment is a disguised capital acquisition cost, and should be capitalized, rather than deducted as a current payment made to the General Partner. It is still too early to tell how far IRS might push this issue, but it is nevertheless an area that can dramatically effect the front end losses of the tax shelter, and the front end deductions should be carefully structured to assure that they are reasonable for the services performed, and are not hidden capital costs.

IV. FINANCING THE TAX SHELTER PROJECT

To understand the real estate tax shelter for subsidized housing, one must have a familiarity with the government programs involved. Today there are two agencies of the Federal Government which are involved in this type of housing—the Department of Housing and Urban Development, and the Farmers Home Administration of the Department of Agriculture. Most of the tax shelters of this date are the so-called Section 8 housing projects. This Section 8 program assists the tenant in paying his rent, and will pay the difference between an established fair market rent approved by H. U. D., and 25% of the tenant's adjusted gross income. In many cases a tenant may be paying $30 to $50 a month for a $250 or more apartment, and the project owner receives the difference in the rent directly from the government in monthly payments. These so-called Housing Assistance Contracts can be for a period of 20 to 40 years, and assist the tenant in making his rent payment. They do not provide the construction or permanent financing necessary to develop a project, so the developer must look to some other source for this financing.

Much of the financing for Section 8 projects has come from the State Housing Agencies. With the sale of their tax exempt bonds they

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\(^{12}\) See *Tulia Feedlot, Inc. vs. United States*, 366 F. Supp. 1089 (N.D. Tex. 1973), rev'd 513 F (2d) 800 (5th Cir. 1975). There are some earlier tax court cases cited that would also support the deduction.

are able to provide construction and permanent financing at a rate which will make the project economically feasible. One of the main security aspects of their loan is the Section 8 Housing Assistance Agreement which is executed between the developer and H. U. D., and assigned to the State Housing Agency as collateral for the loan.

In many instances the developer will be working with both the State Agency and H. U. D., as well as with the local authorities who have zoning, planning, and environmental cognizance process with many pitfalls and bureaucratic delays that are time consuming and costly. The developer who is considering this type of project should move slowly, as many dollars in architectural and engineering work can be spent before any loan is closed.

The other financing program involved is the Farmers Home Administration of the Department of Agriculture. By law their financing is limited to rural areas, which is defined as a town under 10,000 in population. However, they are still able to finance in rural areas which are in close proximity to larger cities, and the local county agent of Fm. H. A. should be contacted to determine the boundaries of the Agency’s authority.

The main financing program of Fm. H. A. is the 515 Rural Rental Housing Program. This is a so-called interest credit program that provides for a permanent interest rate as low as 1% for some tenants whose income would not support a higher rate. The lowest rent paid (or basic rent) must support the 1% interest rate. This might be $140 per month for a two bedroom apartment which would have a $265 market rental based on the normal 9% Fm. H. A. permanent mortgage rate. The tenant would pay 25% of his adjusted gross income, but in no event less than $140, nor more than $265. In some cases, Fm. H. A. has a rental assistance program to help lower income tenants meet their rent, which rental assistance functions similar to the Section 8 payment.

In considering which financing vehicle to use, I would advise the potential developer to follow all possibilities. Funds are just too scarce to bet on one source.

Any developer seeking the tax shelter possibility should not overlook the rehab project. While this will be explored later in more detail, the preferential 5 year depreciation base for rehab structures offers unique possibilities—without any assistance of government agencies.

V. Tax Consequences of the Equity of Contribution Problem

Almost every subsidized housing project involves some contributions by the General Partner, depending on land cost, off-site improvements and such. These costs could be minimal, in an amount of $60,000 or a $2,000,000 mortgage or the contribution could be so substantial that the deal is prohibitive. For a $2,000,000 Farmers Home Project, the
TAX CONFERENCE

equity would approximate $110,000, or 5% of the total project cost. This is a cash requirement which must be paid in at the close of the loan, so these are front end dollars required at the very beginning. What is important from a tax standpoint is just how these dollars are put in the project. The tax consequences can be dramatic for the developer if they are not done properly.

