



2-1-1974

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## Recommended Citation

Lawrence J. Lee, *Approach to Real Estate As a Tax Oriented Investment*, 49 Notre Dame L. Rev. 477 (1974).

Available at: <http://scholarship.law.nd.edu/ndlr/vol49/iss3/1>

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# AN APPROACH TO REAL ESTATE AS A TAX ORIENTED INVESTMENT

Lawrence J. Lee\*

## Introduction

Place 99 lawyers or accountants ("tax advisors") together and one can have 101 philosophies of investment sheltering. One approach—the author's—is set forth in this paper.<sup>1</sup> But an excellent treatment of the subject is found in Clakins and Updegraff, *Tax Shelters*, 26 TAX LAWYER 493 (1973) to which the reader is referred.<sup>2</sup>

Conceptually the approach is four-fold: the homework phase, which involves isolating the taxpayer's current tax status and placing this within the framework of the various taxes and deductions involved to arrive at the optimum investment; the psychological phase, which includes the taxpayer's attitudes and business judgment; the "lawyering" aspect, which tests the legal quality of the investment; and finally comes fortune telling.

## I. The Homework Phase

### A. The Taxpayer's Current Tax Status

First, the lawyer must ascertain whether the taxpayer has a tax problem. Taxes are a fact of life and that the taxpayer pays some tax is not unique or unfair. The tax advisor assists in deciding whether the amount paid exceeds propriety. To do this properly, the tax advisor must familiarize the taxpayer with the various categories of tax involved: ordinary income tax,<sup>3</sup> the capital gains tax,<sup>4</sup> the minimum tax on tax preferences,<sup>5</sup> the maximum tax on earned income,<sup>6</sup> the investment interest limitation,<sup>7</sup> the hobby loss provisions<sup>8</sup> and, perhaps, the limitation on artificial accounting losses and minimum taxable in-

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<sup>1</sup> This is a practical article. But it provides, at best, an outline of points to be noted. The reader is left to his own devices to ascertain the full implications of the Internal Revenue Code sections involved. Secondly, the title "tax oriented" was chosen in preference to "tax shelter" but neither appellation is satisfactory. Tax benefits should be secondary; the economics of the investment, primary. Is the real estate a sound investment? That alone is the consideration.

<sup>2</sup> See also, Cunnane, *Tax Shelter Investments After the 1969 Tax Reform Act*, 49 TAXES 450 (1971).

<sup>3</sup> INT. REV. CODE OF 1954, § 1 (hereinafter section citations in the text refer to the INTERNAL REVENUE CODE OF 1954 unless otherwise indicated).

<sup>4</sup> *Id.* § 1201; technically speaking this is the 25% rate on the first \$50,000 of net long-term capital gain.

<sup>5</sup> *Id.* § 56.

<sup>6</sup> *Id.* § 1348.

<sup>7</sup> *Id.* § 163(d).

<sup>8</sup> *Id.* § 183.

come.<sup>9</sup> Each of these subjects warrants its own article; each is only highlighted here.

### *B. The Limitation on Artificial Accounting Losses*

The Limitation on Artificial Accounting Losses (LAL) and the Minimum Taxable Income (MTI) are Nixon Administration proposals to curb what it regards as abuses in shelters. If either or both of these are enacted, the "charm" of shelters will be lost.

The Artificial Accounting Loss to which LAL applies is the amount by which accelerated deductions for the taxable year exceed associated net related rental income for the same taxable year. "Net Related Income" is gross income<sup>10</sup> from the property, or, as the case may be, related properties, less ordinary expenses but excluding accelerated deductions. "Accelerated deductions" in real estate are defined as: (1) Accelerated depreciation in excess of straight-line depreciation,<sup>11</sup> (2) amortization under § 167(k) of the Internal Revenue Code for rehabilitation housing in excess of straight-line, and (3) amounts of otherwise deductible construction period or "pre-opening" costs which precede the income to which they relate, including, for example, interest; state and local taxes; management, brokerage and legal fees; insurance; advertising; and transfer and recording charges. Such costs may include ground rent. The "construction period" remains to be defined. Thus, if the "construction period" includes any time before the project is income productive, expenses incurred from day one may be regarded as accelerated deductions. On the other hand, if the "construction period" commences when construction actually first starts, ground rent and other start-up charges incurred prior to construction would continue to be deductible without limitation. If the liberal interpretation applies, the obstacle remains in defining the commencement of construction—*i.e.*, when the property is staked and the first shovel of soil is moved, when plans are drafted, or when subdivision authority is sought.

Net related income from residential real property includes rental income from all residential properties held by the same taxpayer plus the sales income from housing held primarily for sale. As to non-residential property, net related income includes only the rental income (and sales income if the property is held primarily for sale) from the particular property to which the accelerated deductions are attributable. In short, commercial property is considered building by building. However, where one or more buildings are located on a single tract or parcel or contiguous tracts or parcels and the buildings are managed and operated as a unit, all such buildings will be treated as a single property for accelerated deductions purposes.

9 U.S. DEP'T OF TREASURY, PROPOSALS FOR TAX CHANGE 83-93, 94-104 (1973). At the time this paper was prepared, the only material available on LAL and MTI was the Treasury's proposal. Chairman Wilbur Mills, Ways and Means Committee, had indicated that tax reform would be taken up by the Committee in September; however, the Committee apparently is now going to consider the Finance Committee's private pension plan legislation and foreign tax matters first, which may delay the Committee's consideration of the Treasury's proposal until early 1974.

10 INT. REV. CODE OF 1954, § 61.

11 *Id.* § 167(b).

Accelerated deductions in excess of associated net related income are not deductible in the year paid or incurred.<sup>12</sup> But they are not lost or forfeited. Instead, such deductions are accumulated in the Deferred Loss Account ("DLA") for the property to which they are related. In the case of residential property, *i.e.*, a situation where all properties in this category are permitted to be aggregated, a single consolidated Deferred Loss Account is established. Each year's accelerated deductions are added to the account. The DLA is "unwound" in each subsequent year when associated net related income exceeds the deductions, ordinary or accelerated for that year; *i.e.*, in any succeeding taxable year in which the net related income exceeds the accelerated deductions for the taxable year, an amount equal to such excess will be subtracted from the DLA and allowed as a deduction in that year. The balance left in the DLA is simply carried forward from each year to the next until excess net related income amortizes it to zero. If the property is sold when there is a balance remaining in the DLA which is attributable to that property and the sales proceeds do not otherwise count as net related income, such as when the property is held primarily for sale to customers, then the allocable portion of the DLA is subtracted from the account and added to the basis of the property thereby in effect reducing the capital gain realized on the sale.<sup>13</sup> If the property is sold at a loss or the effect of adding the accelerated deductions to the basis of the property is to create or increase the loss which would otherwise be realized on the sale, the accelerated deductions are simply allowed in the year of sale as ordinary deductions rather than increasing the capital loss realized.

LAL does not apply to corporations unless the Subchapter S election<sup>14</sup> has been made. It does apply to partnerships. The Subchapter S corporation or partnership determines all LAL items (net related income, accelerated deductions, etc.) at the entity level and reports each shareholder's or partner's distributive share in the same way that partnerships now report each partner's other partnership items. Each shareholder or partner, in turn, is entitled to treat his distributive share of each LAL item in the same manner as if he owned, directly, the property involved. Thus, as in the case of residential real estate, the approach indicated permits the shareholder or partner to "marry" the Subchapter S corporation or partnership LAL items with the LAL items incurred with respect to other residential properties owned by the taxpayer individually.

According to the Administration's proposal, as originally set forth, LAL was to be effective for taxable years beginning after 1973 as to transactions entered into subsequent to April 30, 1973. Pre-May 1, 1973, transactions are "grandfathered" under the old rules. However, on June 1, 1973, Chairman Wilbur Mills, House Ways and Means Committee, announced, in a joint press release with Representative Herbert T. Schneebeli, and with the Treasury's approval,

12 Normal tax accounting continues. For example, even though accelerated depreciation (in excess of straight-line) may be deferred in DLA, the full amount of depreciation computed under the method adopted by the taxpayer is treated as "allowed or allowable" for the purposes of adjusting the basis of the property under INT. REV. CODE OF 1954, § 1016.

13 This is in essence accelerated depreciation recapture since what would have been current ordinary deductions, under existing law, will no longer be allowed as such but merely in effect capital losses.

14 INT. REV. CODE OF 1954, § 1371 *et seq.*

that "we would expect that the effective dates for the new provisions generally would not apply before the date of the announcement of the committee decisions and in any event (in the absence of year-end abnormal transactions) probably not in the case of deductions occurring in 1973. However, if there should be an unusually large volume of transactions in the period immediately ahead, it might be necessary for the Committee to apply the new provisions to some extent during this period." Also, the Administration's proposal excepted housing projects receiving governmental subsidiary assistance. It is not clear whether this includes state and local subsidies as well as federal aid.

As a philosophical matter, LAL may be regarded as forced capitalization of the excess deductions ordinarily realized in real estate transactions, *i.e.*, accelerated depreciation and "front-end" write-offs. All real estate transactions, viewed in a tax context, reach a "cross-over" point. The cross-over point is achieved when rental income exceeds the depreciation, operating expenses, and interest expense arising from the project. Ordinarily this point is the fifth to the seventh year. LAL will simply extend the cross-over point to the twelfth to the fifteenth year. What it does do is limit the average investor's capacity to invest with tax savings realized by the excess deductions. Thus, real estate investments must be made, generally speaking, with "after-tax" dollars. The United States Treasury will no longer assist the taxpayer in buying into the project. On the other hand, once the taxpayer has the capital to invest, substantial shelter benefit can be achieved. For example, if the final LAL proposal continues to permit the "aggregating" of residential real estate, one approach could be to "marry" a cash-flow project with a start-up situation. Assume an older property, with a stabilized rent-roll, but one which has reached the "cross-over" point. A taxpayer could purchase the attractive rent-roll and then shelter that cash flow by becoming involved in a start-up situation which promises attractive front-end deductions and heavy initial accelerated depreciation. The result is a tax-free cash flow from the older project for some period of years. There is speculation that LAL may prove to be a boon to older properties.

The point, of course, is that with LAL there will be no "shelter" if shelter contemplates the use of real estate "excess" deductions to render tax-free the taxpayer's other income (*e.g.*, from his medical practice).

The Treasury gives the following illustration of LAL in operation:

(i) The taxpayer has two residential apartments in 1974; Apartment Building A acquired in 1966 to which LAL does not apply and Apartment Building B to which LAL does apply.

