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Effect of Federal Income Taxation of Housing

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NOTES

THE EFFECT OF FEDERAL INCOME TAXATION ON HOUSING

I. Introduction

Effective attainment of a "decent home and a suitable living environment for every American family"¹ has proved elusive.

The continuing population explosion threatens to overwhelm the national inventory of housing. Housing codes, urban renewal programs, and public housing projects have not yet sufficed to put every American family in a home that meets minimal standards. Instead, despite our efforts, we seem in some respects to be falling farther behind in attaining the goal of adequate housing for everyone.²

The National Commission on Urban Problems was appointed by President Johnson early in 1967 to study the causes of this mounting housing problem and to make specific recommendations for change.³ Part of this study was directed to "Federal, State, and local tax policies with respect to their effect on land and property cost and on incentives to build housing and make improvements in existing structures."⁴ The commission's work in the area of federal income taxation was based primarily on a research report prepared by Professor Richard E. Slitor of the University of Massachusetts.⁵

This Note, drawing primarily from materials contained in the commission's reports, will present an analysis of the effect of the federal income tax on housing. Specifically, the Note will deal with the operation of the federal income tax in four major areas: (1) the housing consumer; (2) the housing investor; (3) the rehabilitation and renewal of substandard housing; and (4) the scarcity of decent low-income housing. The Note will also discuss specific recommendations for changes in the federal income tax designed to help achieve national housing goals.⁶

II. The Housing Consumer

The Internal Revenue Code of 1954 [Code] grants substantial deductions⁷

1 Housing Act of 1949 § 2, 42 U.S.C. § 1441 (1964). This exact language was reaffirmed in the Housing and Urban Development Act of 1968 § 2, 12 U.S.C.A. § 1701t (1969).

2 Everett & Johnston, *Foreword*, 32 LAW & CONTEMP. PROB. 187 (1967).

3 NATIONAL COMMISSION ON URBAN PROBLEMS, *BUILDING THE AMERICAN CITY*, H.R. Doc. No. 91-34, 91st Cong., 1st Sess. vii (1969) [hereinafter cited as DOUGLAS REPORT].

4 Housing and Urban Development Act of 1965, § 301(a), 42 U.S.C. § 1456 (Supp. III, 1968).

5 P. HODGE & P. HAUSER, *THE FEDERAL INCOME TAX IN RELATION TO HOUSING* ii (1968) [hereinafter cited as HODGE & HAUSER].

6 Many of the tax reform proposals which will be examined in this Note have been incorporated in the tax reform bill of 1969. H.R. 13270, 91st Cong., 1st Sess. (1969). This bill was reported out of the House Committee on Ways and Means as this issue was in the final stages of preparation. Although this was, of course, too late to allow for a detailed examination of the bill, references to specific sections of H.R. 13270 have been inserted, where appropriate, in the footnotes.

7 INT. REV. CODE OF 1954, §§ 163-64.

and an exclusion⁸ to the homeowner and his substantial equivalent.⁹ On the one hand, such an individual may, provided he itemizes, deduct from his gross income the interest that he pays on his mortgage¹⁰ and the taxes that he pays on his property.¹¹ On the other hand, the income that a homeowner would realize if he rented his residence is not included in the definition of gross income.¹² This excluded income (called "imputed net rent") is defined as the "gross rental value minus necessary expenses of homeownership such as mortgage interest, property taxes, depreciation, repairs and maintenance, and casualty insurance."¹³ "A homeowner is an investor who takes his return in the form of services. If he wishes to do so, he can convert his imputed return to a cash return by moving and letting his house."¹⁴ Hence, "[h]omeowners obtain a tax-free return on their investment and at the same time are allowed to deduct important items of housing costs"¹⁵

The tenant pays these same housing costs as a part of his rent but does not obtain a tax deduction for them.¹⁶ The tenant's rent goes to pay a share of the mortgage cost and the property tax on the building as well as a return to the owner. The percentage of his rent that is ultimately applied to local property taxes is particularly notable. Professor Netzer of New York University, in his study of the property tax for the National Commission on Urban Problems,¹⁷ found that

very large numbers of urban families pay, via their rents, or directly if owner-occupants, taxes which amount to very sizable increments to their housing costs. This is shown more directly in [a table¹⁸], which contains a distribution of housing units in multifamily rental housing subject to property taxes amounting to a sales tax equivalent of 20 percent or more.¹⁹

8 INT. REV. CODE OF 1954, § 61; see R. GOODE, *THE INDIVIDUAL INCOME TAX* 120-29 (1964) [hereinafter cited as GOODE].

9 INT. REV. CODE OF 1954, § 216 allows the cooperative tenant-shareholder to deduct his proportional amount of taxes, interest, and business depreciation. In view of the fact that homeowners may not deduct depreciation, this section may be said to represent the best of all possible worlds.

10 INT. REV. CODE OF 1954, § 163.

11 INT. REV. CODE OF 1954, § 164.

12 INT. REV. CODE OF 1954, § 61; GOODE 120-29.

13 HODGE & HAUSER 27.

14 GOODE 121.

15 *Id.* at 122.

16 *Id.*

17 JOINT ECONOMIC COMM., 90TH CONG., 2D SESS., *IMPACT OF THE PROPERTY TAX: ITS ECONOMIC IMPLICATIONS FOR URBAN PROBLEMS* (Comm. Print 1968) [hereinafter cited as NETZER REPORT].

18 *Id.* at 18. The substance of the table is set out here.

