Federal Income Taxes and Urban Sprawl

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Federal income tax is one of the most complex, burgeoning fields of law and has consequently fostered the development of legal specialization in that area. Stephen Gurko is such a specialist. His examination of the federal income tax aspects of real estate investments reveals a general policy inherent in the tax law: encouragement of the development of open land near urban areas. Environmentalist concern for the prevention of "urban sprawl" will find here the elements of the practical reform necessary to disestablish real estate developers who presently control the design of urban growth.

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DESPITE certain changes made by the Tax Reform Act of 1969, the laws of federal income taxation continue to provide an array of special tax benefits for investments in real estate, particularly by high-bracket taxpayers. One effect of these laws is to encourage the gradual erosion of our countryside through the development of open land near urban areas, a phenomenon commonly referred to as "urban sprawl." While observers may disagree on whether or not "urban sprawl" constitutes a serious problem, surely all would agree that the federal income tax laws should at least be neutral on the question, which means that these laws should avoid favoring the development of open land as opposed to other forms of economic activity.

The most striking tax incentives in the real estate field are those which encourage "investors" (as distinguished from "dealers") in real estate to purchase open land either for future sale to developers or for the immediate construction of rent-producing buildings such as apartment houses. This article will explain these incentives as they apply to individuals, corporations, and partnerships, and then will suggest changes in the law designed to remove these incentives and to create non-preferential tax treatment for investors making such purchases. The objectives are both to analyze in some depth this major area of incentives to land development, and to call attention to the general bias of the federal income tax laws in favor of such development, a bias which should be corrected with maximum speed.

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2 The term "dealer" refers generally to one who holds real estate "primarily for sale to customers in the ordinary course of his trade or business" within the meaning of CODE § 1221(1), while the term "investor" refers generally to one who holds real estate primarily for rental, or for appreciation and sale other than as part of a business of selling, or for both these purposes.

3 It may be argued that when an investor purchases open land for future sale to a developer rather than for immediate development, the tax incentives which contribute to the purchase do not contribute to the development. However, this ignores the significant assistance which the investor may render to the developer to whom he hopes to sell, such as causing feasibility studies to be made and development plans to be formulated, arranging for vitally important rezoning, and acting as a political force against laws which restrict land development by creating "green belts," parks, wilderness areas, or the like. Moreover, the tax benefits to the investor may be partially reflected in a lower selling price to the developer, thereby obviously facilitating the development endeavor.
I. Tax Treatment of Individual and Corporate Real Estate Investors

A. Introduction

For the typical individual or corporate investor purchasing open land for sale to developers or for the construction of rent-producing buildings, the law offers the delectable benefits of various current deductions from ordinary income (however unrelated such income may be to the real estate in question), followed by an ultimate tax at the favorable long-term capital gain rates on all or most of the gain realized when the real estate is sold. The tax savings from the current deductions often approach or exceed the tax on the ultimate gain, thus producing in many cases an extraordinarily low net tax, or even a net tax subsidy, on a transaction which yields a substantial economic net profit. The following paragraphs will first consider the specific rules of law which provide for the attractive combination of current deductions and ultimate long-term capital gain (with emphasis on the complicated but rather limited “reforms” introduced by the Tax Reform Act of 1969), then will set forth some examples illustrating the magnitude of the benefits involved, and finally will discuss certain other benefits also available to the individual or corporate investor.

B. Current Deductions

1. Interest and Real Estate Taxes—Sections 163 and 164

The most common deductions with respect to real estate held by investors are for interest on indebtedness incurred in order to purchase or develop the property, and local real estate taxes on the property. The general rule of Internal Revenue Code sections 163 and 164 is that interest and real estate taxes, respectively, are not required to be capitalized (i.e., added to basis) as part of the property's cost, but rather are currently deductible from ordinary income.\(^4\) Under this general rule, the current deductions are allowed even though the property is held exclusively or primarily for the realization of gain on a future sale, and is neither producing nor expected to produce significant amounts of current rental or other income.\(^5\) Interest on an indebtedness secured by a mortgage on the taxpayer's property is deductible even though the taxpayer has no personal liability for the indebtedness.\(^6\) Although an accrual basis taxpayer apparently must deduct interest ratably over the

\(^4\) Code §§163(a), 164(a).

\(^5\) Id.

\(^6\) Treas. Reg. § 1.163-1(b) (1965).
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period of the borrowing, a cash basis taxpayer normally deducts interest when he pays it, and thus may be able to prepay and deduct in the current taxable year interest for the use of borrowed funds for one or more future years.

One mild limitation on these generous rules is that if interest or taxes of an individual are not attributable to a trade or business or to property held for the production of rental or royalty income, the deductions are allowable from adjusted gross income but not from gross income, so that they may be claimed only if the standard deduction is not claimed. Another limitation of narrow scope is that real estate taxes “assessed against local benefits of a kind tending to increase the value of the property assessed” may not be currently deducted but must be capitalized (i.e., added to the basis of the property assessed), even if no actual increase in value results in a particular case. However, the general rule of current deductibility applies to any portion of such taxes which the taxpayer can show to be “properly allocable to maintenance or interest charges” (evidently meaning interest charges on funds borrowed to pay for the local benefits).

The Tax Reform Act of 1969 introduced a complex but not very stringent limitation on the deduction of interest attributable to investments in real and personal property. The Act

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8 Cash basis taxpayers were allowed to deduct prepaid interest in John Fackler, 39 B.T.A. 395 (1939), not acquiesced in, 1968-2 CUM. BULL. 3, and Court Holding Co., 2 T.C. 531 (1943), not acquiesced in, 1968-2 CUM. BULL. 3, rev’d (on another issue), 143 F.2d 823 (5th Cir. 1944), rev’d, 324 U.S. 331 (1945). In Rev. Rul. 68-643, 1968-2 CUM. BULL. 76, revoking (on another issue) I.T. 3740, 1945 CUM. BULL. 109, the Internal Revenue Service announced the withdrawal of its prior acquiescences in Fackler and Court Holding Co., and the revocation of its prior ruling allowing a cash basis taxpayer to deduct interest prepaid for a period of 5 years. The Service stated that (subject to certain transitional rules) it would no longer allow a cash basis taxpayer to deduct in the current year interest prepaid for more than 12 months beyond the close of the current year, and would determine the deductibility in the current year of interest prepaid for such 12-month period on a “case by case basis” in accordance with certain factors. However, the Service cited no court decisions contrary to Fackler and Court Holding Co., and there appear to be none.

9 Code §§ 62, 63. The same rule applies with respect to most other deductions of individuals.

10 Id. §§ 164(c) (1), 1016(a) (1); Treas. Reg. § 1.164-4(a) (1964); Caldwell Milling Co., 3 B.T.A. 1232 (1926). It has been held such taxes may not be amortized over the useful life of the benefits. F.M. Hubbell & Co. v. Burnett, 51 F.2d 644 (8th Cir. 1931), aff’d 19 B.T.A. 612 (1930), cert. denied, 284 U.S. 664 (1931). Apparently such taxes must be added exclusively to the basis of the land assessed and not at all to the basis of improvements thereon (so as to be recoverable through depreciation if the improvements are depreciable), although there is no precise authority on this point.

11 Code § 164(c) (1); Treas. Reg. § 1.164-4(b) (1) (1957).
created new Code section 163 (d), which applies to taxable years beginning after December 31, 1971 (subject to certain transitional rules), and which restricts deductions by individuals for "investment interest," defined as "interest paid or accrued on indebtedness incurred or continued to purchase or carry property held for investment." The significance of the section is considerably weakened by the broad categories of investment interest which are allowed to be deducted before the restrictive provision applies.

Section 163(d) first allows a deduction for each year’s investment interest up to the amount of $25,000. Next, any remaining investment interest may be deducted to the extent of "net investment income" for the year, which is defined essentially as the excess of non-business gross income from interest, dividends, rents, royalties, net short-term capital gains from dispositions of investment property, and "depreciation recapture" under sections 1245 and 1250, over related expenses excluding interest (with depreciation being computed for this purpose by the straight line method at the taxpayer's option). It is interesting to note that the investment interest in excess of $25,000 is deductible to the extent of net investment income from any source, not just to the extent of such income from the particular investment property to which the investment interest relates. Next, any still remaining investment interest may be deducted to the extent of any "out-of-pocket" loss (i.e., any excess of rents over business or investment expenses, interest and taxes) sustained with respect to "property of the taxpayer subject to a net lease" (without regard to whether such loss results from investment interest). Next, any still remaining investment interest may be used to offset any excess of net long-term capital gain over net short-term capital loss for the year from dispositions of investment property. Finally, one-half the amount of any still remaining investment interest may

12 CODE § 163 (d) (6).
13 Id. § 163 (d) (3) (D). This definition, plus the related rules concerning the "investment" or "trade or business" status of "property subject to net lease" (§§ 163 (d) (4) (A), 1963 (d) (7), as amended and introduced, respectively, by the Revenue Act of 1971), seem likely to produce even more litigation than has arisen under § 265 (2), which disallows a deduction for interest on indebtedness "incurred or continued to purchase or carry" tax-exempt municipal bonds.
14 CODE § 163 (d) (1) (A). This exemption is $12,500 for a married individual filing a separate return, and zero for a trust.
15 Id. § 163 (d) (1) (B).
16 Id. §§ 163 (d) (3) (A), (B), (C).
17 Id. § 163 (d) (1) (B).
18 Id. §§ 163 (d) (1) (C), 163 (d) (5).
be deducted without conditions, while the other half may not be deducted in the current year\textsuperscript{19} but may be treated (subject to certain limitations) as part of the investment interest of future years under a complicated carry-over provision.\textsuperscript{20}

Assuming an interest rate of 8 percent, the deduction allowed for $25,000 of investment interest will permit an individual to borrow more than $300,000 to purchase or carry investment land or other property (whether or not productive of current income) without suffering any consequences under section 163(d). If the individual has net investment income of $15,000 from all sources (not an unusually large amount for the high-bracket individuals intended to be reached by section 163(d)), he will be able to borrow up to $500,000 for such purpose without suffering any consequences under the section. Thus in practice section 163(d) will disallow deductions for investment interest only on unusually large loans by individuals having relatively small amounts of net investment income, and even then the disallowances will apply only to limited portions of the interest. The section does not apply at all to corporations (except that the income and expense items of subchapter S corporations, like those of partnerships, are attributed to the individual shareholders or partners).\textsuperscript{21} The section applies only to interest and not at all to real estate taxes or any other expenses of investing in real estate or other property.

