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Other Investments

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The attack of the Tax Reform Bill of 1969 on the tax shelter provided by investment in such real estate as shopping centers, commercial and industrial properties cannot be mistaken. Whether or not you agree with the conclusions, you cannot escape the direction of the Committee reports with words like these:

"The present tax treatment of real estate has been used by some high income individuals as a tax shelter to escape payment of tax on substantial portions of their economic income . . . . Moreover, because accelerated depreciation usually produces a deduction in excess of the actual decline on the usefulness of property, economically profitable real estate operations are normally converted into substantial tax losses, sheltering from income tax such economic profits and permitting avoidance of income tax on the owner's other income, such as salary and dividends. Later, the property can be sold and the excess of the sale price over the remaining basis can be treated as capital gain to the extent the recapture provisions do not apply. . . . . Because of the present tax situation, when investment is solicited in a real estate venture it has become the practice to promise a prospective investor substantial tax losses which can be used to diminish the tax on his income from other sources. Thus there is, in effect, substantial dealing in tax losses produced by depreciable real property." [1]

To correct what Congress regarded as an inequity, the attack came in three directions. This produced a new pattern of tax rules for commercial and industrial property. No impelling social purpose was found which necessitated incentives for this construction, as for residential real estate. The following remarks deal with some of the effects of these provisions of the Tax Reform Bill of 1969 and a few of the rulings and cases in this area in the past two years.

The provisions of the Reform Bill came in three areas:

1. Restrictions on the use of accelerated depreciation.
2. Recapture of a greater portion of gain on sale as ordinary income where accelerated depreciation was used.
3. The minimum tax on tax preferences as applied to certain income and deductions often related to the real estate transactions.

Since the enactment of the 1964 Code we had been entitled to the same freedom of choice of methods of depreciation for real estate as for personal property. Accelerated depreciation—sum of the years-digits and double-declining balance methods of depreciation—became the bases for the familiar tax shelter. These methods were available for new property. For old property, the taxpayer could choose 150% declining-balance depreciation. These methods were available re-

[1] Summary of Tax Reform Bill of 1969 prepared by the Staffs of the Joint Committee on Internal Revenue Taxation and the Committee on Finance.

gardless of the use of the real property. With the leverage permitted in real estate investments by a high ratio of mortgage financing and the least possible amount of equity capital, the tax shelter was produced.

The 1969 Act changed this and the investor must be satisfied with less tax shelter or he must make the best of the remaining tax advantages of real estate. Straight-line depreciation is, of course, still available for all real estate ventures. For new property, other than residential properties, acquired after June 24, 1969, a declining-balance method using a rate not in excess of 150% of the straight-line rate is the maximum accelerated method available.[2] For used nonresidential properties acquired after July 24, 1969, no accelerated depreciation is permitted. The straight-line method is the only method available.

The new methods are prospective only. The restrictions apply to properties acquired or constructed after July 24, 1969. For property acquired before that date the taxpayer can continue a method previously elected in a proper manner.

The problem of the investor is, therefore, to make the best of a worsened situation—worse that is, if he is looking for a tax shelter from depreciation. Perhaps he should take a close look at depreciation by components using a different life for wiring, plumbing, roof, etc. and a separate life for the shell of the building.

The case of *Shainberg*[3] may not have originated the component method of depreciation but the frequency of citations indicates its application. The case dates back to 1959. This case involved a shopping center and is worth reading again not only for the justification of component depreciation but also for the arguments used to prove that the useful lives of the components were reasonable. Among the reasons cited were the type of construction used, the nature of the shopping center business with emphasis on its uncertainty, the frequent substantial remodeling required for new tenants, and the relatively short term of the leases. *Shainberg* had notable success in presenting a convincing argument as to the useful life of the buildings in his particular business, as compared with the possible physical life of the buildings—a factor to which the agent is often not inclined to give proper weight.

The Service acquiesced in the *Shainberg* decision but later issued several rulings designed to limit the use of the component method. One of these rulings[4] prohibited the use of the component method for a used building, for the stated reason that the value of the components cannot be separated from the building as a whole.