(ii) For the taxable year, there are the following deductions and related income:

a. Building A—\$260,000 of gross rent; \$235,000 for interest, operating expense, and straight-line depreciation; and an additional \$10,000 of accelerated depreciation (in excess of straight-line). The net related income from Apartment Building A is \$15,000. Since LAL does not apply to Building A, the accelerated depreciation in excess of straight-line is fully allowable both in arriving at adjusted gross income and in computing net related income.

b. Building B—\$150,000 of gross rent (not rented all year); \$100,000 of interest and taxes during construction and other construction period costs;

\$140,000 other interest, operating expenses and straight-line depreciation; and an additional \$30,000 of accelerated depreciation (in excess of straight-line). The net related income for Building B is \$10,000, *i.e.*, gross rents of \$150,000, less \$140,000 for other interest, operating expenses and straight-line depreciation, but without allowance of the \$100,000 of construction period costs or additional \$30,000 of accelerated depreciation.

c. The total net income in the taxable year for all residential real estate is \$25,000, *i.e.*, \$15,000 for Building A and \$10,000 for Building B. The total accelerated deductions on Apartment Building B is \$130,000, *i.e.*, construction period costs of \$100,000 and additional accelerated depreciation of \$30,000. The artificial accounting loss is \$105,000. This amount is added to the Deferred Loss Account to be deducted in the future against net related income from residential real estate.

(iii) In a succeeding taxable year, Building A produces net related income of \$60,000 and Building B has net related income of \$10,000 (computed without regard to accelerated depreciation of \$35,000 in excess of straight-line). Thus, \$35,000, the amount by which the total net related income of \$70,000 for both buildings exceeds the additional accelerated depreciation of \$35,000 in the taxable year, is subtracted for the Deferred Loss Account and allowed as a deduction in the taxable year.<sup>15</sup>

### C. The Minimum Taxable Income

The Minimum Taxable Income (MTI) does not directly bear upon real estate tax shelters, but its impact seriously hampers the individual investor's ability to shelter certain types of his income. Under MTI the individual taxpayer must pay a tax, computed at ordinary income tax rates without the benefit of the 25% alternative tax<sup>16</sup> and the maximum tax on earned income<sup>17</sup> on the larger of his normal taxable income or MTI. MTI is computed, as follows: Adjusted Gross Income,<sup>18</sup> computed in the ordinary manner, is increased to Expanded Adjusted Gross Income (EAGI) by adding to it: (1) the excluded one-half of net long-term capital gains; (2) percentage depletion in excess of basis; (3) exempt earned income from foreign sources, and (4) non-taxable "bargain element" in certain stock options. EAGI is then reduced by subtracting: (1) deductions for personal exemptions; (2) deductions for extraordinary medical expenses in excess of 10% of EAGI; (3) deductions for extraordinary casualty losses in excess of 10% of EAGI; (4) deductions for investment interest and investment expenses but only to the extent of investment income and (5) a \$10,000 "cushion." The difference—the MTI base—is divided by two to arrive at taxable MTI.

In capital gains situations where under the existing rules only one-half of capital gains are taxed, the effect of MTI is to reduce the efficiency of tax deductions to one-half their former effect. Now a taxpayer realizing substantial capital gains is prompted to shelter those gains using the untaxed one-half of the gains to pay for the shelter investment. He will find under MTI at least one-half of capital gains will be taxed at ordinary income rates and in effect he

15 U.S. DEP'T OF TREASURY, *supra* note 9, at 101-02 (1973).

16 INT. REV. CODE OF 1954, § 1201.

17 *Id.* § 1348.

18 *Id.* § 62.

obtains no benefit from the shelter. Under the Administration's proposal, MTI will be effective for taxable years beginning after December 31, 1973.

The Treasury gives the following illustration of MTI:

For the taxable year the taxpayer has:

- (a) \$175,000 of ordinary income (\$100,000 of net income from oil wells before taking the percentage depletion deduction, \$50,000 professional earnings, and \$25,000 dividends and interest).
- (b) \$100,000 long-term capital gain from stock.
- (c) \$50,000 deduction of one-half the capital gain.
- (d) \$50,000 percentage depletion deduction (basis is zero).
- (e) \$75,000 itemized deductions.
- (f) Joint return; \$3,000 deduction for four personal exemptions.

Under present law, adjusted gross income is \$175,000 (\$175,000, plus \$100,000 capital gain, less \$50,000 capital gains deduction and less \$50,000 percentage depletion). Normal taxable income is \$97,000 (\$175,000 AGI, less \$75,000 of itemized deductions, less \$3,000 for personal exemptions). Income tax under present law, computed using the alternative tax on capital gains, is \$42,000. The amount of "tax preferences" subject to the 10 percent minimum tax is \$27,380 (preference items are one-half of the long-term capital gain or \$50,000 and percentage depletion of \$50,000 reduced by a floor of \$30,000 and the income taxes of \$42,620 as allowed under the Minimum Tax). Minimum Tax is \$2,738, and total tax is \$45,358.

Under MTI, Expanded Adjusted Gross Income is \$275,000 (AGI of \$175,000, plus \$50,000 of excluded long-term capital gains, plus percentage depletion of \$50,000). The MTI base is \$262,000 (EAGI of \$275,000 less \$3,000 for personal exemptions, less \$10,000). Minimum Taxable Income is \$131,000 (MTI Base of \$262,000 divided by 2). Income tax is \$64,620.<sup>19</sup>

### D. Ordinary Income Tax

If LAL and MTI are enacted, the taxpayer will have little interest in shelters in most cases. But assuming that reform legislation is not enacted, or modified or is delayed in application, the current statutory scheme becomes relevant.

Obviously, tax advisors and most taxpayers appreciate that under § 1 of the Internal Revenue Code, the ordinary income tax rates range between 14% and 70%. Taxpayers, however, often overlook that it is the last dollars within the bracket which are taxable at the highest percentage rates shown for the bracket. Thus, the shelter deduction must be viewed as decreasing in tax efficiency as the deduction shifts the taxpayer's income from a higher bracket to a lower bracket. For example, while the last dollar of the taxpayer's earned income is taxable at the 50% rate, the shelter deduction may, on an average, only save taxes at a 40% rate.

Consideration must be given to income averaging.<sup>20</sup> Averaging now includes capital gains. But if averaging is used, neither the alternative tax on

<sup>19</sup> U.S. DEP'T OF TREASURY, *supra* note 9, at 89.

<sup>20</sup> INT. REV. CODE OF 1954, § 1301 *et seq.*

capital gains<sup>21</sup> nor the maximum tax on earned income apply.<sup>22</sup> Usually the tax savings resulting from averaging are relatively nominal versus shelter<sup>23</sup> although averaging may, in the long run, be more beneficial than a "one-time" entry into the shelter market.<sup>24</sup> If MTI is enacted, the income averaging sections will be amended to prohibit the averaging out of the EAGI adjustments.

### E. Minimum ("Mini") Tax

A 10% minimum tax is imposed by § 56 of the Internal Revenue Code on the total of tax preferences for the year which exceed a "cushion" composed of (1) \$30,000 (\$15,000 in the case of married taxpayers filing separately);<sup>25</sup> plus (2) the taxpayer's regular tax for the taxable year and; (3) the unused regular tax carryovers (7-year limit)<sup>26</sup> to the taxable year. Real estate related tax preference items include: (1) accelerated depreciation (excess over straight-line);<sup>27</sup> (2) accelerated depreciation on personalty which is net leased (e.g., furniture, fixtures and equipment);<sup>28</sup> and (3) untaxed portion of long-term capital gains.<sup>29</sup> Other common preferences that might involve a shelter oriented taxpayer include the excess of percentage depletion over the cost basis of mineral property<sup>30</sup> and the bargain element in stock options.<sup>31</sup> MTI, if enacted, will replace the 10% minimum tax for individual taxpayers. The minimum tax is not a significant item if the taxpayer is making or proposes to make only modest shelter investments. However, the minimum tax may be significant, particularly where capital gains are being sheltered, if the shelter eliminates most of the taxpayer's tax liability for the year. But even substantial shelter in a current

21 *Id.* § 1201.

22 *Id.* § 1348.

23 Averaging makes a marked difference only when there is a substantial increase in income in any one year. Consider the following example, taken from 4 P-H 1973 FED. TAXES ¶ 33,006:

Brown, a real estate broker, put years of time and effort into building a solid foundation for his business. From 1968 through 1971 his base period incomes were \$8,000, \$9,000, \$11,000 and \$12,000, respectively. In 1972, though, everything jells at once and his taxable income rises to \$52,000. He's married and files a joint return.

Computations show that the tax without averaging would have been \$18,060, but with averaging, the total tax is \$12,860 and Brown saves \$5,200.

24 Often a favorable economic result in shelter investments depends upon the taxpayer's ability to stay with the investments over the long haul (and to honor subsequent assessments) or to diversify his investments or to average investments over a period of years. For example, wisdom may warrant acceptance of the lesser advantages of averaging vis-à-vis investment in a real estate venture which includes future calls for capital, which, if not met, squeeze and penalize the taxpayer to a point where his initial investment gives him a nominal or deferred position in the shelter.

25 INT. REV. CODE OF 1954, 58(a). Apart from the Treasury proposals the Ways and Means Committee is considering proposals to tighten the Mini-tax. Such proposals include: 1) decreasing the cushion to \$15,000, 2) increasing the tax rate to 14 percent, and 3) reducing or eliminating the addition of ordinary tax to the cushion.

26 *Id.* § 56(c). Qualified carryover years start with taxable years beginning after 1969.

27 *Id.* § 57(a)(2).

28 *Id.* § 57(a)(3). Personal property is usually not a significant factor in real estate shelter investments.

29 *Id.* § 57(a)(9).

30 *Id.* § 57(a)(8).

31 *Id.* § 57(a)(6).

year generating substantial preference items is not significant if the taxpayer has paid substantial taxes in prior years, *i.e.*, he has a taxes paid carryover.<sup>32</sup>

Since any individual taxpayer with more than \$60,000 in capital gains has a potential minimum tax problem, shelter planning may warrant consummating a significant capital transaction on the installment method. This assumes a favorable judgment as to the financial soundness of a deferred arrangement, a conclusion can only be reached after measuring the deferral against (1) the tax savings resulting from averaging, and (2) the value of the present use of the dollars net after tax (regular tax and minimum tax). Also to be considered is that installment reporting (3) allows the taxpayer to use the lower alternative tax rate of 25% on the first \$50,000 of long-term gains, and (4) avoids the impact which tax preference items have on the maximum tax on earned income.