2. Other Expenses—Sections 162 and 212

In addition to interest and real estate taxes, the investor in real estate may normally deduct all maintenance and repair expenses, management fees, insurance premiums, advertising expenses, legal and accounting fees, and any other expenditures paid or incurred in connection with the current operation or conservation of the property. These deductions are allowed to a corporation or an individual under Code section 162 if the expenditures are "ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business,"\textsuperscript{22} or are allowed to an individual under section 212 if the expenditures are "ordinary and necessary expenses paid or incurred during the taxable year . . . for the production or collection of income [or] for the management, conservation, or maintenance of property held for the production of income."\textsuperscript{23}

\textsuperscript{19} Id. § 163(d) (1) (D).
\textsuperscript{20} Id. § 163(d) (2).
\textsuperscript{21} Id. §§ 163(d) (4) (B), (C)
\textsuperscript{22} Id. § 162(a).
\textsuperscript{23} Id. §§ 212(1), (2).
While sections 162 and 212 plainly require a profit motive (which is not required for deduction of interest and real estate taxes), such motive is readily established under very liberal rules of interpretation. Thus the investor will generally be allowed the deductions if they relate to his effort to earn net income from the property either in the current year or in a past or future year,\(^{24}\) and either from rentals or from a capital gain on disposition of the property.\(^{25}\) The deductions are allowable even if the property has produced little or no income (either net or gross) for a number of years, provided that the investor demonstrates his intention to earn net income if and when he can.\(^{26}\) At least in some instances an intention to earn gross income or proceeds (but not net income) may suffice, e.g., where circumstances render the earning of net income difficult or impossible.\(^{27}\) Code section 183, as introduced by the Tax Reform Act of 1969 and amended by the Revenue Act of 1971, creates a presumption of the necessary profit motive for taxable years beginning after December 31, 1969 (at least in the case of an individual or a subchapter S corporation), if (a) the taxpayer's "activity" with respect to the property has yielded net income in any two of the five taxable years ending with the current taxable year, or (b) the current taxable year, is either the first taxable year (beginning after December 31, 1969) in which the taxpayer has engaged in such "activity," or is one of the next four taxable years, and net income has resulted in any two of these five years.\(^{28}\) Although the "trade or business" language of section 162 implies that a corporate investor must show more active management or operation of the property than an individual investor must show under section 212, in practice no such showing by corporate investors seems to be required.

A significant limitation with respect to the expenses other than interest and real estate taxes is that they are deductible only if they are for current income production or collection, or for current management, maintenance or conservation of the property in question, rather than for permanent improvements.

\(^{24}\) Treas. Reg. § 1.212-1 (b) (1957).
\(^{25}\) Id.
\(^{26}\) See, e.g., Lorraine Corp., 17 T.C.M. 719 (1958); William C. Horrmann, 17 T.C. 903 (1951), acquiesced in, 1952-1 CUM. BULL. 2; Mary L. Robinson, 2 T.C. 305 (1943), acquiesced in, 1944 CUM. BULL. 23.
\(^{27}\) Treas. Reg. § 1.212-1(b) (1957); Hartford v. United States, 265 F. Supp. 86 (W.D. Wis. 1967).
\(^{28}\) Code §§ 183(d), (e). The taxpayers must elect which of the two alternatives will apply with respect to any "activity." Id. § 183(e).
or other capital items. To the extent expenses are non-deductible under this rule, they are capitalized, i.e., added to the basis of the property. Examples of expenses required to be capitalized are brokers' and attorneys' fees attributable to the acquisition of the property, attorneys' fees attributable to the defense or perfection of title, and construction costs of permanent improvements. Expenses must be "ordinary and necessary" in order to be deductible under section 162 or 212, a requirement which serves primarily to reinforce the other requirements of the sections, and to insure that the expenses are "reasonable" in amount (although the Service seems rarely to raise the reasonableness issue).

3. Depreciation — Section 167

a. In General

If the investor owns real estate which has been developed (either by himself or a prior owner), he will normally be entitled to depreciation deductions with respect to the improvements (including, most importantly, any buildings). Code section 167 allows these deductions if the improvements are either "used in the trade or business" or "held for the production of income." The profit motive implied by the phrases is readily established by the investor under rules of interpretation and presumption which are as liberal or nearly as liberal as those applicable to the corresponding phrases in sections 162 and 212.


The Service's non-acquiescence in George W. Mitchell reverses a prior acquiescence, and perhaps results from the apprehension that inventory might also be considered "held for the production of income" (in the sense of income from sale), and hence might be depreciable, contrary to Treas. Reg. § 1.167(a)-2 (1956) and several pre-Mitchell cases and rulings. There has been no indication that the Service will question the depreciation deductions of the typical investor who rents his developed real estate before selling it, although perhaps such a question should be raised if the investor's own projections show that he anticipates earning no net rental income but only income in the form of tax savings or a gain from a future sale.
b. Depreciable Amount and Useful Life

The depreciable amount with respect to each improvement is the adjusted basis of the improvement less its estimated net salvage value at the end of its estimated useful life to the investor, and the deductions totaling such amount are spread over such estimated useful life. The adjusted basis is normally initial cost or other basis for determining gain, plus upward adjustments for subsequent capital investments and downward adjustments for each year's depreciation deduction. Basis generally reflects the amount of any mortgage liability incurred in connection with acquisition or construction of the improvement, even if the mortgagee may look only to the mortgaged property and not to the investor personally for repayment. Useful life may generally be determined from the guidelines published by the Internal Revenue Service (which provide, for example, for a 40-year life for an apartment house or hotel, and a 20-year life for a parking lot), or a useful life shorter than the guideline life may be adopted if it can be justified. An advance agreement may be entered into with the Service respecting useful life and other elements in the depreciation of the improvements.

Land is not depreciable (presumably because it is considered not subject to physical exhaustion or wear and tear over a determinable useful life), and hence the basis for developed land must often be allocated between the land and the improvements (in proportion to their relative values at the time of acquisition) in order to determine the depreciable basis for the improvements. If developed land is acquired with the intention of demolishing existing improvements (whether or not in order to construct new ones), the general rule is that the demolition costs plus any basis allocable to the existing improvements may neither be deducted nor added to

37 CODE § 167(g); Treas. Reg. §§ 1.167(a)-1(a), 1.167(a)-1(c) (1964); Massey Motors, Inc. v. United States, 364 U.S. 92 (1960).
38 Treas. Reg. §§ 1.167(a)-1(a) (1964), 1.167(a)-1(b) (1956); Massey Motors, Inc. v. United States, 364 U.S. 92 (1960).
39 CODE § 1011 and other sections referenced thereto, notably §§ 1016(a) (1), (2).
42 Id. introduction.
43 CODE § 167(d); Treas. Reg. § 167(d)-1 (1959).
45 Treas. Reg. § 1.167(a)-2 (1956); see, e.g., Algernon Blair, Inc., 29 T.C. 1205 (1958), acquiesced in, 1958-2 CUM. BULL. 4. A similar allocation is often required among the improvements.
the basis of any new improvements, but must be added to the basis of the land.\textsuperscript{46} This rule tends to discourage investors from purchasing developed urban land in order to replace undesirable structures with new ones, and to encourage investors instead to purchase open land outside of urban areas for the building of new structures.\textsuperscript{47}

c. Depreciation Methods

The method of spreading the depreciation deductions over the useful life of an improvement is determined under rules which take no account of either the actual decline (if any) in the value of the improvement or the amounts of income (if any) produced by the improvement over its useful life. Despite changes made by the Tax Reform Act of 1969, these rules continue to allow wide use of "accelerated" depreciation methods which result in the concentration of relatively large depreciation deductions in the early years of the useful life even though the decline in value or production of income in these years may not be correspondingly large.

Prior to the Act, any improvement having a useful life of 3 or more years and either constructed by the investor or acquired new by him could be depreciated by the accelerated methods known as "double declining balance" or "sum of the years-digits."\textsuperscript{48} while such an improvement or any other improvement could be depreciated by an accelerated method known as "150 percent declining balance," or by the straight line method.\textsuperscript{49} Briefly, the straight line method consists of dividing the total depreciable amount into equal annual deductions over the useful life,\textsuperscript{50} while the declining balance methods

\textsuperscript{46} Treas. Reg. § 1.165-3 (a) (1) (1960); Rev. Rul. 69-62, 1969-1 CUM. BULL. 58; see, \textit{e.g.}, Providence Journal Co. v. Broderick, 104 F.2d 614 (1st Cir. 1939).