ESTIMATED NUMBER OF HOUSEHOLDS LIVING IN RENTAL
HOUSING SUBJECT TO HIGH PROPERTY TAX RATES, 1960
[In thousands]

<i>Real estate tax relative to rental receipts, stated as a sales tax equivalent^a</i>	<i>New York City</i>	<i>Elsewhere in United States</i>	<i>U.S. Total</i>
33.3 percent or more	541	676	1,217
25 to 33.3 percent	568	513	1,081
20 to 25 percent	293	1,021	1,314
Total, 20 percent or more	1,402	2,210	3,612

^a Real estate tax as a percent of rental receipts less real estate tax.

19 *Id.* at 17.

These housing costs, while borne by the tenant, may be deducted by the landlord²⁰ on the theory that the true return from an asset can be determined only after the cost of maintaining that asset has been deducted.²¹ Put another way, the landlord must include the returns from his building in his gross income²² and hence is allowed to deduct the costs necessary to maintain the building. This reasoning, however, cannot be applied to the deductions enjoyed by the homeowner because of the exclusion of imputed net rent. The homeowner does not realize any taxable income from his house and therefore his deduction cannot be classified as costs necessary to maintain an income-producing asset.

The tax deductions which the Code allows the homeowner may be criticized not only because they fail to meet the traditional justification for the deduction of costs from income, but also because they give rise to inequities in the tax treatment of individuals. If the progressive nature of the federal income tax is socially desirable, then the deductions which the Code bestows on homeowners are undesirable in that they reduce that progressiveness in two ways.²³ First, those individuals in the lowest tax brackets, who are not able to afford a home and must therefore rent, are placed at a tax disadvantage in comparison to the more prosperous homeowners. Second, as between persons capable of home ownership, the value of the deductions to the individual varies directly with the amount that he spends (or is able to spend) on housing. For example, under the rates effective in 1965 the typical taxpaying homeowner realized tax savings that offset about twelve percent of his annual housing costs, while the tax savings at the \$50,000 level of income offset about one-third of the housing costs.²⁴ This tax saving reduces the higher tax rate that the Code theoretically imposes on high-income individuals.²⁵

In spite of these considerations, the National Commission on Urban Problems has endorsed the exclusion of imputed net rent.²⁶ The commission gave several reasons in support of its position: (1) home ownership encourages social stability and financial responsibility; (2) ownership encourages better maintenance of the structure; (3) ownership helps to eliminate the "alienated tenant" psychology; and (4) ownership helps to reduce the costs of housing to the individual.²⁷ The research report observed that the major criticism of the exclusion was that it primarily benefited wealthy homeowners, rather than low-income homeowners. Some dollar limitation on total deductions was recommended to mitigate this "vertical tax differentiation."²⁸ The report then indicated that "[a]ctive programs of encouragement to cooperative housing or

20 INT. REV. CODE OF 1954, § 212.

21 See GOODE 157.

22 INT. REV. CODE OF 1954, § 61(a)(3).

23 DOUGLAS REPORT 400; see also White & White, *Horizontal Inequality in the Federal Income Tax Treatment of Homeowners and Tenants*, 18 NAT. TAX J. 225 (1965).

24 GOODE 122.

25 The exclusion of imputed net rent has also been criticized because it does not benefit those individuals who cannot purchase a home due to noneconomic considerations. This category would include people who must move constantly due to their work or who are forced to live in the central city where homes are not in abundance. See HODGE & HAUSER 109; GOODE 120-29; Kindahl, *Housing and the Federal Income Tax*, 13 NAT. TAX J. 376 (1960).

26 DOUGLAS REPORT 401.

27 *Id.*

28 HODGE & HAUSER 109.

condominiums which would provide economical housing for low-income urban residents would assist in placing homeowner status within their reach."²⁹ As more individuals are able to attain home ownership through such programs, the deductions allowed homeowners will become far less objectionable in that a deduction for everyone discriminates against no one. Finally, the report pointed out that "[t]hose below this economic level [the level required for home ownership] commonly incur little or no individual income tax liability by reason of personal exemptions and standard deduction allowances against their very small incomes,"³⁰ and hence are not seriously affected by the discrimination in favor of homeowners.

III. The Housing Investor and the Real Estate Tax Shelter

While the Code's favorable treatment of the homeowner as compared with the tenant may be justified on sound policy considerations, the advantages that the housing investor enjoys under the Code are more difficult to rationalize. By carefully conducting his investment activities and remaining alert to the tax consequences of every move, the cautious housing investor is currently able to use devices such as accelerated depreciation³¹ and the capital gain taxation on the sale of property³² to effectively avoid taxes without risking his capital in much-needed low-income housing. This ability to avoid taxation without furthering any special policy goal constitutes what many writers call the "real estate tax shelter."³³

A. Accelerated Depreciation

The owner of "property held for the production of income"³⁴ may deduct from his gross income (1) incidental repair costs,³⁵ (2) state and local taxes on the property,³⁶ (3) interest paid on a mortgage,³⁷ and (4) depreciation, defined as "a reasonable allowance for . . . exhaustion, [and] wear and tear (including a reasonable allowance for obsolescence)"³⁸ The depreciation deduction may be applied to "[a]ny amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate."³⁹ Even if an owner elects to forgo the deduction each year, he must compute what he was allowed to deduct for purposes of determining taxable gain on the sale of the property.⁴⁰ This deduction is provided "to per-

29 *Id.* at 110.