### F. Maximum ("Maxi") Tax

Earned income (which is a term of art, specially defined) is now subject to a maximum tax rate of 50%. The tax under § 1348 of the Code is computed as the total of the following: (1) the tax on the earned taxable income determined up to the 50% bracket (\$52,000 married, filing jointly), plus (2) 50% of the earned income which otherwise would be taxed at greater than a 50% bracket, plus (3) the excess of the tax computed under the ordinary rates but without regard to the maximum tax *over* the tax so computed with reference solely to the taxpayer's earned income. Earned taxable income is the difference between the amount which bears the same ratio to the taxpayer's taxable income as

32 Consider the following examples found in 1 CCH 1973 STAND. FED. TAX REP. ¶ 599G:

*Example (1):* In 1972, Mr. Brown, a married taxpayer filing a joint return, reported taxable income of \$175,000, of which \$75,000 was one-half of the excess of his net long-term capital gain over net short-term capital loss. Using the alternative capital gains tax, his tax for 1972 was \$90,180. Suppose that, in addition to the tax preference item of \$75,000 for capital gain . . . , Mr. Brown also had a tax preference item of \$50,000 for excess investment interest. . . . His minimum tax would be \$482, figured as follows:

50% of capital gain .....	\$ 75,000
Excess investment credit .....	50,000
Total tax preference items .....	\$125,000
Less:	
Exemption .....	\$30,000
Income tax .....	90,180
	120,180
Subject to 10% tax .....	4,820
10% tax .....	482

*Example (2):* Mr. Lakes has a taxable year beginning September 1, 1971 and ending August 31, 1972, for which he has tax preference income of \$40,000 and a regular income tax liability of \$15,000. His \$10,000 tax preference above the \$30,000 exemption level is offset in full by his \$15,000 tax liability so that no minimum tax is due for the year. In addition, he has a \$5,000 excess tax liability carryover.

Assume that in his next taxable year (1972-1973), Mr. Lakes has tax preference income of \$42,000 and a regular tax liability of \$10,000 (not including the carryover). His \$12,000 tax preference income above the \$30,000 exemption level is offset by his \$10,000 liability for the current year, plus \$2,000 of the 1971-72 carryover. The remainder of the carryover (\$3,000) may be carried over to the next six taxable years.

his earned net income bears to his adjusted gross income, less either (1) 1/5th of the average of the taxpayer's tax preferences for the current year and the previous four years, or (2) the sum of tax preferences in excess of \$30,000.<sup>33</sup> Earned net income is earned income less business expenses.<sup>34</sup> Earned income is narrowly defined but, generally speaking, includes salaries, professional fees, deferred compensation, premature H. & R. 10 Plan distributions, income in respect of nonstatutory options, etc.<sup>35</sup>

In considering the benefit of the maxi-tax, the following general observations are in order. The limitation on the rate effects only earned income and not other or passive income (dividends, royalties, etc.). A shelter may benefit with respect to said other income.<sup>36</sup> The maximum tax does not apply to

33 INT. REV. CODE OF 1954, § 1348(b)(2).

If MTI is enacted, earned taxable income will be computed as follows:

$$\text{Taxable Income} \times \frac{\text{Earned Net Income}}{\text{Expanded Adjusted Gross Income}}$$

Since the denominator of the fraction will be Expanded Adjusted Gross Income (EAGI), earned taxable income will be the same proportion of taxable income as earned net income bears to EAGI (which includes tax preferences). However, tax preferences are not applied in further reduction of earned taxable income as under the existing law.

34 *Id.* § 1348(b)(2).

35 *Id.* § 1348(b)(1).

36 As indicated in the following tables, taken from 5A CCH 1973 STAND. FED. TAX REP. ¶ 4843, the tax savings, at least for married taxpayers, under the "maxi" tax are rather nominal on the first \$100,000 of earned taxable income.

#### TAX SAVINGS ON ETI FOR 1972 AND LATER YEARS

Table 1 — For Use *ONLY* by Unmarried Individuals (Other than Certain Surviving Spouses and Heads of Households) for 1972 and Later Years

ETI		Tax Savings on		Tax Savings	On ETI Over
Over	Not Over	Col. 1	+	Rate	
\$ 38,000	\$ 44,000	.....		5%	\$ 38,000
44,000	50,000	\$ 300		10%	44,000
50,000	60,000	900		12%	50,000
60,000	70,000	2,100		14%	60,000
70,000	80,000	3,500		16%	70,000
80,000	90,000	5,100		18%	80,000
90,000	100,000	6,900		19%	90,000
100,000	150,000	8,800		20%	100,000
150,000	200,000	18,800		20%	150,000
200,000	.....	28,800		20%	200,000

Table 2 — For Use *ONLY* by Married Individuals Filing Joint Returns and Certain Surviving Spouses for 1972 and Later Years

ETI		Tax Savings on		Tax Savings	On ETI Over
Over	Not Over	Col. 1	+	Rate	
\$ 52,000	\$ 64,000	.....		3%	\$ 52,000
64,000	76,000	\$ 360		5%	64,000
76,000	88,000	960		8%	76,000
88,000	100,000	1,920		10%	88,000
100,000	120,000	3,120		12%	100,000
120,000	140,000	5,520		14%	120,000
140,000	160,000	8,320		16%	140,000
160,000	180,000	11,520		18%	160,000
180,000	200,000	15,120		19%	180,000
200,000	300,000	18,920		20%	200,000
300,000	400,000	38,920		20%	300,000
400,000	.....	58,920		20%	400,000

corporations or married taxpayers filing separately.<sup>37</sup> It does not apply to a taxpayer who income averages.<sup>38</sup> Where the high income level results from capital gains, the impact is two-fold: the untaxed portion of the capital gains is a tax preference item and at the same time reduces the amount of earned income by the excess of the untaxed capital gain over \$30,000. Again, this is a reason to avoid substantial capital gains in any one taxable year.

In conclusion, assuming a sound business investment, any tax deduction which reduces taxes to lower than a 50% rate is desirable. Preference deductions become a concern *only* in situations where their impact is to shift what might be taxed at no more than 50% to, say, the 70% bracket.

### G. Limitation on Investment Interest

The limitation on investment interest<sup>39</sup> disallows interest expense in excess of the total of (1) \$25,000 (\$12,500, married taxpayers filing separately) plus

37 INT. REV. CODE OF 1954, § 1348(c).

38 *Id.* § 1348(a).

The following illustrates the computation of the maximum tax, as found in Proposed Treas. Reg. § 1.1348-2(d)(4), 36 Fed. Reg. 23814 (1971). *Example (1)*:

Example (1): (i) H and W, married calendar-year taxpayers filing a joint return, have the following items of income, deductions, and tax preference for 1976:

(a) Salary .....	\$155,000
(b) Dividends and interest .....	60,000
	<hr/>
	215,000
(c) Deductible travel expenses of employee allocable to earned income....	5,000
	<hr/>
(d) Adjusted gross income .....	\$210,000
(e) Exemptions and itemized deductions .....	38,000
	<hr/>
(f) Taxable income .....	172,000

In addition, the taxpayers have tax preference items for 1976 of \$80,000 attributable to the exercise of a qualified stock option and total tax preference items of \$300,000 for the years 1972 through 1975. Since the items of tax preference for 1976 exceed the average of the items of tax preference for the years 1972 through 1976, the tax preference offset for 1976 is \$50,000 (\$80,000 - \$30,000).

(ii) H and W have earned taxable income of \$72,222, determined in the following manner:

(a) Earned Income .....	\$155,000
(b) Earned Net Income (\$155,000 - \$5,000) .....	150,000
(c) Taxable income .....	172,000
(d) Adjusted Gross Income .....	210,000

(e) Taxable income attributable to earned net income:

$$\$172,000(c) \times \frac{\$150,000(b)}{\$210,000(d)} = \$122,222$$

(f) Tax preference offset .....

(g) Earned taxable income .....	72,222
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(iii) The tax imposed by section 1 is \$90,969, determined pursuant to section 1348 in the following manner:

(a) Applicable amount from column (2) of Table A, § 1.1348-2(b) .....	\$ 18,060
(b) 50 percent of amount by which \$72,222 (earned taxable income) exceeds \$52,000 (applicable amount from column (1) of Table A, § 1.1348-2(b)) .....	10,111
(c) Tax computed under section 1 on \$172,000 (taxable income) .....	\$ 91,740
(d) Tax computed under section 1 on \$72,222 (earned taxable income) .....	28,942
(e) Item (c) - Item (d) .....	62,798
(f) Tax (total of Items (a), (b) and (e)) .....	90,969

39 INT. REV. CODE OF 1954, § 163(d).

(2) net investment income (this is a term of art specially defined), plus (3) excess of §§ 162, 164 and 212 expenses over net lease rental (again, a term of art, specially defined), plus (4) excess of net long-term capital gain over losses from the disposition of investment property, plus (5) 50% of the investment interest expense in excess of the total of items (1) through (4). MTI, if enacted, will abolish the present limitation on investment interest.

All taxpayers now are entitled to the \$25,000 "cushion" of interest expense plus 50% of investment interest paid or incurred over \$25,000. Applied practically, this means that the taxpayer's share, so-to-speak, of a real estate syndicate's indebtedness must exceed \$312,500, at 8%, in order for the taxpayer to have investment interest expense larger than \$25,000. On the other hand, care must be exercised if the syndicate applies special allocations of deductions for the benefit of investor limited partners. The shifting of all partnership losses to the investor limited partners may result in their receiving all of the interest deductions which could well exceed the limits.<sup>40</sup> Note, however, that a carry-over is permitted for excess interest disallowed in any given year so that the deduction is not permanently lost.<sup>41</sup>

Capital gains are added to the "cushion" to determine the amount of investment interest expense allowable as a deduction in the year. This has two effects: First, each dollar of interest expense is applied to all of the capital gains (not just the 50% included into income) thereby making the interest deduction only 50% efficient for tax purposes. Second, to the extent that capital gains are added into the allowable deduction "cushion," such capital gains are treated as ordinary income for purposes of the 50% long-term capital gains deduction, the minimum tax on tax preference items, and the alternative capital gains tax.<sup>42</sup> Again, this is an added reason, within the context of sound business judgment, to defer the receipt of capital gains in any one taxable year.

The limitation on investment interest does not apply to interest incurred in connection with a trade or business.<sup>43</sup> Accordingly, shelter investments, if possible, should be under the color of a trade or business. Such is not feasible in a syndicate situation because, not only are the investors generally recognized as passive, but they are also specifically forbidden any management or business function in order to maintain their status as limited partners. However, the taxpayer may well be in a trade or business of renting property if he is substantially the sole investor and operates the property.<sup>44</sup>

Another consideration is whether deductions other than interest should be avoided in any year in which the interest expense limitation may be applicable.

