1978

Choice of Entities for Holding Real Estate: Historical Structures and Low Income Housing

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CHOICE OF ENTITIES FOR HOLDING REAL ESTATE: HISTORICAL STRUCTURES AND LOW INCOME HOUSING*

By BRUCE S. LANE

Each of the preceding three speakers has spoken to you about a different form of real estate ownership—the REIT, the partnership and corporate ownership. My assignment is slightly different; it is to speak to you about particular types of real estate—low income housing and historic structures—which have come into the tax laws recently as a meld of social and tax policy.

This all started back in 1968 and 1969 when Congress decided that it would be a good idea, through the use of both the housing laws and the federal tax laws, to provide incentives for getting equity investment into low income housing, and, more recently in 1976, that concept was expanded and extended to historic structures—a particularly timely topic here in Colonial Williamsburg.

There isn't very much doubt in the usual situation about the type of entity that you will use to own such property—it is almost always going to be a limited partnership. The reason for that is simple. In both of these areas, you have on the one hand a person who wants to create this kind of real estate—a developer-builder—and on the other hand you have a need for financing the transaction. The developer-builder can arrange a certain amount of the financing through a lender, but he needs some equity capital. For this he has investors. These investors are not interested in the active conduct of the business, but are looking only for certain investment benefits. Those investment benefits are primarily the ones that Congress has structured—tax losses. In order to protect the investor from liability you create a limited partnership, which permits the investor to be insulated from the liability which a general partner has and which permits a complete pass through of the tax losses. That's the reason why the limited partnership is the typical and, barring very unusual situations, the only form of ownership that you will use in this kind of situation. So with that as a given, let me point out to you what the principal tax features of these particular kinds of real estate holdings are and where some of the pitfalls lie. Understand at all times that the objectives here are to pass tax benefits to investors, to get equity money to the builder, and maybe, at the end of the road, 20, 30, or 40 years from now when the project is eventually sold, to enjoy a capital gain which will be shared in some negotiated manner between the developer-builder and the investors.

The reason why low income housing is attractive currently is be-

* This is the transcript of the speech as delivered at the Tax Conference.

cause the tax laws provide certain incentives for it which don't exist for other kinds of real estate. Those incentives are the following: in the case of all low income housing, you have the ability to deduct currently construction period interest and taxes. You've heard several mentions by the previous speakers of Section 189 of the Internal Revenue Code. That provision of the Code basically requires, in the case of all other real estate, amortization over a 10-year period (after a phase-in period) of any construction period interest and taxes. Many tax losses in a real estate transaction are created during the construction period by the fact that there is a lot of money going out for interest and taxes and there is no income coming in. For most other real estate those losses now have to be amortized over up to a 10-year period. For low income housing you can continue to deduct construction period interest and taxes currently in the year in which it is paid or accrued, and that will continue for anything paid or accrued through 1981. After that, unless the law is changed, there will be a phase-in which eventually in 1987 will require that low income housing, like other real estate, amortize such expenses over a 10-year period. So right now there is a very favorable situation for low income housing.

The second important incentive is what happens down the road. The ways the laws have been changed recently when you come to the time 20, 30 or 40 years from now when you sell the real estate and you've been using accelerated depreciation, that is, a rate of depreciation greater than straight line such as 200% declining balance or sum-of-the-year's-digits depreciation, you create something called "excess depreciation." If you sell the property later on and have a capital gain on the property, then excess depreciation, up to the amount of the gain, will be "recaptured" at ordinary income tax rates. In the case of low income housing, if you hold the property for 16 years-8 months you can avoid this ordinary income recapture and pay only a capital gains tax on the entire transaction. Thus you have the advantage of ordinary income tax deductions during the operating period and a capital gains tax on the entire transaction when you sell. That is a true tax shelter in the sense that you've converted ordinary income into capital gains—a very important business transaction. That exists now only for low income housing.

The third incentive is the ability in the case of rehabilitated low income housing to write the cost of rehabilitation, up to $20,000 per dwelling unit, off over a 5-year period, which is more rapid than any other method of depreciation, so that you can create very heavy ordinary losses in the up-front 5 years and then, 16 years or more later, when you sell the property, convert that to capital gains.