30 *Id.*

31 See JOINT PUBLICATION OF THE HOUSE COMM. ON WAYS AND MEANS AND THE SENATE FINANCE COMM., 91ST CONG., 1ST SESS., TAX REFORM STUDIES AND PROPOSALS U.S. TREASURY DEPARTMENT 439 (Comm. Print 1969) [hereinafter cited as TAX REFORM STUDIES].

32 See *id.* at 440.

33 HODGE & HAUSER 36-38.

34 INT. REV. CODE OF 1954, § 167(a)(2).

35 INT. REV. CODE OF 1954, § 212.

36 INT. REV. CODE OF 1954, § 164.

37 INT. REV. CODE OF 1954, § 163.

38 INT. REV. CODE OF 1954, § 167(a).

39 INT. REV. CODE OF 1954, § 263(a)(1).

40 INT. REV. CODE OF 1954, § 1016(a)(2).

mit taxpayers to recover through annual deductions the cost (or other basis) of the property over its useful economic life.⁴¹

The Code specifically mentions three acceptable methods of computing depreciation for new property: stright line, declining balance not to exceed twice the straight line rate (200 percent declining balance), and sum-of-the-years-digits.⁴² Used property may be depreciated at up to 150 percent declining balance, or one and one-half times the straight line rate.⁴³ Straight line depreciation is computed by dividing the cost of the asset less estimated salvage value by the estimated useful life; the resulting amount may be deducted each taxable year. The declining balance method is computed by determining the rate allowed and applying it to the unrecovered basis of the asset (the cost of the asset less the total amount of depreciation deductions already taken). If, for example, the straight line rate is 20 percent, the 150 percent declining balance rate would be 30 percent and the 200 percent declining balance rate would be 40 percent.⁴⁴ Although the estimated salvage value is not considered in this computation, at no time may an asset be depreciated below its reasonable salvage value.⁴⁵ The declining balance methods of depreciation are termed "accelerated" because they provide a deduction in excess of the straight line method during the early years of an asset's useful life.⁴⁶

The economic advantages of accelerated depreciation are accentuated by the equity owner's ability to base his deduction on the total cost of the asset while most of that cost is financed by a mortgage — a procedure commonly called leveraging.⁴⁷ Unlike most other deductions allowed by the Code, the depreciation deduction does not represent an out-of-pocket expense in the year in which it is taken. Thus, although the owner cannot deduct the principal payments that he makes on his mortgage, accelerated depreciation deductions allow him to protect income from which to make those payments. As the Treasury Department has stated,

accelerated depreciation allowances in the early years exceeds by far the relatively low element of principal repayment in the mortgage service. Consequently, depreciation deductions, and particularly those in excess of any current actual loss of the property's value, serve to provide a tax-exemption cover for cash flow, enabling the cash flow to be withdrawn by the investor without being subject to individual income tax.⁴⁸

Moreover, if the accelerated depreciation deduction is large enough, it may not only protect income from the asset, but also shelter other sources of income from taxation.⁴⁹

41 Rev. Proc. 62-21, 1962-2 CUM. BULL. 418, 429. This procedure contains the useful life guidelines which are now in effect.

42 INT. REV. CODE OF 1954, § 167(b)(1)-(3). For an explanation of sum-of-the-years-digits, see HODGE & HAUSER 14.

43 Rev. Rul. 57-352, 1957-2 CUM. BULL. 150. However, because of the shorter useful life which the owner of used property may claim for his property, his depreciation deduction may in effect be as beneficial as that of the original owner. TAX REFORM STUDIES 440.

44 See A. CERF, REAL ESTATE AND THE FEDERAL INCOME TAX 128-54 (1965).

45 Treas. Reg. § 1.167(a)-1(a) (1956).

46 See A. CERF, *supra* note 44, at 128.

47 HODGE & HAUSER 15.

48 TAX REFORM STUDIES 440 n.1.

49 *Id.* at 440.

As an illustration, assume that an apartment house with a fifty-year useful life costs \$1,000,000 to construct. The depreciation deductions which might be taken by the owner for the first year of the building's life would vary widely according to the method of depreciation employed. This is illustrated in Table 1.

TABLE 1
COMPUTATION OF DEPRECIATION

<i>Method of Depreciation</i>	<i>Computation</i>	<i>Deduction</i>
Straight Line	$\frac{\$1,000,000}{50}$	\$20,000
150 Percent Declining Balance	$\frac{\$1,000,000}{50} \times 1.5$	\$30,000
200 Percent Declining Balance	$\frac{\$1,000,000}{50} \times 2$	\$40,000

Assume further that the apartment building is financed by an \$800,000 mortgage at six percent interest, due in twenty years. If the owner's net income from the building were \$80,000 in the first year, taxable income, without allowance for property tax deductions, would be as reflected in Table 2.

TABLE 2
EFFECT OF ACCELERATED DEPRECIATION ON TAX LIABILITY

	<i>Straight Line</i>	<i>150 Percent Declining Balance</i>	<i>200 Percent Declining Balance</i>
Net Income:	\$80,000	\$80,000	\$80,000
Less:			
Mortgage Interest	48,000	48,000	48,000
Depreciation	20,000	30,000	40,000
	<u>68,000</u>	<u>78,000</u>	<u>88,000</u>
Taxable Income (or Loss)	\$12,000	\$2,000	(\$8,000)

As the table shows, the investor computing depreciation with the 200 percent declining balance method has realized \$80,000 net income on his investment of \$200,000, while at the same time obtaining a tax loss of \$8,000.