40 Under § 752 of the Internal Revenue Code and Treasury Regulation 1.752-1(e), liabilities are shared, among partners, according to their ratios for sharing losses under the partnership agreement. Accordingly, in a special allocation situation, where all losses or 90% of all losses are allocated to the limited partners, all debt is attributed to them and technically it can be argued that all interest expense is attributable to them.

41 INT. REV. CODE OF 1954, § 163(d)(2).

42 *Id.* § 163(d)(5).

43 *Id.* § 163(d)(3).

44 Leland Hazard 7 T.C. 363 (1946), *acq.*, 1946—2 CUM. BULL. 3, and see Lee, "Active Conduct" Distinguished From "Conduct" of a Rental Real Estate Business, 25 THE TAX LAWYER 317 (1972).

One item adding to the allowable expense "cushion" is net investment income.<sup>45</sup> Hence, it may be appropriate to increase investment income by foregoing accelerated depreciation, additional first year depreciation on personalty and "front-end" deductions.<sup>46</sup>

Prepaid interest will be considered below, but the taxpayer should be mindful that if prepaid interest is not disallowed under the Internal Revenue Service's policy, prepayment may load interest expense into a year in which the amount may exceed the allowable limits under § 163(d). Hence, prepaid interest is vulnerable from both Rev. Rul. 68-643<sup>47</sup> and § 163(d).

### H. The Taxpayer's Profile

The various taxes and limitations must next be applied to the taxpayer's profile to determine the optimum shelter investment. Here pencil is put to paper. To illustrate this, take a relatively simple situation: Taxpayer has \$100,000 of professional fee income, \$15,000 of unearned income (assume interest) and \$12,000 of below-the-line deductions and exemptions. He has sold land for a net long-term capital gain of \$100,000. He had taxable income of approximately \$28,000 in years past and he had no unearned income or tax preference items in those years. He is married and expects to file a joint return. He proposes to make either of two shelter investments. The first will produce a \$60,000 write-off, and of this deduction \$40,000 constitutes preference items. The second will produce a \$50,000 write-off, and of this deduction \$30,000 constitutes preference items.

#### REGULAR INCOME TAX—TABLE A

Earned Income (EI)	\$ 100,000
Unearned Income (UI)	15,000
Capital Gains (CG)	100,000
Less: IRC § 1202 Deduction	(50,000)
Adjusted Gross Income (AGI)	165,000
Deductions and Exemptions	(12,000)
Taxable Income (TI)	153,000
Regular Tax (IRC § 1)	78,960

#### ALTERNATIVE TAX—TABLE B

Taxable Income		153,000
Less: Net IRC § 1201 Gain		50,000
		103,000
Ordinary Tax		47,040
25% of \$50,000		12,500
Tax on Taxable Income (A)	(78,960)	
Tax on Ordinary Income + 50% of IRC § 1201(d) gain (B)	(62,700)	
Difference (A) — (B)	16,260	16,260
Tax for Year		75,800
Alternative Tax Savings		3,160
Minimum Tax — 10% of TP		
Tax Preferences (TP)		—0—

<sup>45</sup> INT. REV. CODE OF 1954, § 163(d)(3).

<sup>46</sup> See *id.* §§ 167(b); 179(a); 266.

<sup>47</sup> 1968-2 CUM. BULL. 76.

## INCOME AVERAGING—TABLE C

Average Annual Income for		
base period years		28,000
Current Taxable Income		153,000
Averaging Base		33,600
(1) Tax on Averaging Base		9,332
Averageable Income		119,400
Tax on Averaging Base + 1/5 of		
Averageable Income (\$57,480)		20,964
Difference in taxes		11,632
(2) Tax on Averageable Income (×5)		58,160
Tax Due—Income Averaging		
(1) + (2)		67,492
Averaging Tax Saving		11,468
<u>Minimum Tax — 10% of TP</u>		
Tax Preference (TP)		—0—

Based upon the computations of the regular income tax (Table A), the alternative tax (Table B), and the averaging income tax (Table C), it is obvious that without parting with any shelter dollars, the taxpayer can save \$11,468 in income taxes by averaging (presumably disregarding the alternative tax which produces a savings of only \$3,160). Thus, without investing \$50,000 or \$60,000 or more,<sup>48</sup> the taxpayer can still save \$11,468. In one sense, this is almost a 20% return on dollars NOT invested. The taxpayer is approximately \$60,000 to \$70,000 dollars<sup>49</sup> ahead, *i.e.*, the tax savings of \$11,468 plus the \$50,000—\$60,000<sup>50</sup> of cash he would have spent on shelter investments.

Example (1), Table D, computed without regard to shelter investment, indicates that the maximum tax computation saves the taxpayer only \$796 which is to be compared with the tax savings resulting from income averaging. As both the maxi-tax and income averaging cannot be simultaneously elected, obviously the taxpayer would elect income averaging. However, considering examples (2) and (3), Table D, with Tables A, B and C, indicates obvious savings by making tax sheltered investments.

<sup>48</sup> The assumption of a \$50,000 or \$60,000 write-off assumes that the shelter investment produces a "one-for-one" deduction. In the real estate shelters, a "one-for-one" or "better than one-for-one" deduction for dollars invested is unusual. More likely, the taxpayer would be investing \$100,000 or so to produce a first year write-off of \$50,000.

<sup>49</sup> As suggested in note 45 *supra*, the taxpayer's cash savings is more likely \$110,000, that is, an initial \$100,000 investment (yielding a \$50,000 tax deduction for the year) plus the tax savings of \$11,468.

<sup>50</sup> *Id.*

TABLE D

	Example 1	Example 2	Example 3
Earned Income (EI)	100,000	100,000	100,000
Unearned Income (UI)	15,000	(45,000)	(35,000)
Capital Gains (CG)	100,000	100,000	100,000
Less: IRS § 1202 Deduction	(50,000)	(50,000)	(50,000)
Adjusted Gross Income (AGI)	165,000	105,000	115,000
Deductions and exemptions	(12,000)	(12,000)	(12,000)
Taxable Income (TI)	153,000	93,000	103,000
Regular Tax (IRC § 1)	78,960	40,980	47,040
<i>Compute Earned Taxable Income (ETI)</i>			
TI	153,000	93,000	103,000
Earned Net Income	100,000	100,000	100,000
AGI	165,000	105,000	115,000
Tentative ETI	92,733	88,570	89,570
Less: Tax Preferences (TP) *	(200,000)	(60,000)	(50,000)
ETI	72,733	28,570	39,570
<i>Compute Maxi-Tax</i>			
Tax on ETI through 50%	18,060	7,322	11,947
Plus: 50% of ETI over 50% bracket	10,367	—0—	—0—
Tax on balance of income			
Normal Tax on TI	78,960	40,980	47,040
Normal Tax on ETI	29,223	7,322	11,947
Difference	49,737	33,658	35,093
IRC § 1348 Tax	78,164	40,980	47,040
Compute Minimum Tax (10% if TP)	—0—	1,902	296
Total Tax Due	78,164	42,882	47,336

\* In excess of \$30,000 cushion

Regular Tax (Table D, Example (1))	Table D Example (2)	Tax Saved	Table D Example (3)	Tax Saved
\$78,164	\$42,882	\$35,282	\$47,336	\$30,828
Averaging Tax (Table C)				
\$67,492	42,882	24,610	47,336	20,156

Since the taxpayer has a free choice to elect averaging, the first comparison should be between the tax resulting from averaging and the tax resulting from making the tax sheltered investment. Comparing Example (2), Table D, which involves a cash investment of at least \$60,000,<sup>51</sup> with the averaging tax, the taxpayer saves \$24,610 in income taxes. This means that with each dollar invested, the taxpayer purchases 24 cents of taxes or he has at risk in the venture 76 cents of his own money. The same approach applied to Example (3), Table D, which involves a lesser investment, *i.e.*, approximately \$50,000,<sup>52</sup> indicates that for every dollar invested, the taxpayer purchases 25 cents of taxes or he has at risk in the venture, 75 cents of his own money. Thus, the taxpayer's relative position did not shift much, but the taxpayer has \$10,000 or so, less cash invested in the transaction.

Without averaging, the tax savings are more drastic but note the difference between Examples (2) and (3), Table D, *viz.*, \$4,454 in taxes. By lowering his investment from \$60,000 to \$50,000 or so, the taxpayer must pay an additional \$4,454 in income taxes. On the other hand, in terms of cash investment, he saves at least \$5,546 in cash, or stated, in another fashion, the tax savings of \$4,454 by investing at least \$60,000 in shelter investments costs him \$5,546 in cash. This means that the Internal Revenue Service has a slight edge on the investment since the taxpayer is bearing more of the investment risk than the United States Treasury. Considered in the above light, particularly with averaging involved, the taxpayer may well regard any shelter investment to be uneconomic in terms of investing 75 cents of his own money. The decision, of course, may go otherwise where the investment is sound from an economic point of view.

A tax advisor may legitimately regard income averaging, the benefits of the maximum tax, the avoidance of the minimum tax, or the installment reporting of capital gains, to be adequate shelter under the circumstances. This can only be ascertained by trial computations. If the advisor regards himself as ill-equipped to make the computations, resort can be had to the national accounting houses, and many regional firms, who now have all of these factors on computer and who can make the computation in a matter of minutes at relatively little cost. But even without trial computations, which, as stated, must be made in any event to adequately represent the client, certain general conclusions apply:

- (1) A taxpayer in the 50% or less income tax bracket, whether that in-

<sup>51</sup> *Id.*

<sup>52</sup> *Id.*

come is earned or unearned, *should not*, generally speaking, be in the shelter market.

(2) If the taxpayer has substantially only earned income, *i.e.*, maxi-tax income, tax preference deductions in excess of \$30,000 annually shift each excess dollar from a possible maximum 50% maxi-tax bracket to the highest bracket on the taxpayer's return for the year.

(3) A taxpayer whose income is subject to the maxi-tax should regard all tax preference deductions in excess of \$30,000 as 50% or less efficient in terms of tax savings. Hence, the economic risk in the shelter investment leans to the taxpayer rather than the Internal Revenue Service.

(4) In view of the tax preference status of capital gains, if the taxpayer has income subject to the maxi-tax, the ultimate effective rate on the capital gains may reach as high as 50%.

(5) Weight must be given to the tax cost of disengaging from the shelter investment and the Internal Revenue Service's inherent right to tax reimbursement in due course of time. If the initial tax savings are later recouped by the taxpayer subject to ordinary income tax rates, as for example, with depreciation recapture upon sale of the property, the recoupment will be taxed at the taxpayer's highest bracket since depreciation recapture, if that be the example, is unearned income and is subject to highest brackets of § 1. On balance, this may result in an ultimate net tax cost by moving maxi-tax income, determined with less than 50% efficient tax deductions initially taken, into 70% bracket income in later years.