\textsuperscript{47} The law is more liberal with respect to a loss from a demolition decided on after the developed land is acquired. Such a loss may under various circumstances be (a) immediately deducted, (b) added to the basis of any new improvement which the demolition is intended to permit, or (c) added to the basis (amortizable) of a lease pursuant to which the demolition work is done. The Service and some courts disagree to some extent as to whether or when each approach is correct. Treas. Reg. § 1.165-3 (b) (1960); see, \textit{e.g.}, Feldman v. Wood, 335 F.2d 264 (9th Cir. 1964); Commissioner v. Appleby's Estate 123 F.2d 700 (2d Cir. 1941); Estate of Henry Phipps, 5 T.C. 964 (1945), not acquiesced in, 1946-2 CUM. BULL. 6.

\textsuperscript{48} \textit{Code} §§ 167(a), 167(b) (2), 167(b) (3), 167(c); Treas. Reg. §§ 1.167(b) - 0, 1.167(c)-1 (1956). Whether an improvement is acquired "new" depends on whether its "original use" begins with the investor.

\textsuperscript{49} \textit{Code} §§ 167(a), 167(b) (1); Treas. Reg. § 1.167(b) - 0 (1956). Other less common depreciation methods could also be used, subject to certain limitations. \textit{Code} §§ 167(a), 167(b) (4); Treas. Reg. §§ 1.167(b) - 0, 1.167(b) -4, 1.167(c) (1) (1956).

\textsuperscript{50} Treas. Reg. § 1.167(b) -1 (1956).
involve multiplying the remaining adjusted basis each year by a percentage equal to 200 percent or 150 percent of the percentage of original adjusted basis which would be deductible each year under the straight line method, until the estimated salvage value is reached.\textsuperscript{51} The sum of the years-digits method consists in essence of multiplying, each year, the original depreciable amount by a fraction the numerator of which is the remaining number of years in the useful life (including the current year) and the denominator of which is the sum of the numbers from one through the total number of years in the useful life.\textsuperscript{52} Either of the declining balance methods or the sum of the year-digits method results in larger deductions in the early years and smaller deductions in the later years of the useful life, in contrast to the equal deductions in all years produced by the straight line method.

The committee reports accompanying the Act sharply criticize the accelerated methods of depreciation outlined above.\textsuperscript{53} Nonetheless, intricate new Code section 167(j) (introduced by the Act) retains double declining balance and sum of the years-digits as permissible depreciation methods for new "residential rental property" (defined generally as a building or structure producing gross rental income for the taxable year at least 80 percent of which is from "dwelling units," excluding units in hotels, motels, or other establishments in which more than half

\textsuperscript{51}Id. § 1.167(b)-2 (1964); Hertz Corp. v. United States, 364 U.S. 122 (1960).

\textsuperscript{52}Treas. Reg. § 1.167(b)(3) (1956). Alternately, the denominator of the fraction may be changed each year to take account of only the remaining number of years in the useful life (including the current year), but then the fraction is applied only against the remaining adjusted basis. Id. § 1.167(b)-3(a) (2) (1956).

\textsuperscript{53}For example, the Senate Committee Report declares that "accelerated depreciation usually produces a deduction far in excess of the actual decline in the usefulness of the property." S. Rep. No. 552, 91st Cong., 1st Sess. 212 (1969). This report proceeds to state (on the same page) that

As a result of the fast depreciation and the ability to deduct amounts in excess of the taxpayer's equity, economically profitable real estate operations normally produce substantial tax losses, sheltering from income tax the economic profit of the operation and permitting avoidance of income tax on the owner's other ordinary income, such as salary and dividends.

The Report further states (on the same page) that

Because of the present tax situation, when investment is solicited in a real estate venture it has become the practice to promise a prospective investor substantial tax losses which can be used to diminish the tax on his income from other sources. Thus, there is, in effect, substantial dealing in "tax losses" produced by depreciable real property. The committee, agreeing with the House, believes the desired solution is the elimination of these losses in those cases where there is no true economic loss.

the units are used on a transient basis), and allows the 150 percent declining balance method for any other new real property improvements. The section does generally limit used improvements to the straight line method, but makes an exception for used residential rental property, which may be depreciated by the 125 percent declining balance method if it has a useful life of 20 years or more when acquired. The section thus preserves substantial allowance of the accelerated methods of depreciation for real property improvements, and also preserves preferred treatment for new as distinguished from used improvements, while introducing preferred treatment for residential rental property as distinguished from other improvements. The combined effect is not merely to maintain but to enlarge the previous depreciation incentives for the spread of urban areas into the surrounding countryside through the construction of new residential buildings.

In contrast, continued use of existing residential buildings is encouraged to a limited extent by new section 167(k), which permits depreciation over a 5-year period for expenditures incurred after July 24, 1969, and before January 1, 1975, to rehabilitate "low-income rental housing" (to be defined by the regulations consistently with the policies of the Housing and Urban Development Act of 1968), provided that the expenditures produce improvements with a useful life of 5 years or more and that the expenditures per dwelling unit exceed a total of $3,000 for 2 consecutive years including the taxable year. A total of no more than $15,000 per unit is to be taken into account under the section. If an election is made to use the 5-year depreciation period, only the straight line method may be used, but no salvage value is to be taken into account.

The excess of accelerated over straight line depreciation allowed with respect to any real property improvements (ex-

54 Code §§ 167(j) (2), 167(k) (3) (C).
55 Id. § 167(j) (1) (B).
56 Id. § 167(j) (4).
57 Id. § 167(j) (5) (B). Section 167(j) applies generally to new improvements the construction of which was begun after July 24, 1969 (§ 167(j) (3) (A)), and to used improvements acquired after that date (§§ 167 (j) (4), (5)), but subject to various transitional provisions, (§§ 167(j) (3) (B), 167(j) (6)), and to a temporary liberalization of the provisions relating to changes of depreciation methods for a particular improvement (§ 167) (e)). The section does not apply to certain limited types of improvements which constitute "section 1245 property" rather than "section 1250 property," so that the prior rules continue in effect for such improvements (§§ 167(j) (1), 167(j) (4), 167(j) (5), 1250(c), 1245(a) (3) (B), (C), (D)).
59 Code § 167(k).
cluding an improvement subject to section 1245) is treated as an "item of tax preference" for purposes of the new "minimum tax" on such items, a subject which will be discussed below.

C. Gain on Sale

1. Depreciation Recapture — Section 1250

Although the real estate investor may claim current deductions from ordinary income for his interest, taxes, maintenance and other current expenses, and for depreciation of improvements, his gain from a sale of his real estate will be taxed as ordinary income only to the limited extent provided in Code section 1250 with respect to so-called "depreciation recapture."

Prior to the Tax Reform Act of 1969, section 1250 provided in general that if a real property improvement (excluding an improvement subject to section 1245) were held for 1 year or less and then sold at a gain, ordinary income treatment would apply to the lesser of such gain or the sum of the depreciation deductions allowed with respect to the improvement for all periods after 1963.60 If, however, the improvement were held for more than 1 year, then ordinary income treatment would apply at most to the lesser of the gain or the depreciation allowed in excess of straight line depreciation for all the periods after 1963 (reduced by any reverse excess, i.e., any excess of straight line depreciation over the depreciation allowed for any period after 1963).61 Moreover, even the amount of ordinary income thus determined would be reduced by 1 percent for each month the improvement were held in excess of 20 months.62

The Act made lengthy additions to section 1250, but changed the rules outlined above only by eliminating the 1 percent-per-month reduction of ordinary income with respect to improvements held for more than 20 months,63 while introducing a new 1 percent-per-month reduction with respect to improvements held for more than 100 months and constituting residential rental property or property produced by rehabilitation expenditures depreciated under section 167(k).64 The Act did not

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60 Revenue Act of 1964, § 231(a), 78 Stat. 100, as amended, Code § 1250(a) (1969); Code §§ 1250(b) (1), 1250(b) (3), 1250(c).
61 Code § 1250(b) (1); Treas. Reg. §§ 1.1250-2(b) (1), 1.1250-2(b) (6) ex. (1), (2) (1971). When accelerated depreciation is used, the initial excess over straight line is always replaced by the reverse excess after a certain time, and the reverse excess always equals the initial excess by the end of the estimated useful life.
63 Code §§ 1250(a) (1) (A), (B), (C) (v).
64 Id. §§ 1250(a) (1) (A), (B), (C) (iii), (C) (iv).
alter the basic rule of section 1250 that if an improvement is held for more than 1 year, the ordinary income portion of the gain from sale is never greater than the net excess of post-1963 depreciation over straight line depreciation. The rule of section 1250 is to be contrasted to the rule of section 1245, under which gain from the sale of personal property (or of a real property improvement subject to section 1245) is generally treated as ordinary income to the extent of all post-1961 depreciation allowed with respect to the property, including straight line depreciation.

The new section 1250 provisions introduced by the Act apply generally to post-1969 depreciation (but subject to a transitional rule). The pre-Act provisions continue to apply to depreciation from 1964 through 1969, with the new provisions being applied first to any particular gain, and the pre-Act provisions then being applied if a sufficient amount of the gain remains. The mechanics of the two sets of provisions and of the relationship between them can produce some results which are quite liberal to the investor. For example, if the gain is $100,000, the excess post-1969 depreciation is $120,000, and the applicable percentage is 50 percent (because the improvements are residential rental property held for 150 months), then the ordinary income portion of the gain is not $60,000 but only $50,000, because the percentage is applied to the lower of the gain or the excess depreciation. In this example, no portion of the remaining $50,000 of gain is subject to ordinary income treatment on account of excess depreciation from 1964 through 1969 (even if there is such depreciation), because the total gain of $100,000 is less than the total excess post-1969 depreciation of $120,000.