That leads to a discussion of what is low income housing. Low income housing is very narrowly defined by the Internal Revenue Code and my outline has the definition set out in detail—basically it is housing where the mortgage is insured under the so-called Section 221(d)(3) or Section 236 federal housing programs or where there is a loan from a state housing agency and where there are also restrictions on the return on investment and on rental changes; where there is Section 8 housing assistance to the tenants under the federal housing laws; where there is a loan made by the Farmer's Home Administration under Section 515 of the farmer's home laws; or where there is Section 167(k) rehabilitation low income housing. Read the outline for details. Not all of what you think may be low income housing is, for tax purposes, low income housing. You have to meet one of the statutory definitions that I have mentioned. In general, all of these turn on some kind of federal or state subsidy or loan. There is one exception and that's the rehabilitated housing. That is what I call a free-standing program, that is, you can finance conventionally. There need not be any federal or state aid in any way connected with the project, provided that the tenants are tenants who meet the definition of low income provided for the Section 8 housing program even though they don't have to receive Section 8 assistance. Section 8 is simply a reference point. Where do you find that reference point? You go to any area HUD office and ask for the Section 8 income limits for that geographic area and they will give them to you. If the tenants meet those tests, then the expenditures qualify as low income rehabilitation even if the tenants are not in fact getting Section 8 assistance.

Now in the area of historic structures—this has just come into the law since 1976—Congress has become very concerned with preservation and it has provided a comparable 5-year write off for the rehabilitation of certified historic structures. A certified historic structure is a depreciable building or structure which is listed in the National Register or is located in a registered historic district and is certified by the Secretary of the Interior to the Secretary of the Treasury as being of historic significance to the district. If you spend money to rehabilitate an historic structure you get a 5-year write off for rehabilitation of low income housing, there is no dollar limit on it; there is no $20,000 per unit or any other dollar limit on the amount of the write off. Thus it is a very attractive alternative to the rehabilitation under 167(k). This, by the way, is Section 191 of the Internal Revenue Code. You have an option, too, which is, if you don't want to see the fast 5-year write off you can elect as an alternative to treat a rehabilitated historic structure as a new structure for purposes of the tax law and use the rapid methods of depreciation basically as you would if you had new construction. So you can go either way—you can go for the fast 5-year write off or you can use the same methods of depreciation available for new construction.

There is also a disincentive in the historic structure area which penalizes you if you destroy a historic structure and put something else on the site. In that case you are limited to the straight line method of depreciation for the new structure and you cannot deduct the expenses of demolition. Since I don't have enough time to go into all the details on historic structures and since this is so new, I want to call your attention to two organizations that you should contact for technical help in this area who are very, very important and who are disseminating a great deal of information on it—all free. You should contact them and they will deluge you with very high quality technical information. One is the National Trust for Historic Preservation, which is located at 740 Jackson Place, N.W., Washington, D.C. 20006, and the other is the Heritage Conservation and Recreation Service of the U.S. Department of the Interior, Washington, D.C. 20240. Write to either or both of them, tell them you want information on the tax and other aspects of the renovation of historic structures, and they will send you all kinds of very readable, very helpful information.

Incidentally, you may have observed that there is a very interesting interplay here in that now the Department of the Interior is getting into the tax business and one can see the interweaving of social and tax policy in the housing area which involves HUD, the Department of Interior, and the Secretary of the Treasury. It is a seamless web, and I am sure that Prof. Stanley Surrey might be upset because he doesn't like to see the tax laws used for social policy. I will return in a few minutes to some of what the future is for this. But first I want to mention some of the problems and considerations other than the statute itself.