(6) Generally speaking, tax shelter deductions should not exceed net unearned income, *i.e.*, passive types of income such as dividends, business income, etc.

(7) Because of the tax preference impact being the larger of the average of preferences or the current preferences for the year, in excess of \$30,000, *i.e.*, the five-year moving average of tax preferences, a taxpayer with substantially only maxi-tax income should have a reasonably clear picture of his future income in order to determine whether a tax shelter investment in this year will harm him three, four or five years down the road.

## II. Psychological Inquiry and Business Judgment

### A. *Taxpayer's Internal Shelter Potential*

Before enriching the promoters, the tax advisor should be concerned with the resources which the client has to lessen his tax burden.<sup>53</sup> For example, the taxpayer might maximize deductions this year by inventory build-up or the purchase of tools, supplies, and other expendables. He may undertake capital expenditures timed to the advantage of depreciation conventions,<sup>54</sup> investment

<sup>53</sup> Ideas in this regard can be found in the pamphlets distributed by the commercial tax services checklisting year-end tax planning ideas and also in the commercial tax services themselves.

<sup>54</sup> INT. REV. CODE OF 1954, § 167(m).

credit,<sup>55</sup> additional first year depreciation,<sup>56</sup> and other allowable expense items. This may be the year for the client to actually get under way with the business expansion which he has contemplated. However, the taxpayer need not be exuberant; he should not overlook the obvious tools. For example, equally valid are the installment sale election;<sup>57</sup> sale of portfolio "losers" to offset capital gains; installation of retirement income plans,<sup>58</sup> medical reimbursement plans,<sup>59</sup> group insurance,<sup>60</sup> etc. For a sole proprietor on the cash method of reporting his income, there is the possibility of shifting accounts receivable to a corporation.<sup>61</sup> Then, too, what is ordinarily regarded as estate tax planning becomes relevant. Family partnerships,<sup>62</sup> the subchapter "S" election,<sup>63</sup> gifts of business interests in trust,<sup>64</sup> etc. aid in splitting income within the family group and thereby lowering the overall tax bracket applying to the family's income. The goal is to minimize the client's tax burden; it matters not, for example, whether this is accomplished through family trusts, the installment method, or by an investment in a real estate syndicate.

### B. The "Sleep Factor"

Having exhausted the taxpayer's internal shelter without appeasing his tax problem, the taxpayer can turn to the shelter market. The taxpayer must be mindful of the following additional factors. First, he must viscerally appreciate that a tax shelter exists because of tax concessions which Congress allowed in order to compensate investors for the risks involved in that particular industry or category of transaction. For example, tax concessions are more generous in government subsidized housing<sup>65</sup> than in commercial real estate. It is so for several reasons including that the risk of this type tenant housing is substantial and the allowable rate of return is limited (usually no more than 6% of implied equity).<sup>66</sup> Second, the client is co-venturing with the Treasury. As with any "partner" the Treasury will ask its due eventually. Tax shelters, with the exception of intangible drilling costs, involve deferral, not forgiveness of the tax. In real estate, ordinary deduction items—front-end expenses, interest, accelerated depreciation, etc.—ultimately translate into "negative" capital accounts (discussed *supra*) and depreciation recapture which must be accounted for in taxes when the investment is either disposed of or the taxpayer extricates himself from the investment. Third, even assuming that the optimum shelter investment permits a reduction which is 50% to 60% tax efficient, the taxpayer nonetheless

55 *Id.* § 38.

56 *Id.* § 179.

57 *Id.* § 453.

58 *Id.* §§ 401 *et seq.*

59 *Id.* §§ 104-105.

60 *Id.* § 79.

61 Tiger, *Problems of Mismatched Income and Expenses in the Transfer of a Business through Corporate Organization and Liquidation*, 1970 TUL. TAX INST. 382.

62 See Treas. Reg. § 1.704-1(e).

63 INT. REV. CODE OF 1954, § 1371 *et seq.*

64 Cf. *id.* § 671 *et seq.*

65 See, e.g., *id.* §§ 167(k); 1039(a); 1250(a)(1)(C).

66 See 12 U.S.C. § 1715k *et seq.* and Case, *Profits for Lenders in the Inner-City Housing Market*, 2 REAL ESTATE REVIEW 62 (Winter 1973).

is investing his own dollars. Real estate *seldom* yields a tax deduction equal to 100% of dollars invested. Thus, of the dollars invested, only a third or so may be deductible in the year made with the balance of the deductions retrieved over the next three to five years. The taxpayer has his dollars at risk. Many taxpayers, when they finally understand the implications, including economic risks as well as subsequent tax benefit recapture, would prefer to pay the Treasury 50 cents on each earned dollar than spend 50 cents of their own cash in a shelter investment. This is referred to as the "sleep factor."<sup>67</sup> If the taxpayer invests in a § 236 project, can he rest well with it? Will he worry over occupancy, tenant unrest, deterioration of the property, etc.? Upon close questioning, the client may well be more comfortable with taking the net-after-tax cash and placing it into certificates of deposit or tax-exempt municipal bonds.

### *C. Selecting the Tax Shelter*

Assuming, then, a sophisticated taxpayer, next is to examine the shelter proposal—prospectus, offering circular, write-up, etc. Does the investment, apart from the possible tax benefits, make sense economically? If the investment is not economically gratifying, the query is whether the client would take the dollars proposed for investment in this shelter, and gamble in Las Vegas. If he would be hesitant, he should be reluctant about the investment.

As an aside, despite the tax advisor's protests that he is not an investment counselor, the taxpayer will generally look to the professional with whom he has an established relationship to "bless" the investment. Usually there is no escape. It is doubtful whether the tax advisor's errors and omissions insurance covers investment advice so the risks in this area to the advisor are meaningful. Often there is the risk inherent in double representation, *i.e.*, where the lawyer "marries" two of his clients in an investment. For example, the lawyer represents a real estate developer and a doctor and brings both together. Each client will subsequently assert that they received less than satisfactory professional advice. There should be no reticence in placing the investment advice burden upon the promoter or salesman. If the shelter proposal emanates from an investment house or broker, that firm should have performed "due diligence" before it undertook to underwrite or sell the investment.<sup>68</sup> No reputable firm undertakes an underwriting or sales commitment without first having studied the proposal or obtained outside professional advice on economic feasibility, etc. The taxpayer should have the benefit of these studies.

The checklist, Appendix I, reflects *some* of the factors which the client should consider in a real estate shelter venture.<sup>69</sup> Details or specifics, of course, vary with the type of investment proposed.

Real estate, unlike many shelters, is susceptible to superficial verification. For example, a fee paid to another real estate broker familiar with the area,

67 Courtesy of D. Bruce Trainor, Tax Shelter Advisory Service, Narberth, Pennsylvania.

68 SEC Securities Act Release No. 5275 (April 3, 1963); SEC Securities Exchange Act Release No. 34-9671; SEC SPECIAL STUDY OF SECURITIES MARKET, REPORT TO CONGRESS (August 8, 1963).

69 Hereinafter a reference to "checklist" refers to the one appearing in Appendix I.

is well spent, if that broker can provide the client with comparative figures—occupancy factors; rental rates; area growth, etc. Calls to friends or business and professional acquaintance in the area, are warranted to verify general conditions and atmosphere. A project may look good on paper, but, for example, an investor should think twice about an investment in either commercial or residential real estate in a market generally recognized as saturated, *e.g.*, the Houston, Texas market. Unquestionably, the Houston market will “turn-around,” but is the project sufficiently viable to carry itself over the next few years while that “turn-around” is taking place? A call to the local real estate board may produce area or regional figures on occupancy, etc., to provide a basis of comparison with the investment proposal. One convenient cross-check is to obtain copies of other offerings within the same locality and compare the figures provided in those offering circulars, prospectii, write-ups, or whatever, to see if the projections set forth in this proposal are within the “average.”<sup>70</sup>

### III. “Lawyering” the Tax Shelter Investment

The tax advisor is concerned with two aspects: the general overall legal considerations and the specific tax aspects of the investment. Overriding both considerations is the question: What will the client have gotten himself into?

Consider first, the transaction as a whole. If a sale and leaseback are involved, *e.g.*, the developer sells the project to the syndicate and takes back a lease, is it a like-kind exchange or a financing transaction? In the exchange situation,<sup>71</sup> the developer exchanges the fee for a leasehold estate.<sup>72</sup> While ordinarily this does not materially affect the investors (they own the fee for depreciation purposes and are in receipt of rental income), if the developer does not achieve his expected tax results (an ordinary loss),<sup>73</sup> his annoyance will reflect itself in future dealings with the investors. Any long-term lease coupled with a repurchase option (if not tied to a then current fair market value option price) harbors a “financing” categorization.<sup>74</sup> If adversely decided, the developer continues to own the project, for depreciation purposes at least and the investors have interest income plus a creditor’s interest in the real estate. The expected tax results are obviously not achieved.

#### A. Partnership Law

Assume no such problem for discussion purposes and that the client has been “offered”<sup>75</sup> a limited partnership in a syndicate venture. The general legal considerations which the advisor should consider as follow:

70 On rates of return, *see* McKee, *The Real Estate Tax Shelters: A Computerized Expose*, 57 VA. L. REV. 521 (1971) and Clettenberg and Kronche, *How to Calculate Real Estate Return on Investment*, 2 REAL ESTATE REVIEW 105 (Winter 1973).

71 INT. REV. CODE OF 1954, § 1031.

72 *See* Jordan Marsh Co. v. Commissioner, 269 F.2d 453 (2nd Cir. 1959) and Century Electric Co. v. Commissioner, 192 F.2d 155 (8th Cir. 1951), *cert. den.* 342 U.S. 954 (1952).

73 INT. REV. CODE OF 1954, § 1231.

74 *Helvering v. F & R Lazarus & Co.*, 308 U.S. 252 (1939).

75 The sale of the units is a securities law matter, *see* Securities Act of 1933, Release No. 4877 and Mosburg, *Regulation of Tax Shelters*, 25 OKLA. L. REV. 207 (1972). As to private placements, *see* Henderson v. Hayden, Stone, Inc., 461 F.2d 1069 (5th Cir. 1972) and SEC v. Continental Tobacco Co. of South Carolina, 463 F.2d 137 (5th Cir. 1972).

(1) Is a securities law violation involved?

(2) Will the syndicate be regarded as a limited partnership under the applicable uniform limited partnership act? Will the client be treated as a limited partner?