The pre-Act provisions apply to post-1969 depreciation (as well as to depreciation from 1964 through 1969) with respect to improvements constructed, reconstructed or acquired before January 1, 1975, in connection with certain government-spon-
sored, limited return housing programs. Assuming that the housing in question is normally constructed within existing urban areas in replacement of less desirable housing, this one provision of section 1250 does not encourage the spread of urban areas into the countryside, although the other provisions of the section, in their general leniency, do have this effect.

2. Capital Gain—Sections 1201 and Following

Except to the limited extent provided by section 1250 with respect to developed property, the gain realized by the investor from a sale of his real estate held for more than 6 months will be subject to favorable tax treatment as a long-term capital gain.

Prior to the Tax Reform Act of 1969, an individual's net long-term capital gain (as reduced by his net short-term capital loss) for any year was taxed either by excluding half of such gain from his income and computing the regular tax on the other half, or by excluding all of such gain from his income and multiplying such gain by 25 percent, whichever alternative produced the lower tax. Thus, for example, an individual in the 40 percent marginal bracket would be taxed under the first alternative at a rate of 40 percent of half of such gain, i.e., 20 percent of the entire gain (assuming that the inclusion of half the gain in his taxable income did not cause his marginal bracket to increase), while an individual in the 60 percent marginal bracket would be taxed under the second alternative at a rate of 25 percent of the entire gain. A corporation was generally taxed on such gain either by including all of such gain in taxable income and computing the regular corporate tax (generally 22 percent of the first $25,000 of taxable income plus 48 percent of the remainder), or by applying

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71 Id. § 1250(a) (1) (C) (ii).
72 In addition to the provisions described above, § 1250 contains various complex provisions relating to improvements made and costs incurred by lessees, non-recognized gains, holding periods, improvements treated as consisting of more than one element, and other matters. These provisions will not be considered in detail in this article.
73 Code §§ 1221, 1222, 1201, 1202.
74 Internal Revenue Code of 1954, ch. 736, §§ 1201(b), 1202, 68A Stat. 320, as amended, Code §§ 1201(b), 1202 (1969). "Net long term capital gain" means the excess of the year's gains from sales or exchanges of capital assets held for more than 6 months over the year's losses from such sales or exchanges. Code §§ 1222(3), (4), (7); Treas. Reg. § 1.1222-1(a) (1957). "Net short-term capital loss" means the excess of the year's losses from sales or exchanges of capital assets held for 6 months or less over the year's gains from such sales or exchanges. Code §§ 1222(1), (2), (6); Treas. Reg. § 1.1222-1(a) (1957).
a rate of 25 percent to the full gain, whichever alternative produced the lower tax.\textsuperscript{75}

With respect to individuals, the Act made no change at all in the first alternative for taxing the net long-term capital gain (less the net short-term capital loss), and no change at all in the second alternative with respect to the first $50,000 of such gain.\textsuperscript{76} The only change (excluding the new "minimum tax" discussed below) is that if such gain is in excess of $50,000, the second alternative consists of applying the 25 percent rate to the first $50,000 and then adding the tax which would be imposed on one-half of the excess over $50,000 if the first alternative were used (but disregarding any reduction in such tax which would result from any net ordinary loss).\textsuperscript{77} Thus even after the Act, an individual's rate on such gain (excluding the new minimum tax) can in no event exceed one-half of the rate which would apply if such gain were taxed in the same manner as other income, and can often be substantially less than half of such rate (either because the 25 percent maximum rate on the first $50,000 per year is 10 percent less than half the maximum ordinary income rate of 70 percent, or because the deduction for half the gain removes this half from higher brackets than remain to be applied to the other half).

With respect to corporations, the only change made by the Act (excluding the new minimum tax) is to increase the alternate rate from 25 percent to 30 percent, thus retaining an 18 percent tax saving on the excess of net long-term capital gain over net short-term capital loss of a corporation in the 48 percent bracket.\textsuperscript{78}

The Act's changes described above apply to individuals for taxable years beginning after December 31, 1971, and to corporations for taxable years beginning after December 31, 1970, but subject to several transitional rules.\textsuperscript{79} A significant change made by the Act in the direction of still more favorable treat-


\textsuperscript{76} Code §§ 1201 (b) (1), 1201 (b) (2), 1201 (d) (3), 1202, 1222(11).

\textsuperscript{77} Code §§ 1201(b) (1), 1201(b)(2), 1201(b)(3), 1201(c)(1), 1201(d)(3), 1222(11). The $50,000 figure is reduced to $25,000 in the case of a married individual filing a separate return. Id. § 1201(d)(3).

\textsuperscript{78} Id. §§ 1201(a)(1)(B), 1201(a), 1201(d), 1222(11). This benefit to corporations is retained despite the statement in the Senate Committee Report that "as a realistic matter, a corporation's capital gains are more in the nature of business income which is not essentially different from its other income." S. Rep. No. 552, 91st Cong., 1st Sess. 194 (1969).

\textsuperscript{79} Code §§ 1201(a)(1), 1201(b)(2), 1201(c)(2), 1201(d)(1), 1201(d)(2).
ment of an individual’s net long-term capital gain (less his net short-term capital loss) in any year is that if the first alternative for taxing such gain is used, the half of such gain which is taxable may be taken into account for purposes of income averaging. The Act has restricted capital loss deductions for individuals by providing that each dollar of net long-term capital loss in excess of net short-term capital gain may offset only $.50 of ordinary taxable income (computed without deductions for personal exemptions) up to a maximum of $1,000 of such income in the taxable year or any future year (as contrasted with the dollar-for-dollar offset up to $1,000 allowed under the prior law). The excess of net short-term capital loss over net long-term capital gain is still deductible under the dollar-for-dollar rule, and may be deducted before the excess of net long-term capital loss over short-term capital gain is deducted under the new dollar-for-$0.50 rule. The Act has liberalized capital loss deductions for corporations by allowing such losses generally to be offset against capital gains realized not only in the current and next 5 succeeding taxable years (as previously allowed) but also in the 3 preceding years.

The extraordinary tax favoritism for long-term capital gains, which remains after the Act, not only induces individual and corporate investors to purchase open land for sale to developers or for the construction of buildings for rental and later sale, but also strongly influences farmers and other landholders to accept offers for sales of their land to investors or developers. For this reason, the capital gains favoritism may be the single most important federal income tax factor which is presently stimulating the conversion of open, rural land into developed, urban land.

3. New Minimum Tax — Sections 56 through 58

The complicated new “minimum tax” on items of tax preference, introduced by the Tax Reform Act of 1969, restricts

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80 Id. § 1302 (applicable to taxable years beginning after December 31, 1969). The second alternative may not be used together with income averaging. Id. § 1304(b)(5).
81 Id. §§ 1211(b)(1)(C)(ii), 1212(b)(1)(B), 1212(b)(2)(B), 1212(b)(3) (applicable to taxable years beginning after December 31, 1969).
82 Id. §§ 1211(b)(1)(C)(i), 1212(b)(1)(A), 1212(b)(2)(A). The $1,000 limit per year with respect to either type of loss has been reduced to $500 for a married individual filing a separate return. Id. § 1211(b)(2).
83 Id. §§ 1212(a)(1), 1212(a)(3) (applicable to capital losses sustained in taxable years beginning after December 31, 1969).
84 See Prestbo, Sprawl of Cities Stirs Fears that Agriculture Will Run Out of Space, Wall Street Journal, July 20, 1971, at 1, Col. 6.
to only a very limited extent the tax benefits available to real estate investors.\textsuperscript{85}

An individual's "items of tax preference," as defined in new Code section 57, include (among other items) the excess of accelerated over straight line depreciation allowable for the taxable year with respect to any real estate improvement (generally excluding an improvement subject to section 1245), and also include one-half of the excess of net long-term capital gain over net short-term capital loss for the year.\textsuperscript{86} However, the tax itself, as provided for in new section 56, applies only to the excess of all items of tax preference for the year over the sum of the individual's regular income taxes (including the tax on his capital gains) for the year plus an annual exemption of $30,000, and applies at a rate of only 10 percent.\textsuperscript{87} Thus, for example, if a married couple has $28,000 of ordinary taxable income (not reflecting any items of tax preference) plus a $150,000 long-term capital gain from a sale of real estate held for investment, the new tax does not apply at all, because the item of tax preference is $75,000 (i.e., \(\frac{1}{2}\) of $150,000) and is exceeded by the sum of the regular taxes of $47,040 for the year (computed by using the first alternative for the capital gain) plus the $30,000 exemption, or $77,040. If the couple also had $50,000 of accelerated over straight line depreciation with respect to real estate improvements (such $50,000 being reflected in the $28,000 of ordinary taxable income), the amount subject to the new tax would be only $47,960 (i.e., the items of tax preference totaling $125,000 less the $77,040 of regular taxes plus exemption), and the new tax would be $4,796 (i.e., 10 percent of $47,960), or less than 2.5 percent of the $200,000 of capital gain plus accelerated depreciation. Since the tax savings to the couple from the special capital gains rate alone is $48,780 (this being the additional regular tax the couple would

\textsuperscript{85} \textit{Code} §§ 56, 57, 58 (applicable to taxable years ending after December 31, 1969, with a prorated tax for years beginning in 1969 and ending in 1970).