One taxpayer, Harsh Investment Corporation,[5] recently challenged this position with success and won the right to apply the component

[2] Section 167(j).
[3] Herbert Shainberg, 33TC 241.
[4] Rev. Rul. 66-111, CB 1966-1, 46.
[5] Harsh Investment Corp. vs. U. S., 71-1 USTC 9183 (D. Ore.).

method to a used building. The taxpayer purchased land and building for approximately $7,400,000 and assigned costs to the various components which were depreciated for lives ranging from ten years for the elevators to thirty-five years for the shell of the building. The age at date of purchase is not stated in the decision. The allocation of costs between the various components was made by a "reputable firm of appraisers." The decision should not be regarded as a lasting victory for the use of the component method of depreciation for used buildings, although some of my clients in the real estate business show signs of so regarding it.

After the *Shainberg* case the Service also ruled that it was improper in computing component depreciation to assign the guideline life to the shell of the building and use shorter lives for the other components.[6] In a 1970 ruling[7] the Service attempted to clarify the earlier ruling and stated that the composite method is not required if the taxpayer uses guideline lives. What this apparently means is that the taxpayer may use a class life shorter than guideline life for the shell, but only if he can justify the shorter life.

The component method is, therefore, alive and well. With the accelerated methods so limited for commercial buildings, it may be the best method remaining to maximize depreciation.

In addition to the restrictions on depreciation, the 1969 Act revised the provisions for taxing the gain from disposition of real estate. A greater portion of the gain will be taxed as ordinary income if accelerated depreciation methods are used.

The 1964 Act made a somewhat halting step towards taxing the gain (or a portion of the gain) on sale of real estate as ordinary income. Under the 1964 Act the so-called "additional depreciation" is taxed as ordinary income to the extent that this additional depreciation does not exceed gain on sale of the property. If the property was disposed of within the first twelve months after acquisition the "additional depreciation" was all depreciation after 1963 including straight-line depreciation. If the property was held more than twelve months, the excess of depreciation claimed over straight-line depreciation after 1963 was computed. A declining percentage of this amount was taken into account as ordinary income. After twenty months, the percentage taken into account declined 1% per month. After ten years of ownership none of the gain on sale was ordinary income. These provisions applied regardless of the nature of the depreciable real estate.

The 1969 Act provides considerably more stringent rules, particularly for commercial and industrial property. For such property sold after 1969, all depreciation claimed after 1969 in excess of straight-line depreciation is subject to ordinary income treatment to the extent of gain

[6] Rev. Rul. 68-4, CB 1968-1, 77.

[7] Rev. Rul. 70-383, IRB 1970-30, 8.

on sale of the property.[8] For nonresidential property there is no percentage reduction based on the period the property was held. The 1969 Act, like the prior Act, taxes the gain on sale of real estate held one year or less as ordinary income to the extent of all depreciation claimed.

For property held before 1969 and depreciated on an accelerated method, two computations are necessary, one under the 1969 rules and another under the 1964 rules. The gain is first taxed as ordinary income under the 1969 rules. If the gain exceeds this recapture, ordinary income under the 1964 rules is computed. If any gain remains it is taxed as capital gain.[9]

As under the 1964 rules, the gain on sale of land is capital gain so that it is necessary to establish the gain on each element separately—land, buildings and other Section 1250 property and personal property or Section 1245 property (including elevators and escalators). The gain on sale of a partnership interest is ordinary income to the extent of depreciation recapture.

The investor attempting to minimize the impact of the 1969 depreciation recapture rules has few options open. A change of depreciation method from an accelerated method to the straight-line method is a possibility. The 1969 Act amended Section 167 to provide for a change from an accelerated method to the straight-line method for the first taxable year beginning after 1969,[10] but that option is now past. A change from the double-declining balance method to the straight-line method can still be made under Section 167(e)(1). Otherwise, change must be made as provided by Revenue Procedure 67-40.

If the taxpayer does not change his depreciation method—and few will give up the current advantage—he will have to make the best of a bad situation upon sale. Income averaging may ease the burden. An installment sale may spread the income. On an installment sale, however, the ordinary income from depreciation recapture is reported first. After all ordinary income is reported any capital gain is reported. There is no proration of each payment between ordinary income and capital gain.

For many years critics of our tax system have complained of inequities in its application to some individuals who, through the source of their income or the nature of their deductions, paid what the critics regarded as less than their share of the tax burden. Accelerated depreciation methods and the taxation accorded capital gains were objects of these attacks.

The result is the tax on tax preferences—a minimum tax of 10% on certain items defined as tax preferences. Every investor in shopping centers and commercial property should be aware of these, although,

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[8] Section 1250(a)(1).
[9] Section 1250(a)(2)(A).
[10] Section 167(e)(3).

because of the manner in which the tax is computed, only the most substantial investors or the most fortunate in selling appreciated properties will pay the tax.