For instance, if the requirement of H. U. D., the State Agency or Farmers Home is a "true equity" requirement, and the developer puts in these funds as his equity requirement for the partnership, then this would appear to be a contribution to the partnership. This contribution does not give the developer any front-end write off for a substantial payout which he must make. However, if the partnership agreement and other agreements between the General Partner and his investors are so worded that he must put in funds which are necessary to make up any deficit for the construction of the project, and he is obligated under the agreement to build the project for the amount of mortgage money available, then it would seem that this "payout" by the developer General Partner could be written off against income he might receive from that partnership as a "cost of doing business." (If he is involved in several projects, it would seem that this "business cost" might even be applied against income from these other projects.) It would seem appropriate that any "payments" made by the General Partner would never go through any partnership account, and paid by the partnership as such, but should go into a special construction account which is used for construction only. The agreement should state that this payment is to make up the deficit necessary to complete construction, (and if other funds should be necessary later, the General Partner might even pay these items direct from his own pocket, rather than put such monies through any account associated with the partnership.)

In Farmers Home Administration situations, the problem can be especially troublesome if their counsel should insist that the limited partnership agreement state that the 5% cash requirement, or some many dollars, is the General Partner's contribution to the project. This hardly seems necessary, as the partnership agreement can show the General Partner contributions to be only a nominal amount, say $100.

Farmers Home also requires upon loan closing that 2% of the cost of the project be paid in cash into an operation and maintenance account. In a $1,500,000 project, this can amount to $30,000. In H. U. D. and financed projects, some equity requirement is also necessary for closing, and a letter of credit of 3 to 4% of the total project cost is usually required to cover future operating deficits. If there should be a draw down on these letters of credit, it would appear that the General Partner would have a loss for such which he could balance against income. It might be noted that 5% and 2% cash requirements of
Farmers Home make it difficult to have a profitable project unless the land is already owned at a low cost figure, and would constitute all or a major part of the 5% requirement.

In conclusion, tax counsel should structure the agreements and the guarantees made by the General Partner so that these so called “equity requirements” are not deemed “equity” at all, but a “cost of doing business” by the General Partner in making up deficits. He in turn will write off such against income received from that and other projects in that current year. But by all means, avoid any implication of an “equity contribution.”

VI. STRUCTURING THE DEAL—THE LIMITED PARTNER INVESTOR

Now that we have examined the methods of financing the project, and noted the front end deduction problem, we can consider the all important matter of structuring and pricing the deal for syndication. One of our first projects was a H. U. D. 236: we were originally offered 10.5% of the mortgage amount, told about the enormous investor risks, and finally accepted 11.5%. The market price has certainly changed since then (we shall explore this later), but the risks assumed by the investors is one continuing lament that the promotor shall bear when selling his project. Thus it is essential that the promotor-developer should be aware of these risks, and also examine the alternatives that might minimize them.

How much risk does the investor assume? It is my feeling that if the deal is not greedily structured for enormous tax losses, he assumes very little. In fact, I feel that some syndications can be structured with conservative yet profitable tax losses that have almost no risk, barring fraud on the part of the developer.

Where does investor risk arise? It arises primarily in the onerous recapture provisions of Section 167. Under this code section, real estate improvements (buildings and other structures) may be depreciated over three useful lives determined at the time of acquisition by the investor, regardless of whether the improvements actually do lose value at the indicated rate during the period of ownership. While the various depreciation methods available to the investor are amply covered in the literature, and offer the choice for new construction of subsidized housing of straight line, sum of the digits, or the double-declining balance, the sophisticated tax accountant will use a component depreciation approach.

If an asset consists of more than one element or component, depreciation may be claimed either on an overall “composite” basis or on the individual components making up the asset. When the composite method is used for a building, one rate of depreciation is applied to the entire structure, including all its components. When the component method is used, each item or group of building components or equip-
ment is depreciated separately, based on its own particular useful life. Using the component method, plumbing, heating, wiring, and other building elements can usually be depreciated more rapidly than if a composite method were used.