\textsuperscript{86} Id. §§ 57(a)(2), 57(a)(9)(A). With respect to an improvement produced by rehabilitation expenditures being depreciated under § 167(k), the item of tax preference is the excess of the depreciation allowable under that section over the amount which would be allowable using the straight line method with the useful life and (apparently) the salvage value determined without regard to that section. \textit{Id.} § 57(a)(2); Proposed Treas. Reg. § 1.57-1(b)(4)(i), 35 Fed. Reg. 19762 (1970). For taxable years beginning before January 1, 1972, "excess investment interest" is included as an item of tax preference for an individual (or a subchapter S corporation or personal holding company). \textit{Code} §§ 57(a)(1) (including last sentence of § 57(a)), 57(b), 57(c).

\textsuperscript{87} \textit{Code} § 56(a). The $30,000 is reduced to $15,000 for a married individual filing a separate return. \textit{Id.} § 58(a).
pay if the capital gain were treated like other income), the new tax hardly represents a significant reduction in the benefits derived by the couple from the items of tax preference. These examples illustrate the generally minor or negligible effect of the new tax as applied to individual real estate investors.  

A corporate real estate investor is even less likely to be troubled by the new tax than is an individual investor. Although accelerated depreciation with respect to a real property improvement (excluding an improvement subject to section 1245) is included in a corporation’s items of tax preference to the same extent as in an individual’s, the excess of net long-term capital gain over net short-term capital loss is included to the extent of only 18/48 of such excess (such fraction being determined under a formula whereby the denominator is the combined corporate normal and surtax rate, presently 48 percent, and the numerator is the difference between such rate and the alternate corporate capital gains tax rate, presently 30 percent). Moreover, since a corporation is likely to have substantial regular income taxes if it is engaged in normal business operations as well as in real estate investments, it must have large items of tax preference in order for such items to exceed the regular taxes plus the $30,000 annual exemption so that the new tax will apply. For example, if a corporation has $100,000 of ordinary taxable income, a long-term capital gain of $150,000 from a sale of real estate held for investment, and $50,000 of accelerated over straight line depreciation with respect to real estate improvements (such $50,000 being reflected in the $100,000 of ordinary taxable income), the corporation’s items of tax preference total $106,250 (i.e., 18/48 of $150,000, plus $50,000), which is less than the sum of the corporation’s regular taxes of $86,500 (i.e., $41,500 on the $100,000 of ordinary taxable income plus $45,000 on the capital gain), plus the $30,000 exemption, or $116,500. Consequently, the new tax is not payable at all, although the corporation’s saving from the favorable 30 percent rate alone is $27,000 (i.e., 18 percent of $150,000). 

The regular tax rates used in these examples exclude the possible effects of income averaging.

Special rules apply to the capital gains of subchapter S corporations, life insurance companies, regulated investment companies, and other special types of corporations not subject to the same income taxes as corporations generally.

A corporation’s regular income taxes taken into account for purposes of the new minimum tax do not include the accumulated earnings or personal holding company taxes. *Id.* § 56(a)(2)(A). Subsequent to the
4. Proposed Regulations under New Minimum Tax

As mild as the new tax may seem in the Code, the proposed regulations make it still milder with two liberalizing provisions for which the statutory support is difficult to find. First, although Code section 57(a) (9) (B) plainly provides for \( \frac{18}{48} \) of the excess of a corporation's net long-term capital gain over its net short-term capital loss to be included as an item of tax preference, proposed regulation 1.57-1(i) (2) (i) permits the numerator of 18 to be reduced to such lesser figure as may represent the rate of tax actually saved by the corporation from application of the alternate corporate gains tax to the particular gain. As shown by the examples in this proposed regulation, an actual saving of less than 18 percent can occur if (in the absence of the alternate tax) the gain would have been partly taxed at 22 percent (or at 0 percent) rather than at 48 percent because the corporation's ordinary taxable income is less than $25,000 (or because the corporation has a net ordinary loss). Presumably under the proposed regulation the numerator is reduced from 18 to 0 (so that there is no item of tax preference at all with respect to the gain) if the alternate tax is not used (e.g., because the gain plus the ordinary taxable income totals less than $25,000). Interestingly, the proposed regulation does not require the numerator to be increased above 18 where the actual saving from the alternate tax is more than 18 percent, e.g., where all or part of the gain is taxed at the former alternate rate of 25 percent pursuant to the transitional rule relating to binding contracts entered into before October 10, 1969.\(^9\)

The second liberalizing provision is in proposed regulation 1.57-4, and consists of elaborate rules for disregarding an individual's or a corporation's items of tax preference which produce no tax saving, e.g., because there is zero taxable income even before considering such items, and under the net operating loss carryover rules the items in question do not give rise to such a carryover. Code section 56(b) does provide a limited "no tax benefit" provision in the form of a deferral of the new tax where there is a net operating loss carryover to a subse-

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\(^9\) Id. §§ 1201(a) (1) (A), 1201(d) (1).
quent year, but the proposed regulation goes far beyond this Code provision.\textsuperscript{92}

5. Installment Method—Section 453

Occasionally, a gain realized by an investor from a sale of real estate may be subject to significantly higher taxes because of the Tax Reform Act provisions relating to depreciation recapture, long-term capital gain tax rates, and the minimum tax on items of tax preference. However, the investor can often reduce or eliminate these higher taxes by careful use of an installment approach. If the payments he receives in the year of sale (exclusive of certain evidences of indebtedness of the purchaser) do not exceed 30 percent of the selling price, and if the price is to be paid in two or more installments over two or more taxable years, then the investor may elect under Code section 453 to use the installment method for reporting the gain.\textsuperscript{93} Under the installment method, the gain is reported pro rata as payments are actually received, i.e., each payment when received is treated as consisting of gain in an amount which bears the same ratio to the payment as the total gain bears to the total contract price.\textsuperscript{94} Special rules apply to the disposition of installment obligations before they are paid in full.\textsuperscript{95}

Although all the gain reported under the installment method will be treated as ordinary income from depreciation

\textsuperscript{92} The proposed regulations also contain rules authorized by the Code relating to various special matters including the apportionment of items of tax preference between such entities as subchapter S corporations, regulated investment companies, trusts and estates, and their owners or beneficiaries. \textit{Id.} § 58; Proposed Treas. Reg. §§ 1.58-1 to 1.58-8, 35 Fed. Reg. 19772 (1970).

\textsuperscript{93} \textsc{Code} §§ 453(a)(1), 453(b)(1)(A), 453(b)(2),(A), 453(b)(3); Treas. Reg. §§ 1.453-1(b) (1966), 1.453-1(c)(1), 1.453-4, 1.453-5(a), 1.453-8(b) (1958); \textit{see, e.g.}, Rev. Rul. 69-462, 1969-2 \textsc{Cum. Bull.} 107; 10-42 Corp., 55 T.C. 593 (1971). The requirement of two or more installments over two or more taxable years (as distinguished from two or more installments in a single year) is set forth in Rev. Rul. 69-462, although there appears to be no other authority for this requirement.

\textsuperscript{94} \textsc{Code} § 453(a)(1); Treas. Reg. §§ 1.453-1(b) (1966), 1.453-5(a) (1958). Under a liberal regulation of long standing, the investor may apply his basis against the amount of any mortgage liability which the purchaser assumes or to which the property remains subject, with only the excess of such liability over such basis being treated as a "payment" and as part of the "total contract price." Treas. Reg. § 1.453-4(c) (1958). This regulation often permits the investor to report all or most of his gain as he receives cash payments from the purchaser over a number of years following the sale, even though the transfer of the mortgage at the time of the sale may represent more than half of the total selling price. It is not clear under what circumstances, if any, the mortgage transfer may be treated as one of the two or more installments of the selling price which is required in order for the installment method of reporting to be available.

\textsuperscript{95} \textsc{Code} § 453(d).
recapture until the full amount of such ordinary income has
been reported, the spreading of such ordinary income over
two or more taxable years may significantly reduce the rate
at which such income is taxed. In addition, the installment
method may permit an individual investor to avoid the in-
creased alternate rate introduced by the Act for long-term
capital gains in excess of $50,000 in a given taxable year. For
every, if an individual realizes and reports in one year a
long-term capital gain of $250,000 from a sale of real estate
(and no other capital gains or losses), the alternate rate for
$200,000 of the gain will be the increased rate introduced by
the Act, while only $50,000 of the gain will be eligible for the
25 percent alternate rate. If, however, the individual reports
20 percent of the gain in each of 5 years under the install-
ment method (and has no other gains or losses over the 5-year
period), the entire gain of $250,000 will be eligible for the 25
percent alternate rate. Similarly, either an individual or a
corporate investor may use the installment method to maxi-
mize the use of the $30,000 annual exemptions so as to reduce
the amount of gain subject to the new minimum tax. Thus
in the preceding example, if the individual has no other income
or loss over the 5-year period, the installment method will
provide him with five exemptions of $30,000 each to offset
against the $125,000 item of tax preference, thereby eliminating
the minimum tax on such item.

D. Examples

The following examples are intended to illustrate the tax
benefits of current deductions from ordinary income, followed
by favorable treatment of gain on sale, which are available to
real estate investors.