From a historical viewpoint, this accelerated depreciation device is difficult to justify. The provision, originally enacted in 1954, appears to have been directed primarily at industrial machinery and equipment.⁵⁰ A recent study of the relative merits of accelerated depreciation, assembled by the staff of the Joint Economic Committee in 1964, places most of its emphasis on machinery and equipment.⁵¹ In fact, the Treasury Department has stated that "[n]o conscious

⁵⁰ *Id.* at 445.

⁵¹ STAFF FOR THE JOINT ECONOMIC COMM., 88TH CONG., 2D SESS., THE FEDERAL TAX SYSTEM: FACTS AND PROBLEMS 95-104 (Comm. Print. 1964) [hereinafter cited as FEDERAL TAX SYSTEM REPORT].

decision was made to adopt the present system as a useful device to stimulate building or to provide us with more or better housing, let alone lower income housing. The present tax system for buildings just happened."⁵²

Congress temporarily suspended the use of accelerated depreciation, along with the seven percent investment credit, in 1966.⁵³ As the committee hearings indicated, however, the primary purpose of this suspension was to slow down the economy in order to ease inflationary pressure.⁵⁴ When the hearings to consider restoration of accelerated depreciation and the investment credit were held, practically none of the discussion concerned accelerated depreciation.⁵⁵ Thus, although some might wish to interpret the reinstatement of accelerated depreciation as positive congressional approval of this device, the record indicates that this was not the case. A move to abolish accelerated depreciation would only have confused the primary issue under consideration, which was again control of inflation.⁵⁶ This was indicated by Secretary of the Treasury Fowler's response to a committee question concerning a tax reform rider to the restoration bill:

We are not in any position to delineate the agenda for tax reform as a preliminary consideration to the enactment of the bill pending before this committee. We need, I need personally a very great deal of study and effort and I am sure Mr. Surrey [Assistant Secretary of the Treasury] and the staff do as well.⁵⁷

B. Capital Gains

To the housing investor, the economic advantages of accelerated depreciation are further enhanced by the tax treatment of any capital gain realized on the sale of his asset.⁵⁸ For when the owner sells his property, the difference between the adjusted basis of the property (cost less accumulated depreciation) and the sale price will be taxed at capital gain rates.⁵⁹ Capital gain rates are, of course, lower than ordinary income rates, on the theory that capital appreciation occurring over a period of several years should be taxed at a rate below the rates applied to income realized on a yearly basis.⁶⁰ Consequently, "[t]he maximum tax that can be paid on the excess of long-term capital gain over net short-term capital loss is 25 percent and it may be less."⁶¹

For those who use accelerated depreciation, an early sale of the asset is quite beneficial because part of the recognized gain represents prior over-

⁵² TAX REFORM STUDIES 445-46.

⁵³ The original suspension was to be effective from October 10, 1966 to December 31, 1967. Act of November 8, 1966, Pub. L. No. 89-800, § 2, 80 Stat. 1513. This period was later shortened, however, to March 9, 1967. INT. REV. CODE OF 1954, § 167(i).

⁵⁴ *Hearings on H.R. 17607 Before the House Comm. on Ways and Means*, 89th Cong., 2d Sess., at 1 (1966) [hereinafter cited as *1966 House Hearings*] and *Hearings on H.R. 17607 Before the Senate Comm. on Finance*, 89th Cong., 2d Sess., at 5 (1966) [hereinafter cited as *1966 Senate Hearings*].

⁵⁵ *Hearings on H.R. 6950 Before the Senate Comm. on Finance*, 90th Cong., 1st Sess. (1967).

⁵⁶ *Id.* at 3 (testimony of Secretary of the Treasury Fowler).

⁵⁷ *Id.* at 47.

⁵⁸ HODGE & HAUSER 139-41.

⁵⁹ INT. REV. CODE OF 1954, § 1231.

⁶⁰ FEDERAL TAX SYSTEM REPORT 67.

⁶¹ See A. CERF, *supra* note 44, at 70.

depreciation rather than capital appreciation. To reap the maximum benefit, the property must be sold when the accelerated depreciation deduction becomes equal to the amount which would be deductible under the straight line method.⁶² If the asset is held beyond this time, much income will be exposed to ordinary tax rates. For purposes of illustration, Table 3 presents the amount of depreciation that an investor might deduct on a \$1,000,000 building over the first twenty years of its fifty-year useful life.

TABLE 3
ANNUAL DEPRECIATION OF \$1,000,000 BUILDING

Year	Straight Line Deduction	200 Percent Declining Balance Deduction	Year	Straight Line Deduction	200 Percent Declining Balance Deduction
1	\$20,000	\$40,000	11	\$20,000	\$26,594
2	\$20,000	\$38,400	12	\$20,000	\$25,530
3	\$20,000	\$36,864	13	\$20,000	\$24,508
4	\$20,000	\$35,390	14	\$20,000	\$23,536
5	\$20,000	\$33,974	15	\$20,000	\$22,586
6	\$20,000	\$32,614	16	\$20,000	\$21,684
7	\$20,000	\$31,310	17	\$20,000	\$20,816
8	\$20,000	\$30,058	18	\$20,000	\$19,984
9	\$20,000	\$28,856	19	\$20,000	\$19,184
10	\$20,000	\$27,702	20	\$20,000	\$18,416

As the table clearly shows, the accelerated depreciation deduction finally falls below the amount deductible under the straight line method after seventeen years. By that time accelerated depreciation has provided \$160,422 more in deductions than the straight line method. Sale of the asset at this point would allow the owner to realize that much more at capital gain, rather than ordinary income, rates of taxation. The effect of this procedure is to permit capital gain taxation on what would otherwise have been ordinary income.⁶³ This ability to take accelerated depreciation and to reap capital gain on an early sale has been largely responsible for the "frequent turnover and instability of tenure"⁶⁴ that exists in the housing market today.