As applied to real estate investments, three preferences are important:

1. Excess investment interest.
2. The excess of accelerated depreciation over straight-line depreciation.
3. The untaxed portion of capital gain.

The minimum tax is imposed at a 10% rate on the total amount of tax preferences reduced by a $30,000 exemption and reduced also by the taxpayer's regular income tax. Tax preferences of a partnership or Subchapter S corporation pass through to the partners or stockholders. Carryovers are provided for operating losses and for the excess of the regular tax over tax preference items. For the accountants, this brings the reporting problem to the individuals concerned. It also results in the problem of explaining what was reported as few clients have the vaguest understanding of the terminology used.

The problems in regard to excess investment interest are the most troublesome. The application of the definitions involved to real estate investments produce particularly difficult questions. Excess investment interest is the excess of investment interest expense over net investment income. Net investment income is defined as the excess of investment income over investment expense. Investment income is income from various investment sources (including rents) but only to the extent this income is not derived from the conduct of a trade or business.[11]

The particular problem as related to commercial real estate is to differentiate between a trade or business and an investment. The Code is specific in only one respect. Property subject to a net lease entered into after October 9, 1969, is treated as property held for investment.[12] The proposed regulations state that property is not held for investment if the expenses paid in connection with the property are allowable as deductions under Code Section 162 dealing with trade or business expenses. The proposed regulations also give as an example of this application that "real property held in the conduct of the business of renting real property is property actually used in the conduct of a trade or business."[13]

The net lease rule will probably be the greatest problem in applying the rules of tax preference of investment interest. Property is automatically treated as investment property if it is subject to a net lease entered into after October 9, 1969. If the total trade or business ex-

[11] Section 57(b)(2).
[12] Section 57(b)(3).
[13] Proposed regulations 1.57-2(b)(2).

pense deductible under Section 162 is less than 15% of the rental income the lease is regarded as a net lease. This expense test relates only to the business expenses deductible under Section 162. Depreciation deductible under Section 167, interest allowable by reason of Section 163, and taxes allowed by Section 164 will not help in meeting the expense test. Many leases of commercial property will therefore, be regarded as net leases. The 15% expense test is an annual test and is applied to each piece of rental property or, if there is more than one lease for a single property, is applied to each lease. A lease which guarantees a specific return or guarantees against loss of income is a net lease. Interest during the construction period is not classified as investment interest if the property will be held as business property. Construction period interest on net lease property would be investment interest.[14]

The tax preference from accelerated depreciation on real property is of considerable importance to the investor in commercial property even though the 1969 Act limits this deduction. The tax preference from accelerated depreciation is subject to the minimum tax even though the sale of the property may result in taxation of this amount as ordinary income. This is a further factor to be considered in contemplating a change in method.

The tax preference classification for the untaxed portion of the capital gain (50% of the gain in the case of the individual) makes the installment method attractive in order to take advantage of the annual exemption.

The 1969 Act has little effect on the manner in which investment property should be held except as the form of ownership might be affected indirectly by other provisions. In a 1970 case, one intrepid taxpayer tested the application of Subchapter S to a corporation owning an office building.[15] The claim was made that the corporation furnished significant services beyond merely furnishing the use of the office space and was therefore not barred by the test of 20% of its income from passive sources. The Court found that the services were no different from those customarily furnished to tenants and barred the use of Subchapter S.

The Subchapter S corporation should not be dismissed as the vehicle for real estate ventures. With the tax shelter of accelerated depreciation severely limited, the great attraction as a tax shelter may be the losses during the construction period from interest on construction loans, taxes, ground rent and other noncapitalized expenses. The Subchapter S corporation may be an entirely satisfactory means of passing these deductions through to the stockholders during the construction period with reversion to regular corporate status once rental income is generated. This procedure would require some care as to the timing

[14] Proposed regulations 1.57-2(b)(1)(iv).

[15] Bramblette Building Corp., Inc. 70-1 USTC 9361 (ca 5).

of deductions and the adoption of the proper fiscal year to maximize the deduction passing through to stockholders. A shareholder of a Subchapter S corporation can deduct losses only to the extent of the basis of his stock and his loans. Any losses in excess of this amount are lost forever. No carryover is permitted. The partner has a distinct advantage in this respect since the value of his partnership interest is increased by his share of partnership indebtedness. This ordinarily gives plenty of basis for deduction of losses, and any losses of a partner which are not deductible when incurred become deductible at a later date when he acquires sufficient basis.