The effect of using component depreciation is that the overall effective rate of depreciation for the entire property will be substantially larger than if the building were depreciated at one composite rate. Suppose, for example, that a building costing $1 million and with a forty-year life is depreciated on the straight line basis under the regular method. Depreciation would amount to $25,000 per year (1/40 x $1,000,000). If the component method were used, the depreciation would be double that, or $50,000, calculated as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Cost</th>
<th>Life (Years)</th>
<th>Approximate Annual Depreciation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Building</td>
<td>$600,000</td>
<td>40</td>
<td>$15,000</td>
</tr>
<tr>
<td>Wiring</td>
<td>$60,000</td>
<td>15</td>
<td>4,000</td>
</tr>
<tr>
<td>Plumbing</td>
<td>$45,000</td>
<td>15</td>
<td>3,000</td>
</tr>
<tr>
<td>Roofing</td>
<td>$50,000</td>
<td>10</td>
<td>5,000</td>
</tr>
<tr>
<td>Heating</td>
<td>$100,000</td>
<td>10</td>
<td>10,000</td>
</tr>
<tr>
<td>Paving</td>
<td>$25,000</td>
<td>10</td>
<td>2,500</td>
</tr>
<tr>
<td>Ceiling</td>
<td>$25,000</td>
<td>10</td>
<td>2,500</td>
</tr>
<tr>
<td>Air Conditioning</td>
<td>$50,000</td>
<td>10</td>
<td>5,000</td>
</tr>
<tr>
<td>Elevators</td>
<td>$45,000</td>
<td>15</td>
<td>3,000</td>
</tr>
</tbody>
</table>

$1,000,000 $50,000

The useful life assigned to components in a building may be challenged by the IRS, and the selection should be realistic. While each case depends on its own special facts, most of the liberal useful lives shown above have been sustained by the Tax Court. Note that when component depreciation is used, the life assigned to the building shell ordinarily should be longer than the guideline composite rate for the entire property.

In the above case, depreciation under the component method doubles the amount of the composite depreciation deduction, and if the component double declining balance depreciation should be used, then the rate would be four times that over the composite straight line. The depreciation deduction reduces ordinary income and also reduces the tax basis of the property. When the property is sold, the taxpayer will be taxed on the depreciation previously taken on a long term gain basis, if the property was Section 1231 property used in a trade or business.

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In 1964 the law was amended to convert this long term gain into ordinary income to the extent of this excess depreciation, but the law also provided that this "depreciation recapture" would decline by 1% per month after the property had been held for 20 months, with the result that there would be no recapture and the gain would be entirely long term after the property had been held for ten years. The Tax Reform Act of 1969 continued this rule only with respect to new residential rental property financed pursuant to Sections 221 (d) (3) and 236 of the National Housing Act or similar state programs.

For the taxable years effective 1 January 1977, Section 202 of the Tax Reform Act of 1976 provides for full recapture of excess depreciation on residential rental property, except for certain subsidized and other low income housing. With respect to these, there will be full recapture if the owner sells the property during the first 8\(\frac{1}{3}\) years. The recapture amount thereafter will be reduced by 1% each month, so that there will be no recapture after 200 months, or 16\(\frac{2}{3}\) years.

Thus this "recapture at ordinary income level" is a powerful motive—or necessary incentive—for the partnership to hold the project for the requisite holding period. If payments are not made on principal and interest on the mortgage, and foreclosure should occur, this foreclosure is tantamount to a sale. Recapture of excess depreciation occurs, and the investors are saddled with large sums of ordinary income. Obviously this can happen even though the General Partner guarantees the payment of any deficits, for such guarantees are only as sound as his resources, and this guaranty is also usually limited to the four or five year period of the limited partner's contributions.\(^{15}\)

The second risk involves IRS scrutiny. If some or all of the front end deductions made by the partnership should be disallowed on audit, then a substantial portion of the contemplated tax losses are not available. Obviously the risk of this disallowance is directly proportionate to the size of the front end payment, and the heavier this payment in the early years, the greater the magnitude of audit disallowance.

When a project has large underwriting and consulting fees paid to the underwriters in years one through three, there is an element of disallowance risk. It appears that in the large syndicated projects that this large fee problem is one inherent in the size. Due to the size of the project, the underwriter is an essential ingredient from a securities sale standpoint, as well as giving additional security to the project. To cover these fees, the limited partner contributions must be larger and in turn the tax losses, and the excess depreciation route is required to help generate these losses.

\(^{15}\) Internal Rev. Code of 1954, Section 1250(a)(1)(c). An amendment to Section 1250 in the T.R.A. of 1976 is designed to avoid stalling tactics to minimize recapture in that a transfer—pursuant to foreclosure is deemed to occur at the commencement of the foreclosure proceedings for purposes of determining the amount of depreciation recapture.
1. *Minimizing Risk Alternatives of the Limited Partner*

If the project must create such large losses that excess depreciation is required, the investor then must look only to the stability, resources, and management ability of the General Partner to assure that the recapture threat shall never become real. Even in this situation, however, it would seem that the deal should still be so structured that in the event of front end loss disallowance, there would still be sufficient losses to cover at least the contribution of the limited partner.