As an illustration, assume that the building used in the previous example is sold after ten years for \$1,200,000.⁶⁵ The difference in the gain on the sale, depending upon which method of depreciation is used, is indicated in Table 4.

62 HODGE & HAUSER 118-19.

63 *Id.* at 15; TAX REFORM STUDIES at 440.

64 HODGE & HAUSER 38. *Contra*, G. STERNLIEB, THE TENEMENT LANDLORD 102 (1966).

65 In the strong real estate markets which have prevailed during the post-World War II period, the value may not decline at all and may indeed rise well above the original cost in spite of the underlying forces, partially offset by deductible repair and maintenance expense, causing gradual physical and economic depreciation of the building.

HODGE & HAUSER 119.

TABLE 4
CAPITAL GAIN REALIZED ON SALE

	<i>Straight Line</i>	<i>200 Percent Declining Balance</i>
Cost	\$1,000,000	\$1,000,000
Less: Total Depreciation	200,000	335,168
Adjusted Basis	\$ 800,000	\$ 664,832
Sale Price	\$1,200,000	\$1,200,000
Less: Adjusted Basis	800,000	664,832
Capital Gain	\$ 400,000	\$ 535,168

The owner using accelerated depreciation in this illustration has, up to the point of sale, exposed less income to taxation because he has taken larger annual depreciation deductions. Had both owners retained their properties for a full fifty years, the total deductions taken by each would be equal. However, an early sale allows the user of accelerated depreciation to divest himself of the property before the equalization can occur. He must recognize more gain on the sale, but that gain is taxed at the advantageous capital gain rates. Hence, he has employed his deduction to shelter ordinary income and then recognized that income when capital gain rates apply.

C. Recapture

In order to prevent the wholesale conversion of ordinary income into capital gain, Congress in 1964 adopted the recapture rules now set forth in section 1250 of the Code.⁶⁶ *Recapture* is simply the taxation of capital gains at rates applicable to ordinary income. For depreciation taken on property held for a period of less than 12 months after 1963, the section provides for total recapture — application of ordinary income tax rates to all gains reflecting depreciation taken since 1963. For a holding period between 12 and 20 months, the section recaptures all depreciation deducted since 1963 in excess of the amount deductible under the straight line method. For a holding period of more than 20 but less than 120 months, the section recaptures a percentage of the depreciation taken since 1963 in excess of straight line equal to 100 percent less 1 percent for each month the property is held over 20 months.⁶⁷ Thus, the owner need only hold his property for 120 months (ten years) to completely avoid recapture.

The ineffectiveness of the recapture provisions may be illustrated by the example used in Table 3, where the annual 200 percent declining balance deductions did not fall below straight line deductions until the asset had been held seventeen

⁶⁶ INT. REV. CODE OF 1954, § 1250.

⁶⁷ HODGE & HAUSER 123.

years. By that time, the declining balance method had provided \$160,422 in excess deductions. These considerations have led to suggestions that all depreciation in excess of straight line be recaptured.⁶⁸ Certainly the present provisions, as one commentator has noted, "should not discourage any taxpayer from taking accelerated depreciation."⁶⁹

D. Reform

The cost of these tax advantages to the federal government, at 1967 tax and economic levels, is conservatively estimated by the Treasury Department to be some \$750 million due to accelerated depreciation and \$100 million due to capital gain treatment of sales.⁷⁰ Of this \$750 million, only an estimated \$50 million went "directly into the process of rewarding investors who currently or recently have made commitments increasing the low- and moderate-income housing supply."⁷¹ One reason for this lack of interest in low- and moderate-income housing is that the tax advantages operate best where high leveraging, assured high income, and the prospects of capital gain in excess of overdepreciation are available. Investments like motels, luxury high-rise apartments, and shopping centers are most likely to meet these requirements. "Tax shelter operators on the grand scale do not find the low-income rental project attractive."⁷²

The effects of these tax concessions on certain individual taxpayers are even more striking. The Code, for all its defects, has achieved acceptance as the "fairest of all taxes" largely because of the popular conviction that it "accords best with the ability to pay."⁷³ The high rate of federal taxation does draw complaints, but the ability of some people to legally avoid all taxation threatens the viability of the tax to a much greater degree.⁷⁴ The Treasury Department's examination of a sample of tax returns from taxpayers engaged in real estate operations showed that

out of one group of 13 individual returns for the year 1966 depreciation losses reduced the Federal tax liability of nine of them to zero and of two others to less than \$25. In the aggregate, the 13 taxpayers studied — all of whom had substantial gross incomes — reported capital gains on real estate of \$1,260,000, depreciation deductions of \$462,000, and net rental losses of \$370,000 after deducting all expenses and depreciation.⁷⁵

68 This suggestion has been embodied in the tax reform bill of 1969. H.R. 13270, 91st Cong., 1st Sess. § 521(b) (1969). The bill provides that "when depreciable real property is sold after July 24, 1969, accelerated depreciation taken after July 24, 1969, in excess of allowable straight-line depreciation is to be recaptured as ordinary income to the extent of the gain occurring upon the sale." H.R. REP. NO. 91-413, 91ST CONG., 1st Sess., pt. 1, at 167 (1969). Nevertheless, even 100 percent recapture cannot entirely offset the effect of the excess annual deduction. For recapture cannot operate until there is a sale, while the prior deductions have a "present value" in excess of their dollar amount.