(a) Is everything being done to avoid a defective formation? For example, will the certificate of limited partnership be filed or recorded, as the case may be, in all the required localities—where formed, where real property is located, etc.? Suppose that the certificate is filed where the partnership is formed but is not recorded where the real estate is located. Does a limited partnership exist?<sup>76</sup>

(b) Uniform Limited Partnership Act (ULPA) § 17:

(1) A limited partner is liable to the partnership (a) For the difference between his contribution as actually made and that stated in the certificate as having been made, and (b) For any unpaid contribution which he agreed in the certificate to make in the future at the time and on the conditions stated in the certificate.

Is the investor liable to calls? Is the maximum call or calls stated so as to ceiling the investor's potential liability to the partnership?

(c) What happens if the taxpayer, in addition to his equity investment, is either required to or in fact lends money to the limited partnership? Is the loan really equity? Can it be secured? See ULPA § 13.

(d) ULPA § 6:

If the certificate contains a false statement, one who suffers loss by reliance on such statement may hold liable any party to the certificate who knew the statement to be false. (a) At the time he signed the certificate, or (b) Subsequently, but within a sufficient time before the statement was relied upon to enable him to cancel or amend the certificate, or to file a petition for its cancellation or amendment as provided in Section 25(3).

What assurances are there that the certificate will be kept current and accurate?

(e) ULPA § 17:

When a contributor has rightfully received the return in whole or in part of the capital of his contribution, he is nevertheless liable to the partnership for any sum, not in excess of such return with interest, necessary to discharge its liabilities to all creditors who extended credit or whose claims arose before such return.

If cash flow distributions are regarded as a return of capital because the limited partnership is operating at an accounting as well as tax loss, will the certificate of limited partnership be amended, from time to time, to restate downward the capital commitments of the investors?

<sup>76</sup> The problem is that the place to file or record is the "principal place of business" of the partnership and the question is whether the stated place of formation (*e.g.*, New York) or the location of the real estate (*e.g.*, Texas) (where rents are collected, business is transacted, repairs made, etc.) is the "principal place of business?"

(f) ULPA § 7: "A limited partner shall not become liable as a general partner unless, in addition to the exercise of his rights and powers as a limited partner, he takes part in the control of the business." Suppose that the investor limited partners have the right to veto sales of partnership assets (to avoid having their tax positions sold out), to change the general partners if operating results are not satisfactory, etc. Are these rights, even unexercised, as conferred upon limited partners by the partnership agreement, sufficient to constitute the limited partners as participating in the control of the business? If one limited partner takes part in control of the business does his act taint all the other limited partners? Suppose that the general partners contribute no cash or other property to the capital of the partnership, and obtain their participations for services to be rendered, are the general partners merely "agents" or "dummies" for the limited partners so that there really is a general partnership with the putative "general partners" merely hired help? Are "general partners" with no capital investment to be regarded as under the influence and control of the investors? Is the result any different, even assuming that the general partners invest cash or other property, if they defer their position to the investor limited partners at least until the investor limited partners have recovered their invested capital since during the interim the general partners really have no direct financial stake in the partnership?

(3) Does the partnership have good and sufficient title to the real estate, the leases, the furniture and equipment, etc. as represented in the offering circular? Is this supported by the opinion of counsel who lawyered these aspects?

(4) Are the general partners or other "management" tied into the transactions to stay with it, for better or worse, at least until the investors withdraw?

(5) Is the financing package all neatly tied up? Are the financial commitments viable, available for inspection and confirmed in writing, by the bank, insurance company, etc., on a current basis?

(6) Does the investment package include all of the "opportunities" inherent in the deal? Is the client building the shopping center for a promoter who will then develop the adjacent land as an office building and residential complex? Does the client have an option for participation in the further development of the project or the promoter's other projects?

(7) Are representations concerning costs and expenses firm? Is the construction contract fixed price, or cost plus a fee? Is there a development agreement whereby the developer agrees to deliver a completed project ready for occupancy for a fixed price? Is performance personally guaranteed and does the developer have the financial wherewithal to support guarantees?

(8) How much can the developer take and when? Is his participation junior to the investors and carried until the investors recapture their investment? If the developer will lease, manage and operate, what are the limits on his fees and is he entitled to a fee if the operation proves unprofitable or unsuccessful?

(9) Can the client extricate himself from the transaction? Is his interest transferrable? Is there a market for his interest? Is the transfer subject to arbitrary approval of the general partners? Is there a right of first refusal, option, buy-back penalty?

### B. *Tax Aspects*

A look at the "forest" gives the tax advisor a reading as to whether the developer is sophisticated. If so, it indicates competent professional advice which means that the details will receive attention.

Sophisticated tax planning is suggested by items such as these:

(1) Did the developer bring the investor into the picture well before expenses were incurred in order to maximize the deductions to the investors?

(2) Were all purchases of capital items, *e.g.*, land, materials, etc., made for and through the syndicate in order to afford to the investors the deductions for transfer taxes and sales and use taxes?

(3) Apart from its success for tax purposes, if the developer incurred substantial expenses before the investors entered the picture, is the promoter willing to arrange a partnership "guaranteed" payment (the equivalent to salary or interest) as reimbursement so as to try to obtain for the investors, an expense write-off rather than a larger depreciation base?

(4) What guarantees does the promoter give that corporate general partners will maintain the minimum net worth requirements as per Rev. Proc. 72-13?<sup>77</sup>

(5) What limitations or restrictions are placed upon sales of property or liquidation of the syndicate; *e.g.*, no sales are permitted unless the net cash flow from the sale equals 50% of the gain realized?

(6) If the initial investments are escrowed until the required minimum capital is achieved, is the transaction so structured to make the investor a participant in present tax losses with the right to rescind if certain stated conditions are not satisfied? If staggered or "stages" investments are called for, has the promoter dealt with § 483 of the Code, imputed interest on the investment?

(7) Will the partnership treat as an expense—and hence a deduction to the investors—the promoter's partnership interest granted to him for promotional services or future services to be rendered?<sup>78</sup>

(8) Is the developer carefully handling the syndication? Is he receiving capital contributions which avoids tax termination or does he own all of the partnership participations and is selling his interests? A 50% change in ownership in a partnership in any 12-month period results in a termination for tax purposes.<sup>79</sup> A termination may have adverse results to the partnership in that it may (a) require a tax accounting and the payment of tax upon liquidation,<sup>80</sup> (b) destroy the first user status for depreciation purposes,<sup>81</sup> or (c) prohibit the partnership from applying the component method of depreciation.<sup>82</sup>

Structure should be reviewed next. The following are examples of points to be considered:

77 1972-1 CUM. BULL. 735.

78 See Sol Diamond, 56 T.C. 530 (1971).

79 See Treas. Reg. § 1.708-1.

80 INT. REV. CODE OF 1954, § 731(a).

81 *Id.* § 167(c).

82 Rev. Rul. 66-111, 1966-1 CUM. BULL. 46, but *cf.* Hastings v. United States, 279 F. Supp. 13 (N.D. Calif. 1967), and Harsh Investment Corp. v. United States, 323 F. Supp. 409 (D. Ore. 1970).

(1) The taxpayer's ability to claim on his return the tax deductions arising from the project against his other income depends upon the partnership's ability to pass through to him its expense items in the form of partnership losses for the year. Will the entity be taxed as a partnership? If this point is covered by a tax ruling, is the ruling current to the date of the offering? If the ruling is somewhat dated, have the circumstances changed so as to invalidate the ruling (which freezes the facts set forth in the ruling application as of the date of the application)? Does a comparison of the ruling application with the documentation of the transaction indicate that the ruling is based upon the facts applying?

If the status of the partnership is confirmed by the opinion of counsel, depending upon the advisor's regard for that opinion, these further points should be examined:

(a) Is the partnership duly constituted as a uniform limited partnership act type partnership?

(b) Does the partnership have at least as many partnership attributes as corporate attributes?<sup>83</sup>

(c) If the sole general partner is a corporation, or a corporation is relied upon as the partner giving substance to the partnership, have the financial criteria posed by Rev. Proc. 72-13<sup>84</sup> been satisfied, and further, what protections are provided to maintain the required net worth? Note, also, that according to Rev. Proc. 72-13 the corporation's interest in the limited partnership and accounts and notes receivable from and payable to the limited partnership are excluded in computing the minimum net worth. Additionally, the net worth requirements must be satisfied for each limited partnership in which the corporation serves as a general partner based upon the same conclusion of intra-partnership accounts and value. The net worth requirement is doubled for two partnerships, tripled for three partnerships, etc.

(d) If there is a co-individual general partner or simply several individual partners, do these individuals have sufficient net worth to make them more than nominees, agents, or dummies for the limited partners? For rulings purposes, where reliance is placed upon individual general partners, these individuals must have substantially the same net worth as required for a corporate general partner. It is not clear whether the required net worth can be spread among several general partners—each providing a part to make the minimum required—and whether the mixture can be of individuals and corporations.

(e) Do the general partners, individual, corporate, or both, have sufficient economic interest or participation in the transaction so that they are more than nominees, agents, or dummies for the limited partners? For ruling purposes, the Internal Revenue Service may require that the general partners have, at the outset and throughout the life of the partnership, at least a one percent participation in profit and losses and capital, obtained in exchange for a contribution of tangible property.

(f) Is prohibited incest absent? Rev. Proc. 72-13 provides that the limited partners may not own, directly or indirectly, more than 20% of the stock of the

83 See Treas. Reg. § 301.7701-2-3.

84 1972-1 CUM. BULL. 735.

corporate general partner or its affiliates. Also prohibited are options to purchase stock (this exclusion prohibits any options even if for less than 20% of the stock). If the corporate general partner has more than one class of stock, presumably the ownership test must be satisfied class by class even though the limited partners own, in the aggregate, less than 20% of the equity or net worth of the corporation.