In this connection, one should note the "safety margin" that can be created in the deal when the investor is one in the 70% bracket rather than the 50% bracket. Most of the tax loss projections done by the accountant assume that the taxpayer is in the 50% bracket, and all the figures are based on this assumption. Naturally, the investor in the 70% bracket has a 40% differential, and could withstand a deeper disallowance of the front end costs than the lower bracket investor. My experience has been that in the deals requiring few investors, the 70% investor is just as available as the 50%, and this allows a large latitude that such investor will not be hurt beyond his contribution amount on audit, and his risk is substantially reduced.

In smaller projects a different approach might be used if the developer is willing to take his compensation over a longer period of time. The usual syndication pays the promotor fees over a four to five year period. To generate losses to cover these amounts, the contributions of the Limited Partners and the depreciation must be as large as possible. However, should the developer agree to a slower rate of payment, and in turn one which is larger in total amount, the contributions and the depreciation can be reduced to the point where accelerated depreciation is not required to create losses that are still attractive from an investor's standpoint. I know of several small projects which involve payment over a period of ten years. In this instance the front end losses are smaller, and thus less probable to disallowance on audit, and the contributions are accordingly less. Usually only one to four investors have been involved, who have been located on a private placement, or clients of a law firm with whom the developer has had contact. In this instance the underwriting fees are eliminated, which in turn gives more compensation to the developer. I am aware of syndications structured in this general fashion which have produced attractive tax losses for the investor on a straight line component depreciation basis, and still given the promotor close to 29% of the mortgage amount, spread over a ten year period.

In addition, this form of depreciation eliminates investor concern of recapture under Section 167. Each year is an independent year as far as he is concerned, and from year one the partnership has generated sufficient losses to make his investment attractive, and the front end partnership losses have been nominal, thus minimizing the risk on
audit. Each year the investor makes his contribution to the partnership only after the General Partner has certified that all principal, interest, taxes and insurance have been paid, and when he makes his contribution, he has almost every assurance that he will receive his losses for the coming year.

Should the project fall into hard times, and the General Partner is unable to keep it out of foreclosure, this would be no great threat to the limited partner. Accelerated depreciation has not been used, so there is no recapture concern. If it is necessary, the limited partner can withhold his contribution for that year, or even "just forget" the whole matter. He is still far on the plus side of the ledger as far as his tax losses are concerned. In addition, should his income status over the ten year contribution period decrease to such a point that the tax losses are unattractive, he could always sell or transfer his interest to another Limited Partner who could step into his shoes, and receive the same tax losses, that the original limited partner would have received. (In each of these instances, of course, there could be some aspects of a capital gain due upon the sale if the balance of the mortgage amount was assumed and was larger than the investor basis, but proper handling could keep this to a minimum.)

I feel that this situation is one with almost no risk to the investor. Here the recapture threat is avoided, the front end audit menace is reduced, and the contributions are so structured over a longer period of time that even if some disallowance of these payments to the General Partner should occur, the depreciation loss could still cover the contribution. The Limited Partner makes this contribution each year only when all is in order, and if it should not be, he withholds it. He also has the freedom of not being locked in a partnership interest which he cannot sell or assign if his income status should change.

VII. WHAT IS A SUBSIDIZED HOUSING TAX SHELTER WORTH?

It is with some hesitancy that I approach this subject, for the value of any shelter is dependent on the individual doing the project. One with a good track record of construction and management is certainly worth more than a newcomer to the field. Management after the construction is complete is most important, as it is this ability that will keep the project healthy, and the principal and interest and project operation expenses paid. As a rule of thumb, those with this background will bring up to 22 to 23% of the mortgage amount, net to the developer after all expenses have been paid. This amount is paid over the usual four or five years.

If a longer payout period is used, and the syndication is handled directly by the developer, possibly with the clients of a law firm familiar with him, he could receive up to 29 or 30% of the mortgage amount.
His payout period would be considerably longer, and approach ten years.

At this point there is one aspect of pricing the deal that should be noted—that of residual equity. It has been my experience that little or no value is placed by the investor on the potential value of the project at some future date. In pricing the deal, it is strictly a matter of numbers, and hardly any consideration is given to the so-called “residual equity.” What will a Section 8 project be worth in 10-15-or 20 years? It is a difficult question to answer, and that is probably why little or no value is placed on that aspect in the pricing structure.