69 Horvitz, *Sections 1250 and 1245: The Puddle and the Lake*, 20 TAX L. REV. 285, 442 (1965).

70 TAX REFORM STUDIES at 439.

71 *Id.* at 442.

72 HODGE & HAUSER 32.

73 GOODE 11.

74 See NEWSWEEK, Feb. 24, 1969, at 65; TIME, April 4, 1969, at 84.

75 TAX REFORM STUDIES 443-44.

The realization that some individuals may use these various devices to legally avoid all taxation has led to recommendations for a minimum income tax. Such a proposal was originally developed by the Treasury Department during President Johnson's administration.⁷⁶ The department pointed out that:

Whatever may be the merits of each of these tax preferences, of overriding importance is the principle that every individual with substantial income should pay a minimum tax toward the cost of Government that in itself bears a relationship to the income involved.⁷⁷

The Nixon administration originally expressed disapproval of this proposal,⁷⁸ but later decided to endorse it.⁷⁹

The real estate tax shelter could be readily eliminated by requiring that property held for use as rental housing be depreciated at the straight line rate only.⁸⁰ Such a reform would remove the incentive for quick property turnovers and induce owners to better maintain their property in order to protect its long-term income-producing potential.⁸¹

The permanent abandonment of accelerated depreciation would probably be opposed with arguments similar to those urged against its suspension in 1966.⁸² The major problems of the housing industry, as recognized by the president of the National Association of Homebuilders during the 1966 hearings, "have been the extremely tight credit picture, rising interest rates, and the diversion of funds from homebuilding into other areas of investment."⁸³ Proponents of accelerated depreciation would be able to show that rental and homeowner vacancy rates have fallen since 1966,⁸⁴ and that abolition might cause a rise in rents as well as a withdrawal of millions of dollars from the mortgage market.⁸⁵

While these objections are not without force, the fact remains that the

76 *Id.* at 13-14.

77 *Id.*

78 N.Y. Times, March 20, 1969, at 23, col. 1.

79 N.Y. Times, April 23, 1969, at 32, col. 1.

80 Although this was one of the reforms recommended to the National Commission on Urban Problems by Hodge and Hauser, the commission declined to either approve or disapprove it. Compare HODGE & HAUSER 104 with DOUGLAS REPORT 405-6. A modified version of the proposal has been embodied in the tax reform bill of 1969. H.R. 13270, 91st Cong., 1st Sess. § 521(a) (1969).

Under the bill, new construction (other than new residential housing) will no longer be eligible for the double declining balance method of depreciation or the sum of the years-digits method unless (1) the construction of the building began before July 25, 1969, or (2) a written binding contract with respect to any part of the construction or for permanent financing was entered into before July 25, 1969. Other new construction will be limited to 150-percent declining balance, in the same manner as used property is limited under present law.

H.R. REP. NO. 91-413, 91st Cong., 1st Sess., pt. 1, at 166 (1969). The bill also provides that in the case of used buildings acquired after July 24, 1969, only straight line depreciation may be taken. *Id.* at 166-67.

81 See HODGE & HAUSER 36-38, 104; TAX REFORM STUDIES 449.

82 See, e.g., 1966 Senate Hearings 304-7 (testimony of Larry Blackmon, president of the National Association of Home Builders).

83 1966 House Hearings 253.

84 BUREAU OF THE CENSUS, HOUSING VACANCIES 19 U.S. Dep't of Commerce (Series H-111, No. 55, 1969).

85 1966 House Hearings 260-61 (testimony of Peter H. Edwards). Mr. Edwards argued that loss of accelerated depreciation would reduce the rate of return on investment in housing. Such reduction, he concluded, would force lenders to withdraw funds from the mortgage market in order to invest in more profitable ventures. *Id.*

present "remedy" (i.e., accelerated depreciation) is both inadequate and inequitable. Accelerated depreciation is inadequate from a social viewpoint because it fails to foster investment in low-income housing; it is inadequate from an economic viewpoint because it does not strike at the core problem which housing investors face. The real problem — the high cost of money — cannot be solved by tax concessions. Finally, accelerated depreciation is inequitable simply because it allows some individuals to avoid altogether their share of governmental costs.

IV. Substandard Housing

The beneficial Code treatment of investors involved in housing construction can be contrasted with the adverse effect which the Code has on other investors who rehabilitate or demolish substandard housing. In a recent study of slum housing in Newark, New Jersey, Professor George Sternlieb, of Rutgers University, found that such slum investors are engaged in a "relatively specialized occupation. The investor in this type of property typically is not party to other areas of real estate investment."⁸⁶ (Italics in original omitted.) As a rule, such investors evidence little concern for their parcels, resulting in progressive deterioration.⁸⁷ This apathy has been caused, at least in part, by the structure of the present Internal Revenue Code.