Suppose that an individual investor in the 40 percent mar-
ginal bracket borrows $100,000 in order to purchase a parcel
of open land for such amount, that he then pays interest and
real estate taxes totaling $25,000 over a 3-year period, and that
he then sells the property for $150,000. His current deductions
for the $25,000 of interest and taxes will save him $10,000 in
federal income taxes, while his long-term capital gain of $50,000
(i.e., $150,000 of amount realized less $100,000 of adjusted basis)
will be subject to a maximum tax rate of 25 percent (assuming
he has no other capital gains or losses for the year of the sale),

\*Treas. Reg. § 1.1250-1(c)(6) (1971); Dunn Construction Co. v. United
States, 323 F. Supp. 440 (N.D. Ala. 1971) (upholding the correspond-
ing regulation under Code § 1245).
for a maximum tax of $12,500. Thus the individual's net gain of $25,000 (i.e., $150,000 of sales proceeds less $125,000 of total expenditures) will be subject to a net tax of at most only $2,500, representing an effective rate of only 10 percent, which is 4 percent less than the minimum rate of 14 percent on an individual's taxable income as provided for in Code section 1. In addition, the individual will enjoy an interest-free loan of $10,000 from the government between the times he saves this amount on account of his deductions and the time he pays the $12,500 capital gains tax.

Now suppose the above example is changed by assuming a 60 percent rather than a 40 percent marginal bracket for the individual. The $25,000 of current deductions will then save him $15,000 in taxes, while the maximum capital gains tax will remain at $12,500, with the result that his $25,000 net gain produces no tax at all but rather a $2,500 tax saving, plus a $12,500 interest-free loan until the capital gains tax is paid. The so-called "negative income tax," so often attacked as an incentive for people not to work, is thus a reality for many high-bracket individuals with respect to their real estate investments. If the example is changed by assuming a corporation in the 48 percent bracket rather than an individual, the $25,000 of current deductions will save $12,000 in taxes, while the capital gains tax will be $15,000, for a net tax of only $3,000, or only 12 percent of the net gain of $25,000, as contrasted with the 22 percent minimum rate on corporate taxable income which is provided for in Code section 11. In addition, the corporation will enjoy an interest-free loan of $12,000 until the capital gains tax is paid.

Now suppose that an individual investor in the 60 percent marginal bracket borrows $500,000 in order to purchase open land for $50,000 and build an apartment house on the land for $450,000. Suppose that the loan provides for payment of interest at 8 percent per year but no principal for the first 5 years, that the average net rental income from the apartment house (i.e., gross rents less all operating expenses including real estate taxes) equals the $40,000 per year of interest expense, that depreciation is claimed under the double declining balance method using a 40-year useful life and a $50,000 salvage value, and that at the end of 5 years the land and apartment house are sold for $600,000 payable in five equal annual installments.

Despite the absence of a cash deficit in any year while the apartment house is held, the individual may claim net deduc-
tions from his ordinary income in amounts equal to each year's depreciation allowance, which (in order of the five years) will be $22,500, $21,375, $20,306, $19,291 and $18,326, for total net deductions of $101,798, and total tax savings of 60 percent thereof, or $61,079. The individual’s adjusted basis in the apartment house will be reduced by $101,798 to $348,202, so that upon the sale for $600,000 he will realize a gain of $201,798 (i.e., $600,000 of amount realized less $398,202 of combined adjusted basis for the apartment house and the land). Under the depreciation recapture rules, $51,798 of this gain will be taxable as ordinary income (i.e., the excess of the depreciation deductions of $101,798 over the deductions allowable under the straight line method, which are $10,000 per year for a total of $50,000). The tax on this $51,798 of income will be $31,079, while the remainder of the gain, totaling $150,000, will be taxable at the 25 percent alternate long-term capital gain rate for a tax of $37,500 (assuming the individual makes an appropriate election of the installment method and has no other capital gains for the years of the installment payments). The total tax will thus be $31,079 plus $37,500, or $68,579. The excess of this tax over the $61,079 of tax savings from the depreciation deductions is only $7,500, which represents a tax at a rate of only 7.5 percent on the individual's economic net profit of $100,000 from the investment. In addition to this extremely low rate (which is only a small fraction of the individual's normal rate of 60 percent), the individual will enjoy interest-free loans from the government totaling his $61,079 of annual tax savings, which he will repay only as he pays taxes on the installment payments received in the years following the sale.

It should be noted that in none of the examples in this series is the investor affected at all by the “reforms” introduced by the Tax Reform Act of 1969 respecting disallowance of investment interest deductions, increased capital gain tax rates, and minimum tax on items of tax preference. This assumes that in each case the investor has no investment interest, capital gains or items of tax preference other than as stated in the examples. For simplicity, the examples disregard possible increases or decreases in marginal rates and possible effects of income averaging, and the third example disregards the likely cash deficit and tax loss during the construction period (which in practice would usually be followed by a positive cash flow and net pre-depreciation income after construction, at least if some part of the land and building
cost were furnished from the investor's own funds rather than borrowed).

E. Other Benefits

1. In General

In addition to current deductions for ordinary income, plus long-term capital gain treatment of gains from sales, the law of federal income taxation offers at least two other categories of potential benefits to individual and corporate real estate investors. First, if the investor finds that he lacks sufficient income against which to offset all of his real estate deductions for a particular taxable year, the law offers him several possible ways of using the deductions to offset income in other years. Second, under various circumstances the law permits the investor to dispose of his real estate at a gain without paying any income tax at all at the time of such disposition, and, in many cases, without ever paying such tax.

2. Use of Deductions in Other Years
   a. Optional Capitalization of Expenses — Section 266

One way to defer various real estate deductions is provided by Code section 266, under which an investor (or other taxpayer) may elect to capitalize rather than deduct "such taxes and carrying charges as, under regulations prescribed by the Secretary or his delegate, are chargeable to capital account with respect to property . . . ."\(^7\) Capitalization means that the items in question are added to the basis or adjusted basis of the property, for use in future years either as depreciation deductions (to the extent the items are allocable to depreciable improvements) or as offsets in computing gain from sale.\(^8\) The regulations provide that in the case of "unimproved and unproductive real property," the items to which the election may apply are "[a]nnual taxes, interest on a mortgage, and other carrying charges."\(^9\) In the case of real property in the process of development (including already developed property being additionally developed), the regulations permit the election for interest on a loan, taxes of the owner measured by

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\(^{7}\) Code § 266.

\(^{8}\) Id. §§ 1016(a) (1), 1011, 167(g), 1001(a); Treas. Reg. § 1.266-1(b) (1) (1958).

\(^{9}\) Treas. Reg. § 1.266-1(b) (1) (i) (1958). It appears that the mortgage must either have been placed (or left) on the property in connection with the acquisition thereof, or have been placed on the property after acquisition in order to secure a borrowing used to pay costs of retaining the property. Queensboro Corp. v. Commissioner, 134 F.2d 942 (2d Cir. 1943); Howell Turpentine Co., 6 T.C. 364 (1946), rev’d, 162 F.2d 319 (1947).
compensation to his employees, taxes of the owner on the purchase, storage, use or other consumption of "materials" (presumably including personal property as well as sales and use taxes), and other necessary expenditures to the extent that any of such items are paid or incurred for the development and during the development period. The regulations also allow the election for certain items in the case of personal property, and for "[a]ny other taxes and carrying charges with respect to property, otherwise deductible, which in the opinion of the Commissioner are, under sound accounting principles, chargeable to capital account." The regulations imply that (in the absence of special approval by the Commissioner) the election is not available in the case of improved or productive real property other than with respect to the process of development. However, a court has apparently determined that taxes and mortgage interest on improved and rent-producing real property not in the process of development are eligible for the election (even without the Commissioner's approval) if the property is held primarily for sale at an advantageous time.

The essential benefit of section 266 to real estate investors is that the section is entirely elective, thus permitting the investor to choose freely between current deductions or additions to basis according to which is more advantageous to him. The election for each year must be filed with the original
return for such year," and an election for any "item" (evidently meaning interest on a particular loan, taxes of a particular kind, and so forth) with respect to real property in the process of development must apply to all items of the same type which are paid or incurred with respect to the same development either in the year of election or in any subsequent year. Otherwise, the election may generally be made or not made separately each year for each eligible item. It seems that if an item is not allowable as a current deduction (disregarding a section 266 election), such item is not eligible for a section 266 election.

b. Net Operating Losses—Section 172

Another approach to offsetting one year’s real estate deductions against another year’s income is offered by Code section 172, relating to net operating losses. In general, if an investor (or other taxpayer) has total deductions in excess of total income for any year (whether with respect to real estate or otherwise), such net loss may be carried back 3 years and forward 5 years under section 172 so as to offset net income in any of such 8 years in order of time. One limitation in the case of an individual (or other noncorporate taxpayer) is that in computing such net loss, nonbusiness deductions are generally taken into account only to the extent of nonbusiness gross income. However, for this purpose the holding of real estate for rental is usually treated as a business, so that deductions attributable to such real estate (including any losses from the sale or other disposition thereof) are fully taken into account. Another limitation is that the net loss of an individual (or other noncorporate taxpayer) is in effect reduced by any deductions for (or in lieu of) personal exemptions, or for any excess of capital losses over capital gains, or for one-half of any net long-term capital gain over net long-term capital loss. The reduction is for such deductions for the year of the