Perhaps this residual equity is much overlooked from the promotor’s standpoint. After World War II, many 608 projects were built with FHA financing, they were worth a mint just 15 years after construction, and have since doubled and redoubled in value. Many have long since been refinanced with conventional loans, thus putting tax free dollars in the investors pockets. Why can’t the same happen to today’s projects? If there should be no prohibition on refinancing such low income housing projects after 15 or 20 years, why shouldn’t they also have a value that would reflect today’s inflationary trends?

The promotor should be aware of this possibility—even though the syndicators will call it remote, and attempt to receive as much of this residual equity as possible. Since the developer is being paid little or nothing for it, he could insist on the agreement providing for a 50-50 split between the General and Limited Partners on distribution, upon sale of the property, or refinancing. He should also insist that the agreement does not provide that in such distribution, the Limited Partners shall first receive back their contributions, as that amount would come off the top. This is certainly a point for negotiation, rather than the General Partner accepting the usual “boiler plate” terms which the syndicators will sometimes furnish.

VIII Securities Aspects

One cannot overlook the fact that the sale of partnership interests to the limited partner investors is a transaction that could fall under the Securities Act of 1933. Much has already been said and written on this subject, and it is a question for which there is no precise answer.

Some very large syndications by the large broker houses have gone through full registration, with expenses in the six figures. Smaller syndications involving sales by brokers have been sold under the Rule 144 offering memorandum, but the cost of even this “simplified compliance” can be upwards to $25,000, which is a prohibitive cost to the small tax shelter.

If a project is being syndicated by a broker—dealer, there is probably no alternative to at least the Rule 144 offering, and the expenses con-
nected therewith. However, if the developer could offer his deal to some law firm who might have one to four clients whom they wish to place in such, it would seem this is the optimum manner to seek out investors without using any public sale route. The law firm's relations with the clients would seem to mitigate to some degree the matter of disclosure, and in any event, it offers less problems than dealing direct with the public in general. This matter of securities compliance, however, should be thoroughly discussed between the developer and his counsel.

IX. SMALL DEVELOPER TAX SHELTER POSSIBILITIES

With the large amount of competition for Section 8 and Farmers Home Administration projects, it is becoming increasingly difficult for a small developer to receive funding for such. Budgetary considerations for the future will make the situation tighter, so he must look to other avenues for his tax shelter possibilities. Perhaps the most promising field is that of rehabilitation, for this is an avenue where neither government financing nor low income housing is necessary.

The rehab incentive of Section 191, relating to certified historic structures used in the trade or business, or held for the production of income, provides for a five year write-off of the rehab costs of such structures. This possible tax shelter could be financed by conventional means, and some states have tax abatement statues, which would offer additional attractive tax possibilities. The investment tax credit available under Section 48 (2) should also be kept in prospective. In this case, the project would have lucrative residual equities, and this could be a prime factor in the pricing structure.

Under Section 167 (k), capital expenditures made for the rehab of old properties (such as slum or substandard houses) rented to persons of low or moderate income may be depreciated under the straight line method over a five year useful life. The total deduction for any one dwelling unit may not exceed $20,000. Low interest funds are available through H. U. D. for such rehab, and many cities and communities have special low interest loans. The State of Maryland through its Rehab Fund will provide up to $25,000 per unit for 20 years at 6%.

The trend appears to be one of increasing emphasis on rehabilitation, and the developer seeking possible tax shelters should explore this. There is also much congressional interest in the Capital Cost Recovery Act, which would provide for a ten year write off on new non-residential construction. This depreciation rate could possibly provide as attractive a tax shelter as subsidized housing, yet still have the residual equity which is a questionable in the latter.

In looking for the shelter with residual equity, the small developer might also consider the single family house or duplex for rent. In this case, it is irrelevant whether the unit is government financed or has
the Section 8 housing assistance, for it could be done on a conventional basis. If such projects should be structured similar to those of the subsidized tax shelter, where cash flow is not a major consideration, they can be attractive tax investments. In addition, the residual value of such nominally priced dwellings should reflect the inflationary trends in significant capital appreciation.

I have enjoyed this opportunity to speak to you about some of the practical problems facing the small tax shelter developer. Naturally, many of my comments are from the standpoint of such a developer, and they should be construed in that light. And by all means, in the end, consult able tax counsel!