A. Rehabilitation

The Code's requirement that substantial capital outlays for maintenance be depreciated over the useful life of the improvement⁸⁸ causes several tax problems that are particularly burdensome for the owner of substandard housing: (1) the depreciation deduction will usually not be responsive to the slum owner's special situation in that the actual life span of slum-located improvements may be considerably shorter than the "useful life" over which they may be depreciated;⁸⁹ (2) the improvements rarely command appreciable return in the form of capital gains; and (3) the present recapture rules will run separately on the repairs, requiring a longer holding period to avoid recapture.⁹⁰ Thus, "the possible tax and other disadvantages of substantial maintenance expenditures on older properties have reinforced the underlying economic forces which create and perpetuate substandard housing concentrations."⁹¹ Moreover, these disadvantages are not balanced by any tax incentive, since the owner may deduct depreciation on the building without making any repairs at all.⁹²

Two specific recommendations for changes in the tax law to aid in slum

⁸⁶ G. STERNLIEB, *THE TENEMENT LANDLORD* 124 (1966).

⁸⁷ *Id.* at 124-28.

⁸⁸ INT. REV. CODE OF 1954, § 263(a)(1).

⁸⁹ If occupants use the property roughly, the effect of conventional repair and maintenance such as redecorating or even improvements such as new kitchen or plumbing fixtures may be evanescent and have to be repeated quickly with no net economic gain. HODGE & HAUSER 39.

⁹⁰ INT. REV. CODE OF 1954, § 1250(f)(3)(4).

⁹¹ HODGE & HAUSER 5.

⁹² INT. REV. CODE OF 1954, § 167.

rehabilitation merit discussion. The first would amend the Code to allow a reasonable amount spent on rehabilitation of substandard housing⁹³ to be deducted as a current expense.⁹⁴ Instead of being forced to capitalize the amount spent to rehabilitate his building, the landlord would be able to write off the cost against his income as a current expense. Hence, he could recover part of the cost of repairs immediately instead of waiting several years to recover it through depreciation deductions. This change would recognize that most of the essential maintenance work on substandard housing represents an accumulation of neglected ordinary repairs and that such work usually causes little capital appreciation.⁹⁵ The change would also further one of the goals of the Housing Act of 1964,⁹⁶ in which Congress "recognized that conservation and rehabilitation, including [housing] code enforcement, must be stressed if the total urban renewal program is to be a success."⁹⁷

The second proposed amendment to the Code designed to foster rehabilitation would deny the depreciation deduction to housing which does not conform to local housing code standards.⁹⁸ Most major cities have adopted such codes to aid in the struggle against urban blight, but enforcement has proven difficult.⁹⁹ The proposed amendment is designed to aid local enforcement of these codes by taxing the unheeding slumlord out of business.¹⁰⁰ The advocates of this proposal argue, *inter alia*, that tax deductions ought not be given for illegal activity.¹⁰¹ Unfortunately, administrative problems and probable ineffectiveness militate against such a reform. If enforcement required local certification of housing (which is quite likely), the rules might lead to harsh results, such as the loss of certification for a minor code violation. This could invite corruption. The predictable decline in property values that loss of the ability to deduct depreciation would cause could force rent increases or wipe out the equities of many owners. The end result would probably be the disappearance of the remaining concerned slum landlords.¹⁰² As one authority has concluded,

[l]ooking at the whole approach from what might reasonably be expected to be the Federal tax policy standpoint, the denial of tax depreciation would seem merely to shift to the Federal tax system and its depreciation rules in particular much of the burden of enforcing penalties for noncompliance with local housing codes.¹⁰³

93 Hodge & Hauser recommend that structures be at least thirty years old to qualify as "substandard" in this context and that dollar limitations per dwelling unit be enacted to prevent luxury apartment owners from abusing this amendment. HODGE & HAUSER 106.

94 See HODGE & HAUSER 60-68; DOUGLAS REPORT 406. A modified version of this proposal has been embodied in the tax reform bill of 1969. H.R. 13270, 91st Cong., 1st Sess. § 521(a) (1969). The bill would allow a taxpayer who meets certain requirements to write off within five years expenditures made on rehabilitating substandard housing. See H.R. REP. NO. 91-413, 91ST CONG., 1ST SESS. pt. 1, at 167 (1969).

95 HODGE & HAUSER 34.

96 Housing Act of 1964, Pub. L. No. 88-560, 78 Stat. 769 (codified in scattered sections of 12, 15, 20, 38, 40, 42 U.S.C.).

97 Comment, *Conservation and Rehabilitation of Housing: An Idea Approaches Adolescence*, 63 MICH. L. REV. 892, 911 (1965).

98 HODGE & HAUSER 68-74.

99 Note, *Municipal Housing Codes*, 69 HARV. L. REV. 1115, 1123-26 (1956).

100 HODGE & HAUSER 69.

101 *Id.* at 73.

102 *Id.* at 74.

103 *Id.* at 72.

B. Renewal

Any Code amendment to foster rehabilitation by allowing the deduction of substantial maintenance expenses might well be accompanied by a change to foster demolition of substandard housing. Treasury regulations require the investor who purchases property with the intent of razing it to add the cost of demolition to the value of the land.¹⁰⁴ Since land is not a depreciable asset,¹⁰⁵ the investor cannot write off the cost of demolition. If, on the other hand, an investor's building loses its usefulness and is abandoned, a retirement loss is allowed for income tax purposes.¹⁰⁶

The net effect of the capitalization or deferred write-off of unrecovered capital costs on old buildings plus any additional net costs of tearing them down in situations where intent or contractual agreement indicate that the land is worth more in the new use cleared than with the old building on it is to give pause to demolition or to drive investors into a carefully planned sequence of transactions to obtain the most favorable tax results, if the demolition losses and costs are significant.¹⁰⁷

The "carefully planned sequence of transactions" refers to the activities of an investor who will use a slum building for a few years rather than indicate his intention to demolish. Such a subterfuge enables him to claim the abandonment loss mentioned above, for it is often difficult, if not impossible, to prove that his original intention was otherwise.