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103 Treas. Reg. § 1.266-1(c) (3) (1958).
104 Id. §§ 1.266-1(c) (1), 1.266-1(c) (2) (ii) (a) (1958).
105 Id. §§ 1.266-1(c) (1), 1.266-1(c) (2) (i) (1958).
106 Id. § 1.266-1(b) (2) (1958); Parkland Place Co. v. United States, 354 F.2d 916 (5th Cir. 1966) (involving interest payable between related parties and disallowed under Code § 267. An unresolved question (raised but not decided in Megibow v. Commissioner, 218 F.2d 687 (3d Cir. 1955)), is whether this rule bars the election for an item which cannot be currently deducted because the standard deduction is claimed.
107 Code §§ 172(a), 172(b) (1) (A) (i), 172(b) (1) (B), 172(b) (2), 172(c), (d), (e).
108 Id. § 172(d) (4).
net loss, while any such deductions for any of the 8 years to which such net loss may be carried will reduce the amount of such net loss which may be carried to any subsequent year, except insofar as such deductions for any of such 8 years have reduced the net loss of any year earlier than the loss year in question.\textsuperscript{110}

c. Tax Benefit Rule

If an investor finds that the limitations of section 172 prevent him from fully utilizing his real estate deductions of one year against his income of another, he may be able to obtain a similar result through use of the so-called "tax benefit" rule. Briefly stated, this rule provides that if the deduction for a particular expenditure or loss (or a portion of such deduction) does not reduce income tax liability, then a subsequent recovery of such expenditure or loss (or of the portion thereof which did not reduce income tax liability) is excludible from gross income.\textsuperscript{111}

The regulations and most of the cases and rulings applying the tax benefit rule seem to require that there be a very close relationship between the expenditure or loss and the amount said to constitute a subsequent recovery thereof, as where losses are sustained on sales of stock purchased from a particular vendor and part of the purchase price is subsequently recovered from that vendor, or where interest or taxes payable to a particular person or government are later cancelled or refunded by that person or government.\textsuperscript{112} However, the rule was extended markedly in Smyth v. Sullivan,\textsuperscript{113} involving an estate which derived no tax benefit from certain of its deduc-

\textsuperscript{110} \textit{Code §§} 172(b)(2)(A), 172(c), 172(d)(2), 172(d)(3); \textit{Treas. Reg. § 1.172(4)(a)(3) (1956).}

\textsuperscript{111} \textit{Code § 111; Treas. Reg. § 1.111-1 (1956); see, e.g., Dobson v. Commissioner, 320 U.S. 489 (1943) (not disturbing tax benefit rule as applied by several lower court decisions).}

\textsuperscript{112} \textit{Treas. Reg. § 1.111-1(a)(2) (1956); see, e.g., Dobson v. Commissioner, 320 U.S. 489 (1943) (recovery of stock purchase price); Rev. Rul. 56-546, 1956-2 CUM. BULL. 143 (cancellation of interest); Rev. Rul. 56-447, 1956-2 CUM. BULL. 129 (refund of taxes). A number of cases have held that the expenditure or loss and the alleged subsequent recovery were not sufficiently related to permit application of the rule. See, e.g., Burnet v. Sanford & Brooks Co., 282 U.S. 359 (1931) (expenses incurred in performing contract not allowed to be offset against judgment subsequently collected from other contracting party); Sloane v. Commissioner, 188 F.2d 254 (6th Cir. 1951) (loss on worthlessness of debt owed by corporation not allowed to be offset against compensation subsequently received from "liquidating trust" for services in managing and selling corporation's property after corporation's liquidation; Allen v. Trust Co. of Georgia, 180 F.2d 527 (5th Cir. 1950), cert. denied, 340 U.S. 814 (1950) (bad debt loss not allowed to be offset against subsequent gain from sale of stock received in satisfaction of the debt)).}

\textsuperscript{113} 227 F.2d 12 (9th Cir. 1955).
tions for taxes and mortgage interest with respect to real estate which it held for 8 years until it was able to arrange a sale at a suitable price. The court held that the overall transaction of holding and subsequently selling the property was sufficiently integrated to permit the estate to exclude from gross income, under the tax benefit rule, a portion of the sales proceeds equal to the taxes and interest which had produced no tax benefit. Although the court stressed that the rental of the property during the 8 years was merely incidental to the objective of sale, there seems no logical reason why the tax benefit rule, as interpreted by the court, would not permit an investor to offset one year's taxes and interest against a later year's net rental income if renting were the investor's objective. The regulations expressly exclude depreciation as an item with respect to which the tax benefit rule applies, and this is supported by the requirement of section 1016 that adjusted basis be reduced by "allowable" depreciation deductions regardless of tax benefit, but a different position might well be adopted by a court which applied the tax benefit rule as broadly as the court in Smyth v. Sullivan. That case thus creates substantial untapped opportunities for real estate investors to offset one year's real estate deductions against a subsequent year's income from the same real estate, where the deductions would produce no tax benefit but for such offset.

3. Deferral or Elimination of Tax on Gain
   a. Exchanges of Real Estate—Section 1031

Code section 1031 is one of the important sections which permit an investor to dispose of his real estate at a gain but without "recognition" thereof, that is, without inclusion of the gain in income for income tax purposes at the time of the disposition. Under this section and the regulations interpreting it, if real estate "held for productive use in trade or business or for investment" is exchanged solely for other real estate to be held for either of such purposes, complete nonrecognition is provided for any gain realized on the exchange (i.e., any excess of the fair market value of the real estate received over

114 The taxes and interest to which the tax benefit rule was applied were in addition to taxes and interest allowed to be capitalized under a pre-section 266 code provision, as explained earlier.


116 CODE § 1016(a) (2).

117 For a case in which the court refused (without explanation) to consider the broadened tax benefit rule of Smyth v. Sullivan, see Michael August, 23 T.C.M. 24 (1964).
the adjusted basis of the real estate transferred). If any money or property other than business or investment real estate is received in the exchange, any realized gain is recognized only to the extent of such money plus the fair market value of such other property. Although for this purpose the section treats a transfer of liabilities by the investor as the receipt of money by him, the regulations permit such liabilities to be reduced by any liabilities transferred to him or by any cash or other property transferred by him. Section 1031 is expressly inapplicable if the real estate transferred or received constitutes “stock in trade or other property held primarily for sale,” but the regulations again adopt a liberalizing approach by declaring that “Unproductive real estate held by one other than a dealer for future use or future realization of the increment in value is held for investment and not primarily for sale.” And although the section requires that the property transferred and received be of “like kind,” the regulations explain that open land and developed land are of “like kind” because both are real estate.

Various holdings under section 1031 have generously allowed its nonrecognition of gain benefits in cases of multiparty transactions where the party acquiring the investor’s real estate is different from the party who owned the real estate acquired by the investor, and in cases where a contract of sale for cash is altered (before being carried out) to provide for a section 1031 exchange. Section 1031 provides for nonrecognition of loss on exchanges to which it applies (whether or not money

118 Code § 1031(a); Treas. Reg. § 1.1031(a)-1 (1967).
119 Code § 1031(b); Treas. Reg. § 1.1031(b)-1 (1967).
120 Code § 1031(d).
121 Treas. Reg. §§ 1.1031(b)-1(c) (1956), 1.1031(d)-2 ex. (2) (1956). Any cash or other property received by the investor (other than a transfer of liabilities by him) may not be offset by any liabilities transferred to him (Treas. Reg. § 1.1031(d)-2 ex. (2), and Coleman v. Commissioner, 180 F.2d 758 (8th Cir. 1950)) but evidently may be offset by any cash or other property transferred by him (Sayre v. United States, 163 F. Supp. 495 (S.D.W. Va. 1958)). In this discussion, a liability is considered “transferred” from one party to another when the second party either assumes the liability personally or acquires property subject to it.
122 Code § 1031(a).
123 Treas. Reg. § 1.1031(b) (1967). Apparently investors have been found to hold property “primarily for sale” only where they acquired the property for immediate resale. See, e.g., Regals Realty Co. v. Commissioner, 127 F.2d 931 (2d Cir. 1942).
124 Treas. Reg. §§ 1.1031(a)-1(b), 1.1031(a)-1(c)(2) (1956).
or other property in addition to business or investment real estate is received),\textsuperscript{126} and provides in general for the business or investment real estate received to have a basis equal to the adjusted basis of the real estate transferred (with an increase under section 1012 for the amount of any other consideration paid for the real estate received).\textsuperscript{127} The broad nonrecognition provisions of section 1031 for business or investment real estate exchanges also apply to "like kind" exchanges of certain other types of business or investment property, excluding, in particular, stocks or securities, exchanges of which are generally subject to nonrecognition treatment only if the far stricter requirements of the Code's corporate reorganization sections are satisfied.\textsuperscript{128}

\textbf{b. Compulsory or Involuntary Conversions — Section 1033}

Code section 1033 provides liberal nonrecognition rules for cases where real estate "held for productive use in trade or business or for investment" (but not constituting "stock in trade or other property held primarily for sale") is "compulsorily or involuntarily converted" as a result of "its seizure, requisition, or condemnation, or threat or imminence thereof."\textsuperscript{129} If the conversion is directly into other business or investment property of "like kind," the section provides for automatic nonrecognition of any gain realized,\textsuperscript{130} while if the conversion is into money or other property and within a specified period of time other business or investment property of "like kind" is purchased as a replacement, the section permits nonrecognition of gain except to the extent such money plus the fair market value of such other property exceeds the purchase price of the replacement property.\textsuperscript{131} As for purposes of section 1031, the original and the replacement properties are considered of "like kind" as long as both are real estate (even if one is

\textsuperscript{126} \textit{Code} §§ 1031(a), 1031(c).