(2) Will the anticipated tax benefits follow? For example, will the mortgage points for construction financing be allowed in the year paid or must the points be amortized over the term of the construction loan?<sup>85</sup> If a single FHA insured financing is involved, vis-a-vis conventional construction and permanent mortgages, will points be allowed when paid or be required to be amortized over the life of the mortgage? Will promoters' consideration be allowable as current deductions as taken down? Examples include acquisition fees (generally capitalized), lease-up fees (may be required to be amortized over the life of the lease), special promotion or advertising fees (may be disguised capital costs).<sup>86</sup> Will the partnership elect the appropriate taxable year?<sup>87</sup> Obviously if the client anticipates a year-end write-off, but the partnership elects as its first year, a taxable year ending January 31, the deductions will be deferred into the client's next calendar year. Will the partnership elect the appropriate accounting method?<sup>88</sup> The accrual method may assist in the deduction of prepaids.<sup>89</sup> Is interest being prepaid? If so, is § 163(d) violated and is the prepayment within the "safe harbour" established by Rev. Rul. 68-643?<sup>90</sup> That ruling did more than disallow a current deduction for interest prepaid beyond the end of the taxpayer's next taxable year. It stated that the deductibility of interest prepaid for the balance of the current year and the next 12 months would be decided on the basis of whether the particular facts and circumstances reflected a material distortion of income by reason of the prepayment. The ruling obviously did *not* sanction 12 months prepaid interest. The Internal Revenue Service has also issued a technical advice to the Los Angeles, California, district to the effect that the determination of material distortion of income, in a limited partnership context, should be made at the partnership level as well as the individual level, and that a material distortion exists if the partnership has no income in the year in which the prepayment is made by the partnership. LAL, if enacted, will effectively eliminate prepayments since accelerated deductions in excess of the project's income will not be allowed as deductions against the taxpayer's other income. If the prepayment of interest is made by a cash basis partnership with borrowed funds, is the deduction allowable?<sup>91</sup>

Are the useful lives assigned to the improvements and personality realistic?

85 Rev. Rul. 69-582, 1969-2 CUM. BULL. 29.

86 As to prepaid services, see Rev. Rul. 71-252, 1971-1 CUM. BULL. 146; Rev. Rul. 71-579, 1971-2 CUM. BULL. 225, but cf. Tim W. Lillie, 45 T.C. 54 (1965) and Pinney and Olsen, *Farmers' Prepaid Feed Expenses*, 25 TAX LAWYER 537 (1972).

87 INT. REV. CODE OF 1954, § 441(a).

88 *Id.* § 446.

89 The accrual method may work a hardship if rent is delayed in actual receipt.

90 1968-2 CUM. BULL. 76.

91 Nat Harrison Associates, Inc., 42 T.C. 601 (1964).

If used, is the component method of depreciation properly applied?<sup>92</sup> Are the legal, accounting, and other service fees shown deductible in the projections—actually capitalizable start-up expenses, as, for example, expenses incurred in the formation and registration of the partnership?

Is the partnership structured so as to afford to the client sufficient income tax basis with which to absorb his share of partnership losses? This is largely a function of non-recourse or "no personal liability" financing.<sup>93</sup> If none of the partners have any personal liability with respect to partnership debt, then all partners, including limited partners, are regarded as sharing the liability in the same proportion as they share in the profits of the partnership.<sup>94</sup> This translates to basis, *i.e.*, the limited partner investor is entitled to treat his share of non-recourse debt as part of his income tax basis in his partnership interest. An indemnification agreement whereby limited partners agree to indemnify the general partners against potential losses will not increase the basis of the limited partners' interest in the partnership.<sup>95</sup> The practice whereby the developer sells to the limited partnership an as-yet-to-be-built project in exchange for an "all-inclusive" mortgage or deed of trust in the amount of the completed project price is also questionable. For example, suppose that the developer contemplates a \$2,000,000 real estate project. On day one, he sells this project to the partnership for \$2,000,000 with the intent that all payments made on the wraparound will be deductible interest expense to the partnership. The transaction obviously lacks economic reality since no investor is willing to pay the completed project price upfront for an uncompleted project. Non-recourse advances by the general partners to the limited partnership or non-recourse advances coupled with a conversion right in the general partners may well be regarded as equity capital contributions by the general partners to the partnership and not as non-recourse debt which adds to the basis of the limited partnership interests.<sup>96</sup>

Will special allocations of partnership losses or partnership expense items to the limited partners be sustained?<sup>97</sup> Does the allocation have economic substance? This is the key factor and is generally regarded as requiring that the limited partner be accountable dollar and tax-wise for "negative capital."<sup>98</sup> "Negative capital" arises in those situations where for book purposes the losses allocated to the limited partner exceed the capital contributions made by him. A full deduction of the losses may well be allowed for income tax purposes since a deduction is allowed to the extent of the limited partner's basis in his interest in the partnership, which includes nonrecourse debt. However, his capital account on the books of the partnership will reflect a negative balance to the extent that losses allocated to the partner exceed the capital (equity capital contribution)

92 See *Hastings v. United States*, 279 F. Supp. 13 (N.D. Calif. 1967), and *Harsh Investment Corp. v. United States*, 323 F. Supp. 409 (D. Ore. 1970).

93 But cf. *Daniel F. Bolger*, 59 T.C. No. 75 (1973), and see *Perry, Limited Partnerships and Tax Shelters: The Crane Rule Goes Public*, 27 TAX L. REV. 525 (1972).

94 Treas. Reg. § 1.752-1(e).

95 Rev. Rul. 69-223, 1969-1 CUM. BULL. 184.

96 Rev. Rul. 72-135, 1972-13 IRB 16 and Rev. Rul. 72-350, 1972-2 CUM. BULL. 394.

97 Treas. Reg. § 1.704-1(b).

98 See *Stanley C. Orrisch*, 55 T.C. 395 (1970); *Driscoll, Tax Problems of Partnerships — Special Allocation of Specific Items*, 10th USC TAX INST. 421 (1958) and *WILLIS ON PARTNERSHIP TAXATION* § 19.08 (1971).

first credit to that account. This "negative capital" is a reflection of the tax deductions which the limited partner has enjoyed. To demonstrate that this enjoyment of special tax losses has an impact economically, it may be necessary for the partnership agreement to provide that upon the occurrence of any event involving the distribution of capital—as, for example, upon distribution of the proceeds of the sale of the partnership assets, liquidation, refinancing, etc.—the limited partners having negative capital must first restore the cash equivalency of negative capital to the partnership (for the enjoyment of partners not having any negative capital or less negative capital accounts) before participating in cash distributed.

Speaking to special allocations, the taxpayer should be mindful of the tax effects of the "flip-flop." This is a situation where the percentage participations change after certain levels of capital retrieval or performance have been achieved. For example, the limited partners may be entitled to 90% of profit and loss until cash distributed to them equals their initial capital investments at which point, their participations decrease to 50%. The limited partner's share of non-recourse debt depends on profit participation. When this changes downward, it is the equivalent for tax purposes of having been relieved of that amount of debt. Relief from debt is the equivalent of cash. Cash distributed to a partner is taxable to the extent it exceeds the partner's income tax basis in his interest. In short, the "flip-flop" may result in unexpected tax.

Is unique partnership structuring involved such as two-tier partnerships? For example, the investment partnership ("parent") invests its funds as a limited partner in various local partnerships ("subsidiaries") which actually develop, construct, rent and operate the projects.<sup>99</sup> The Internal Revenue Service has evidenced concern for this arrangement but is currently, at least, issuing rulings to the effect that the various partnerships' attributes and items, including basis for non-recourse debt, do pass from the subsidiary partnership, through the parent partnership, to the investor limited partners.

If the client enters upon the venture late in the year, such as December 31, is he entitled to a full year's share of the partnership losses? There is some question on the allowability to him of more than one day's share of partnership losses.<sup>100</sup>

Finally, there is the question of whether the venture is one undertaken for profit? Generally speaking, § 183 disallows deductions in excess of related income if the activity involved is not undertaken or engaged in for profit. Ordinarily, most real estate ventures are undertaken for profit even if this is ultimately only the anticipated increase in the market value of the real estate. However, suppose that the prospectus or offering circular makes it painfully evident that the only economic return to be anticipated is by way of tax savings. Or, suppose the client, being scrupulously honest, admits that he cared little for the investment and participated solely for the tax benefits to be derived. Is the necessary profit

<sup>99</sup> See Ruling issued to National Housing Partnership dated December 6, 1971 (T:I:I:2:2).

<sup>100</sup> See Treas. Reg. § 1.706(c)(2)(ii).

motive present under either of these circumstances?<sup>101</sup> Then too, certain investments are offered which in reality amount to no more than a financing transaction. For example, suppose that the developer, *e.g.*, a city housing authority, offers to sell a housing project to the limited partnership but has the option to repurchase the property at an option price equal to the then unamortized mortgage balance. In short, the investors buy depreciation. Besides the question of whether this arrangement will be regarded as simply a second mortgage, is it a profit motivated venture? Usually the investor can anticipate little or no operating cash flow and in light of the option cannot even expect appreciation. He has purchased only tax losses.

#### IV. Living with and Divorcing the Shelter Fortune Telling

The taxpayer contemplates a *de minimis* tax bill on April 15th (which in substantial part is attributable to the fees paid to the advisor for professional tax advice). Nevertheless, before the taxpayer invests, he must decide whether he can live with the shelter and pay the price of extricating himself from the investment.

##### *A. The Client's Expectations*

Despite the effort spent in verifying the investment, it is still a business risk. There may be no cash return, indeed, further calls may be necessitated to salvage the project. "Practical" calls are always possible notwithstanding what is stated in the documents. The taxpayer should worry about liquidity. Not only must he have the financial depth to respond to future calls, but also confidence that he will not need in the future to convert the investment into cash. Even if the offering is registered under either SEC, Blue Sky, or both, there may be no market for the participation. Will the client be able to "bank" the participation? And, in a private placement situation, is any such sale or hypothecation a violation of the client's investment representations? As will be discussed further, below, can the taxpayer withstand the tax cost of selling his participation?

##### *B. Anticipating the Unexpected—Tax Costs*

The taxpayer may be confident that he controls his financial needs, but what if matters are taken out of his hands? If the limited partnership is constituted in a manner to sustain its status as a partnership for income tax purposes, it will likely terminate, for tax purposes, upon the death or other form of termination of a general partner<sup>102</sup>—as, for example, the insolvency of the corporate general partner or if the corporate general partner fails to maintain the minimum net worth. Well conceived partnerships are arranged with a combination of partners, corporate and individual, so that a tax termination does not occur until

101 See *Knetsch v. United States*, 348 F.2d 932 (1965), *cert. den.* 383 U.S. 957 (1965) indicating that "profit" cannot embrace profit seeking in which the only economic gain derived results from a tax reduction.

102 Treas. Reg. § 1.708-1.

the termination of the sole surviving or remaining general partner. But suppose that the unlikely occurs.