The need to resort to such devices would be removed if present treasury regulations were amended to allow an investor to include the cost of razing substandard housing in the total cost of the new housing unit for depreciation purposes. The investor would then be able to recover the cost of demolition during the useful life of the new structure, instead of being forced to wait until the asset is sold.

V. Tax Incentives

The fundamental difficulty with low- and moderate-income housing as an investment is that it does not pay a competitive rate of return. Faced with constantly rising construction costs and high interest rates, the real estate industry cannot finance housing for near-poverty-level tenants without governmental aid.¹⁰⁸ Spokesmen for President Nixon's administration have urged a program of tax incentives to meet this problem.¹⁰⁹ Such incentives are favored because: (1) business is more amenable to programs which dispense with bureaucratic control; (2) incentives have been effectively used in the past; (3) incentives are stable (a result of congressional reluctance to amend the Code), and this

104 Treas. Reg. § 1.165-3(a)(1) (1960).

105 HODGE & HAUSER 13.

106 *Id.* at 136.

107 *Id.* at 138.

108 See, e.g., *Hearings on S. 2100 Before the Senate Finance Comm.*, 90th Cong., 1st Sess. 314 (1967) (testimony of Edward P. Eichler) [hereinafter cited as 1967 *Senate Hearings*].

109 N.Y. Times, March 20, 1969, at 1, col. 4.

aids long-term planning; and (4) congressional approval is, traditionally, relatively easy to obtain for tax incentives.¹¹⁰

On the other hand, tax incentives have been criticized on several grounds. The initial difficulty is that incentives erode the tax base by excluding a source of income from taxation.¹¹¹ They therefore necessitate a rise in the general rate of taxation to obtain the revenue lost. Certainly, if incentives were the most efficient method of attaining the desired goal, this general rise would be less than the rise needed to fund a spending program designed to achieve the same goal. However, by their very nature, such tax incentives are difficult to study on a yearly basis. Studying numerous tax returns to analyze the effectiveness of incentives is both costly and cumbersome.¹¹² Another difficulty with incentives is that they could create serious tax inequity, for incentives may bring unintended benefits to those investors who are able to use them as "loopholes" in the law. Yet if the law is so specific as to avoid the possibility of abuse, it may contain the type of bureaucratic control which the incentive is designed to avoid.¹¹³ Moreover, many congressional observers feel that Congress now recognizes that tax incentives represent an expense just as a subsidy does and hence will be just as careful in its consideration of any incentive program.¹¹⁴

Both the Treasury Department (during President Johnson's administration)¹¹⁵ and the National Commission on Urban Problems¹¹⁶ have opposed placing primary reliance on tax incentives. The commission stated that "governmental efforts to encourage the construction and rehabilitation of housing for low- and moderate-income families should rely *primarily* upon direct subsidy programs . . ."¹¹⁷ This would assure that all governmental efforts to aid housing would be controlled by one specialized agency rather than being divided between a specialized housing agency and the Treasury Department. Direct negotiations with business would assure that all interested parties would be given a chance to participate, instead of only those who could take advantage of tax incentives.¹¹⁸

As with accelerated depreciation, the chief argument against tax incentives is that the federal income tax is not equipped to effectively combat the housing problem. The Code, primarily designed to collect revenue, should exclude no source of income from coverage unless the exclusion can clearly be shown to be the most efficient means available to achieve an important social or economic goal.¹¹⁹ A decent home for every American family is an important social and economic goal; tax incentives simply do not appear to be the best means of achieving that goal.

110 HODGE & HAUSER 97-98.

111 *Id.* at 87.

112 *Id.*

113 *Id.*

114 *Id.* at 96, 99.

115 *Id.* at 89-96. 1967 *Senate Hearings* 140-60 (testimony of Joseph W. Barr, Undersecretary of the Treasury).

116 DOUGLAS REPORT 405.

117 *Id.*

118 HODGE & HAUSER 99.

119 GOODE 99-100.

VI. Conclusion

Tax reform in relation to housing should be enacted by the Ninety-first Congress.¹²⁰ Elimination of accelerated depreciation would help to effectuate overall housing policy goals and would make the tax laws more equitable. Such an amendment would remove much of the incentive for quick turnovers in the housing market, and would thereby encourage adequate maintenance of housing. The federal income tax would be more equitable in that investors would neither be able to shelter income behind overdepreciation nor to convert ordinary income into capital gain.¹²¹ Amendments to allow the deduction as a current expense of substantial capital outlays for maintenance of substandard housing¹²² and to allow depreciation of demolition costs in housing renewal would also help to counteract the deterioration of our housing supply.

Nevertheless, the major governmental effort to provide low- and moderate-income housing should rest primarily on a program of direct subsidies. The primary consideration here is the inability to effectively evaluate the efficiency of tax incentives. Given the social advantages of home ownership, any governmental effort should be directed, at least in part, toward constructing cooperative low-income housing. Home ownership would provide low-income families with a stake in community development, which in turn aids community stability. An intelligent tax policy can, at best, only assist a broader governmental program to alleviate the current housing problem.

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120 See note 6, *supra*.

121 See notes 68 & 80, *supra*.

122 See note 94, *supra*.