One section of the 1969 Act which may strike a blow at corporations owning real estate is the addition of Section 312(m) to the Code requiring that a corporation must compute its earnings and profits for taxable years beginning after June 30, 1972, by using straight-line depreciation. This requirement may eliminate the possibility of dividends which are partially or wholly nontaxable. Corporations in this position might consider liquidation. If prior years' accelerated depreciation has kept earnings and profits at a minimum amount, but the value of real estate has increased, a prompt liquidation under Section 333 might be appropriate.

There is another 1970 case particularly appropriate to a discussion of the corporate form of ownership of real estate ventures. The question presented was just how vulnerable the corporation is to the tax on unreasonable accumulation of surplus.[16] You will recall that a corporation can generally retain earnings without imposition of this tax up to the greater of (1) the reasonable needs of the business or (2) $100,000.00 A "mere holding or investment company" is limited to the exemption of $100,000.00. It has no defense of reasonable business needs. Here, the corporation purchased land and constructed a shopping center which it leased to tenants. The corporation owned several other rental properties. The corporation paid no dividends, and accumulated earnings in excess of $100,000.00 to purchase land and construct another shopping center when an attractive opportunity appeared. The Treasury argued that the corporation was a "mere holding or investment company" and was subject to the tax on accumulated earnings in excess of $100,000.00.

The Tax Court found sufficient activity to remove the corporation from the definition of a "mere holding or investment company" by reason of such activities as:

1. Location of suitable undeveloped land.
2. Negotiation of price and purchase of land.
3. Securing leases from Triple A rated tenants.
4. Arrangement for construction loan.
5. Handling of various management functions.

[16] Daklem Foundation, Inc. 54TC 1566.

6. Maintenance and repair of various portions of the center.
7. Management of other property.

The taxpayer won this case, but the question remains as to just how passive the income may become without being classified as a "mere holding or investment company."

The cooperative housing corporation and the condominium have considerable appeal in giving the individual the tax benefits of home ownership without some of the disadvantages. The appeal of the tax deduction of real estate taxes and interest is considerable to the high bracket taxpayer who might otherwise be paying nondeductible rent on an apartment. The cooperative housing corporation is a corporation organized to own and maintain dwelling units (usually apartments) for its stockholder-tenants. In the condominium the individual owns directly his own dwelling unit and is a co-owner of the commonly used land and improvements.

The tenant-stockholder of the cooperative housing corporation is allowed to deduct his proportionate share of the real estate taxes on the housing units and of the interest paid in connection with the acquisition and construction of these units. To provide these benefits the corporation must meet the requirements of Section 216 of the Code. The corporation

1. May have only one class of stock outstanding.
2. Each stockholder must be entitled to occupy a unit as a dwelling solely by reason of his ownership.
3. No stockholder may be entitled to receive a distribution not out of earnings of the corporation except in liquidation.
4. 80% or more of the gross income for each year must be derived from tenant-stockholders.

The stockholder must have the right to occupy the apartment, but he is not required actually to occupy it and may hold it for the production of rental income. If so held, the tenant-stockholder may deduct depreciation and other expenses as for any other rental property.

Corporate stockholders will not disqualify the corporation as a cooperative housing corporation provided the individual tenant-stockholders supply 80% or more of the gross income.

The corporation is not exempt from tax. Its receipts from tenant-stockholders and others are its income and it is entitled to deduct interest, taxes, depreciation and other expenses, and is required to pay corporate tax on any net income. In this respect the corporation and the individual stockholders are deducting the same taxes and interest expense.

The tenant-stockholder's interest in the cooperative housing corporation qualifies for the nonrecognition treatment for sale of a personal residence provided it is being used as his principal residence prior to the sale. Likewise, the ownership in a cooperative housing corporation qualifies for reinvestment of the sales proceeds of a personal residence.[17]

The condominium owner has direct ownership in his property and is entitled to deduction of real estate taxes and interest in the same manner as the owner of any single-family home. His status for nonrecognition of gain on sale is the same as any other home owner. As tenants in common for the commonly used areas, each individual will be entitled to deduct his share of the interest and real estate taxes. If he concludes he should rent his dwelling unit, he is entitled to deduct depreciation and the other related expenses in the same manner as other property owners.

[17] Section 1034(f).