If the partnership at any time during its existence is terminated for tax purposes either because of a termination of a general partner or because of a change in ownership of 50% or more within a 12-month period, the client is concerned with more than loss of depreciation status (discussed above) but also the implications of "negative capital." As previously indicated, the lustre of tax shelters in partnership form is that each partner obtains income tax basis in his partnership interest equal to the equity capital he has contributed plus his pro rata share (based on profit sharing) of nonrecourse partnership indebtedness. The partnership itself is allowed an income tax basis in its properties equal to its investment which includes the nonrecourse debt to which the property is subject. Hence, depreciation, interest, front-end deductions, real estate taxes, management, and other operating expenses incurred generate substantial tax losses which are passed out by the partnership and applied by the partners against the income tax basis which they have in their interests. Usually these deductions, claimed by the individual partners, exceed, for partnership book purposes, the amount of equity capital which each partner has actually contributed. The partnership, for accounting purposes, reflects negative capital accounts for its partners, which, accounting-wise at least, are regarded as informal loans of capital to the partners. If the partnership terminates prematurely, the Treasury may wish to tax, at capital gains rates, the negative capital appearing in each partner's capital account.<sup>103</sup> After all, to the extent that a partner has enjoyed tax losses in excess of his capital contributions to the partnership (losses to the extent of his contributions spend his money), he buys those losses, so-to-speak, with the Internal Revenue Service's money. That the use of the Treasury's money be accounted for in taxes upon a termination of a partnership, is not unreasonable.

Then, too, there is the danger that the client's tax position will be sold out by the general partners. As suggested above, too much control upon the general partners may constitute limited partner participation in the "control" of the business which is adverse from a limited partnership law point of view. Contrariwise, no control may be a tax disaster. If there is a sale of partnership assets and a termination and liquidation of the partnership, recapture as well as "negative capital" become a concern. If the partnership sells its property, depreciation recapture,<sup>104</sup> investment credit recapture,<sup>105</sup> and tax benefit recapture may apply. Depreciation recapture, under § 1250 translates gain on sale or other disposition of the real estate into ordinary income to the extent it represents a recoupment or recapture of certain prior depreciation. The amount of ordinary income is the lesser of either the gain realized or the "additional depreciation," each multiplied by the "applicable percentage." Additional depreciation is, generally speaking, the excess of depreciation claimed over the straight-line allowance. The applicable percentage varies with the type of property, as, *e.g.*, residential currently declines 1% per month after a 100-month holding period, so recapture runs out after 16 years and 8 months. Most taxpayers and all tax advisors appreciate de-

103 See Rev. Rul. 57-318, 1957-2 CUM. BULL. 362; Rev. Rul. 73-301.

104 See INT. REV. CODE OF 1954, §§ 1250 and 1245.

105 *Id.* § 47.

preciation recapture and the subject need not be dwelled upon here. But, if a partnership has expensed certain tangible items, *e.g.*, expendables used in maintaining the real estate, linen and related items used in apartment houses, etc., to the extent such items are sold, the tax benefit derived from expensing such items must be restored to ordinary income.<sup>106</sup> The result is that all or part of the gain passed through the partnership to the individual partners will be subject to ordinary income treatment by reason of recapture items. An often overlooked feature is that if a taxpayer is relieved of indebtedness in a sale situation, not only is the "relief" measured in the gain realized but is treated as "cash." As a result, the tax payable on the taxable gain realized (either capital gains or ordinary income) from the sale, as passed through to the taxpayer by the partnership, may well exceed the actual cash proceeds from the sale. This is often the case where the real property, *e.g.*, government subsidized housing, is sold for the remaining balance of the mortgage indebtedness. The results can be awkward.

On the other hand, assume that the partnership is not terminated and the general partners do not sell the partnership's properties. Instead, the client simply desires to extricate himself from the investment either voluntarily or because he needs cash. Or, as is often the case, the partnership has reached the "cross-over" where tax deductions have declined and income exceeds deductions; and the taxpayer cannot absorb additional ordinary income especially if not fully funded with cash flow from the partnership. Again, a "negative" difference between the partner's share of taxable income and cash flow is common. Cash flow is often committed to debt service and amortization. If the client sells his interest (assuming that he can locate a buyer and no securities law violations are involved), he should expect certain results. First, no matter what the selling price, he must recognize gain to the extent of his "negative capital." Second, the gain realized, which will always be larger than cash proceeds of sale to the extent of "negative capital," will not all be long-term capital gains. Under § 741, the gain derived on the sale includes the client's pro rata share of all the so-called § 751 items which the partnership has at the time of sale. § 751 items include not only appreciated inventory (not usual in real estate) and unrealized receivables (not usual in real estate or at least not appreciable), but also recapture (depreciation, tax benefit and investment credit). The client's gain, therefore, must be measured against his share of recapture which may well mean that substantially all of that gain is ordinary income.

### *C. The Expected Result*

By this time, the taxpayer appreciates two points. First, tax shelter in real estate means tax deferral and no more. The taxpayer must account (either in ordinary income or capital gain) to the Treasury for the deductions which he earlier claimed. "Negative capital" will haunt him. Second, tax shelters are additive. The taxpayer may become an initiate of the tax shelter "treadmill." Thus, to avoid the impact of income (due to a partnership sale of its assets or the sale of his participation), the client may be compelled to find addi-

106 *Id.* § 111.

tional shelter. As a rule, in growth situations, *i.e.*, where the client continues to earn more ordinary income, entry into a tax shelter means subsequent pyramiding of shelter investments. The only possible escape is that the client has died<sup>107</sup> or that he has entered upon his twilight years and has little or no other income to contend with when he extricates himself from the shelter. Finally, if the client comes eventually to view the shelter as an albatross, he cannot expect to simply abandon it, give it away or whatever. Such deeds, seemingly harmless, still involve "relief" from an obligation (his share of indebtedness) and "negative capital" which are "forgiven" by the partnership.<sup>108</sup> As a minimum, capital gains are incurred.

### *Appendix I*

#### CHECKLIST

- (1) Who are the promoters? (Builder, Contractor, Developer, etc.)
- (2) Who is construction contractor?
- (3) What experience do the promoters and contractors have?
- (4) Who is taking what, how much, and when?
  - (a) At what price is the land or the completed project being sold to the partnership and what was the actual or original cost?
  - (b) Is there an acquisition fee (more than 1% would probably be high)?
  - (c) Is there a rent-up fee (more than \$100 per residential unit would be high)?
  - (d) Is there a management fee? Is it a percentage of gross assets, gross rent or how measured? Is there a maximum on such fee (*e.g.*, not more than 25% of the cash flow)?
  - (e) Is there a liquidation fee? A sales commission?
  - (f) The promoter's "front-end" for putting the project together should not exceed, for example, 10% to 15% of the mortgage financing.
- (5) What conflicts of interest are involved (*e.g.*, is this a "nickel and dime" job compared to other projects the promoter is involved with)? Is the promoter also going to manage for a fee?
- (6) Is all the financing arranged (*e.g.*, do the investors "sweat-out" the permanent mortgage)? What is the debt service and amortization burden?
- (7) Is the project financed by nonrecourse loans?
- (8) Has the maximum loan-to-equity ratio been achieved?

<sup>107</sup> The expected result is a step-up in income tax basis thereby washing "negative capital," although it is by no means clear that "negative capital" is not income in respect of a decedent, see *id.* § 691.

<sup>108</sup> See discussion, 37 JOURN. OF TAX. 63 (1972).

- (9) What guarantees of completion are offered?
- (10) What cost controls are involved both during construction and after the project has been completed? Will the promoter and contractor permit outside auditors?
- (11) Will the promoters or builders repurchase the project at the syndicate's cost if it is not completed by a fixed date?
- (12) Does the promoter possess the wherewithal to back up his guarantees?
- (13) If, for example, the project is FHA financed, will the promoter permit the investors to see his FHA application and presentation? If the project is conventionally financed, will the promoter permit the investors to see what he has been showing to the bankers and the insurance companies?
- (14) If the project is FHA financed, to what degree does the local office of the FHA supervise construction and costs?
- (15) Has the promoter sought to maximize the investor's return?
  - (a) What share of the partnership is given to the investors?
  - (b) Is there a special allocation of losses to investors?
  - (c) Are investments staged as to dates of contribution and are the stages tied to realistic achievements so the investor knows that his money is being well spent?
  - (d) Is the money being held in escrow pending the sale of sufficient investment units?
- (16) Does the promoter offer cash flow guarantees or priorities (*e.g.*, all cash flow until the investors' equity investment has been returned)? Does the promoter have the wherewithal to sustain his cash flow guarantees?
- (17) Are reasonable projections presented?
  - (a) Do the projections reflect investment return by treating each payment as a reduction of capital so that each year's rate of return is shown against a lower capital base?
  - (b) Do the projections consider the investor's income tax cost while he is an investor and especially his cost of getting out?
  - (c) Do the projections "sell" by showing appreciation? Equity build-up from mortgage amortization? A high occupancy factor? Are the projected rents (particularly percentage rentals) reasonable? Are realistic operating expenses (*e.g.*, real estate taxes based on historic assessments before the land is improved) shown? Are replacement reserves considered and are they realistic?
  - (d) Do the projections reflect a realistic rent-up time?
- (18) What is the recovery or retrieval period for the investor's equity contribution (*e.g.*, anything over say four years would be unreasonable in residential property)?

- (19) Project items.<sup>109</sup> The following are some of the considerations concerning the proposed project itself:
- (a) Study of the area.
  - (b) Actual and projected population growth or decline.
  - (c) Breakdown of population by income and age.
  - (d) Economic growth or decline and pattern of development.
  - (e) Current strength or softness of the rental market.
  - (f) How near and of what size and quality are shopping areas.
  - (g) Educational facilities: Are they adequate, convenient and of a reasonable caliber?
  - (h) What community services are available, such as libraries, parks, museums, etc.
  - (i) Is public transportation convenient and adequate?
  - (j) Site analysis.
  - (k) Zoning:
    - (i) Can the proposed structure be built now, or must zoning be changed?
    - (ii) Is there zoning which would allow detrimental or non-conforming use of nearby land?
  - (l) What are the available utilities, such as water, sewage and electricity?
  - (m) Bearing qualities of the soil.
  - (n) Terrain:
    - (i) If it is flat or rolling, there are generally no serious problems; if there is either a rapid drop-off or a rapid rise, serious engineering and cost factors become involved.
    - (ii) What else has been cleared for future construction which would offer competition to this investment? This does not always show up in the developer's feasibility study.
  - (o) Specifications and plans. A detailed study and evaluation must be made of:
    - (i) Structural system
    - (ii) Layout of the units
    - (iii) Room sizes
    - (iv) Quality of materials
    - (v) Heating systems and fuel supplies
  - (p) Ultimate feasibility of proposed investment:
    - (i) Projected costs must be reviewed and evaluated to make sure they are practical and realistic.
    - (ii) Realistic operating expenses based on comparable buildings or national or local indices must be projected. (Mortgage submission expense figures are often on the low side.)
    - (iii) Carrying costs for the mortgage plus interest must be added to projected operating costs, then subtracted from estimated income—to determine if the return is reasonable in terms of the risk to be taken.