First of all, because tax losses are so important in this area there is one tax point that I want to stress above all others. Al Aronsohn mentioned it briefly, and it is very important in the area of low income housing. You must always be certain that the mortgage loan related to the real estate transaction is a non-recourse debt, meaning that no partner—either limited or general—NO partner—limited or general—has any personal liability, direct or indirect, for the principal or interest of either the construction or the permanent loan. If there is such liability, you most probably will prevent the investor limited partners from including in their tax basis a share of the underlying debt; they won't be able to take advantage of the *Crane* case that Alan spoke about and it will mean that they will end up with tax losses that they can't use. That is one of the most serious technical pitfalls that I deal with in this area, and I would like to alert you to it. Very often in low income housing you have to look beyond the note and mortgage to be sure that you don't have non-recourse debt, because very often the partners will be asked to sign other kinds of instruments, such as letters of credit, completion assurance guarantees and other documents, which, if you read them carefully, may include, in addition to the other obligations, an obligation with respect to the principal and/or interest on the note and may be considered a guarantee of that liability.

You should also be aware that the Internal Revenue Service is a little bit different than the Congress in that it doesn't look upon these tax shelters with quite the same favor; and so it has been seeking to narrow this tax shelter area to what it considers the letter of the law. Thus, there is a pulling and hauling going on between the private sector and the Internal Revenue Service on that subject. Right now there are three critical attacks that the Internal Revenue Service is levelling on these transactions, some of which they've been successful in court on, others of which either haven't been litigated or they haven't been successful.

First, the Internal Revenue Service may allege that the partnership is not engaged in a trade or business prior to the time that rent up activities begin; in other words, during the construction period it is not engaged in a trade or business, therefore business expenses other than interest and taxes will be disallowed as pre-opening expenses. Other ordinary and necessary business expenses which you had hoped to deduct under Section 162 will be disallowed as pre-opening up until the time that rental activities begin. There has been one Tax Court Memorandum Decision favorable to the Service on that. There is a Court of Appeals (2nd Circuit) case which is unfavorable. That case is older and the Service prefers to ignore it, and there is a 5th Circuit case involving the television industry, not real estate, which the IRS cites as authority. Finally, there is a case which I am currently litigating in the Court of Claims, which one way or another may prove to be an important decision in this area.

The second issue that the government often raises is the so-called one loan/two loan issue. This relates only to a transaction which has either federally insured loans or state housing loans. The Internal Revenue Service takes the position that there is not a construction loan and a permanent loan in those transactions but only one single loan. They make this argument because the documents often are a single set of documents. Having made that argument, they then argue that expenses which you could normally amortize over the construction period, such as certain financing fees for the construction loan and things like that, must be amortized over the much longer period (up to 42 years) of the entire lending transaction. That changes the tax write offs enormously! Thus far, the Service has been successful with that argument and there are two Tax Court cases, one is called *Lay,* one is called *Wilkerson,* which basically support that theory. It has not bene tried in any other court yet but there are pending cases and people are still trying to get other courts to come out differently on that matter.

Lastly, and the most serious attack of all, is the so-called "hobby loss" attack. Because Congress intended these transactions primarily as tax shelters and not particularly for cash flow or long term gain, the Internal Revenue Service is saying that these were not transactions entered into for a profit, and is applying Section 183 of the Internal Revenue Code, the so-called "hobby loss" provision, which in essence limits your write off to the amount of revenues that you take in. You can't shelter income from outside the project if you are subject to the hobby loss rules. This is the most disastrous attack of all. If the courts uphold this attack, in my opinion there will be no more low income or historic structure transactions arranged at all for private investors; they'll just go out of business. It is my personal belief that this was not what Congress intended and that the Internal Revenue Service will lose this case in court, but there has been no final litigation on it yet. It has been raised in the particular case which I am handling and we are trying to have it disposed of as a matter of government policy. We have asked HUD and the other government agencies to have this argument withdrawn from the case, because we don't believe that it is legitimate for the Internal Revenue Service to raise this issue in this kind of transaction. Nevertheless, the Internal Revenue Service at the present time is raising it, often at the audit level, and you should be prepared for it.

Finally, what's the future of all this. I mentioned several dates. By and large, many of the incentives for low income housing expire at the end of 1981. Unless Congress extends them beyond then, all of what I've said in this area will be obsolete by that time. Thank you very much.