\textsuperscript{127} \textit{Id.} §§ 1031(d), 1012. Treas. Reg. §§ 1.1031(d)-1(b), 1.1031(d)-1(c) (1967) contain examples where the basis of the real estate received is less than the adjusted basis of the real estate transferred because the amount of money plus the fair market value of the other property received exceeds the realized gain, but in these examples all the gain is recognized so that § 1031 really has no application at all. Where money and other property are received and a loss is sustained, the basis of the real estate received is the adjusted basis of the real estate transferred less the sum of the amount of money and the fair market value of the other property received.

\textsuperscript{128} \textit{Code} §§ 1031(a), 354, 355, 356, 366.

\textsuperscript{129} \textit{Id.} §§ 1033(a), 1033(g).

\textsuperscript{130} \textit{Id.} §§ 1033(a) (1), 1033(g).

\textsuperscript{131} \textit{Id.} §§ 1033(a) (3) (A), 1033(a) (3) (B), 1033(g).
developed and the other is open land), and unproductive real estate held for appreciation is apparently not considered held "primarily for sale."\(^{132}\) The specified replacement period begins with the date of conversion (or any earlier date of its threat or imminence) and ends 2 years after the close of the first taxable year in which any portion of the gain from the conversion is realized, but permission for extension may be obtained under certain circumstances.\(^{133}\) Special rules for extension of the statute of limitations on deficiency assessments apply if non-recognition is elected under section 1033.\(^{134}\)

The nonrecognition provisions of section 1033 with respect to the conversions described above appear even more liberal to the investor than the nonrecognition provisions of section 1031, for at least the following three reasons: (1) where the conversion is into money or other property, the investor is free to choose recognition rather than nonrecognition of gain if this is favorable to him, e.g., because he will obtain greater depreciation deductions from a cost basis for his replacement real estate (this being his basis if the gain is recognized\(^{135}\)) than he will from a "carry-over" of the converted real estate's adjusted basis to the replacement real estate (this being the rule if the gain, or any part of it, is not recognized\(^{136}\)); (2) nonrecognition of gain may be chosen if the money or other property is reinvested in the acquisition of 80 percent control (as defined) of a corporation which owns real estate "similar or related in service or use" to the converted real estate;\(^{137}\) and (3) no provision is made for nonrecognition of loss. In addition to its above-described provisions, section 1033 contains provisions for nonrecognition in cases of complete or partial destruction, or theft, or various kinds of conversions involving property other than business or investment real estate, but subject to the general requirement (plainly stricter than the "like kind" requirement) that in any of these cases the replacement property must be "similar or related in service or use" to the property converted.\(^{138}\)

\(^{132}\) Treas. Reg. §§ 1.1033(g)-1(a) (1960), 1.1031(a)-1(b) (1956).

\(^{133}\) CODE § 1033(a) (3) (B); Treas. Reg. § 1.1033(a)-2(c) (3) (1963). If the replacement property is purchased before the conversion, it must be held on the date of the conversion. CODE § 1033(a) (3) (A) (i). Replacement property is considered "purchased" only if (but for § 1033) its basis would be its cost. Id. § 1033(a) (3) (A) (ii).

\(^{134}\) Id. §§ 1033(a) (3) (C), 1033(a) (3) (D).

\(^{135}\) Id. § 1012.

\(^{136}\) Id. § 1033(c).

\(^{137}\) Id. §§ 1033(a) (2), 1033(a) (3) (A).

\(^{138}\) Id. § 1033(a).
c. Other Rules Regarding Deferral or Elimination of Tax on Gain

Code section 1039, introduced by the Tax Reform Act of 1969, permits owners of certain federally assisted low-income housing projects to elect nonrecognition of gain realized from a federally approved sale or other disposition of such project to the tenants or occupants or to a nonprofit organization for the benefit of the tenants or occupants, if the sales proceeds are reinvested in a similar project within a specified period of time. The structure of section 1039 is quite parallel in a number of respects to that of section 1033.

One exception to the nonrecognition provisions of sections 1031, 1033, and 1039 is that section 1250 "depreciation recapture" income realized with respect to transferred real property improvements is recognized to the extent that such income exceeds the cost (or, in certain cases, the fair market value) of acquired real property improvements, or to the extent that nonrecognition would otherwise be provided only under the provisions of section 1033 relating to reinvestment of conversion proceeds in stock of a corporation owning the replacement property. As permitted by section 1031, 1033, or 1039, the remainder of the section 1250 recapture income is not recognized, but complex special rules are provided for allocation of basis, determination of excess depreciation and determination of holding period, with the evident objective of causing realization of the nonrecognized recapture income if and when the acquired improvements are sold.

The "carry-over" basis provisions of sections 1031, 1033, 1039, and 1250 which are summarized above are intended to result in deferral rather than permanent elimination of income taxes on gains realized in section 1031, 1033, or 1039 transactions. However, section 1014 provides that upon an individual's death, his real estate (and almost all his other property) acquires a new basis equal to its fair market value at the date of death, or at the alternate federal estate tax valuation date if elected. Thus, income taxes are permanently eliminated on real estate appreciation which the individual has succeeded in protecting from income taxes during his life, either by not disposing of the real estate or by disposing of it only in trans-
actions qualifying for nonrecognition of gain. In such a case, the income tax benefits from the real estate in question consist not merely of current deductions from unrelated ordinary income followed by favorable treatment of the gain on disposition, but rather of current deductions from unrelated ordinary income followed by no tax whatsoever on the gain on disposition. With benefits as attractive as these, it is easy to understand why real estate investments are considered among the finest of "tax shelters."

II. TAX TREATMENT OF REAL ESTATE INVESTMENTS BY PARTNERSHIPS

A. Introduction

A number of additional federal income tax advantages are available when a partnership is formed by individual or corporate partners (or both) for the purpose of making investments in open land for sale to developers or for the construction of rent-producing buildings. For example, a partnership may allocate its losses, i.e., its excess of current deductions over current income, in such a way that the largest portions of such losses may be deducted by those partners who are in the highest income tax brackets. Careful planning may enable a partner to deduct such losses in amounts larger even than the sum of his contributions to the partnership plus his potential liability for the partnership's debts. A further advantage is that a partner who is a dealer in real estate may obtain capital gain treatment for his share of the partnership's income from a sale or sales of real estate, if the partnership is not a dealer. Still another advantage is that a "promoter" who receives a profits interest in exchange for his services of organizing and managing the partnership may treat his share of the profits as capital gains to the extent that these profits are capital gains to the partnership, even though compensation for services is normally treated as ordinary income. Finally, and of great current importance, a limited partnership may be used to obtain the legal and organizational benefits of a corporation together with the tax benefits of a partnership. The following discussion will consider each of these advantages in detail.

B. Allocation of Losses

The Code provides for a partnership not to be subject to tax,\(^{142}\) but rather for the partnership to compute its taxable income or loss in the same manner as an individual (with

\(^{142}\) Code § 701.
certain exceptions), and for the partners then to report separately their distributive shares of such income or loss (including the particular items reflected therein, such as capital gains and losses, "section 1231" gains and losses, charitable contributions, etc.). Subject to one exception explained below, the partners' distributive shares are determined by the partnership agreement. This agreement may be either written or oral, and may be amended either in writing or orally with respect to any taxable year, provided that the amendment is adopted by the time (without extensions) for filing the partnership's information return for the taxable year and is either agreed to by all the partners or is adopted in such other manner as may be provided by the partnership agreement.

Suppose that individual A, in the 60 percent bracket, and individual B, in the zero bracket, decide to form a partnership to which each is to contribute $50,000, that the partnership is to borrow $400,000 and invest $500,000 in the purchase of open land and the construction of an apartment house thereon, and that the partnership is expected to sustain substantial "losses" in its early years (i.e., an excess, in each year, of interest, taxes, depreciation, and other allowable deductions over gross rental income). In accordance with the rules outlined above, the A-B partnership agreement may provide for all of the partnership's losses to be allocated to A so that he may deduct them all, even though only half the losses are attributable to A's contribution and share of the borrowings. In effect, the use of the partnership form enables B to transfer his net current deductions to A, thus doubling the deductions which A could claim against his high-bracket income if he invested individually. If A and B understand that they are to be equal partners in an economic sense, their partnership agreement may reflect this by providing for profits to be allocated entirely to A until all losses are recovered, and then to be allocated equally between A and B. To the extent that the losses are recovered through a capital gain from a sale of the partnership's property, A will enjoy a doubling not only of his current deductions from year to year, but also of the amount of his ordinary income which is converted into capital gain on account of the project as a whole.

The Internal Revenue Service might advance at least two

143 Id. § 703.
144 Id. § 702.
145 Id. § 704(a).
146 Id. § 761(c); Treas. Reg. § 1.761-1(c) (1956).
arguments for allocating all losses (and profits) of the A-B partnership in equal amounts to A and B, but it appears that careful planning by A and B would enable them to defeat these arguments.

First, the Service might rely on Code section 704(b) (2), which sets forth the one significant exception to the general rule in section 704(a) that a partner's distributive share of the partnership's taxable income or loss (including each item reflected therein) is determined by the partnership agreement. Section 704(b) (2) states that a provision in the partnership agreement respecting a partner's distributive share of an "item of income, gain, loss, deduction, or credit" is to be disregarded if the "principal purpose" of such provision is "the avoidance or evasion" of federal income tax.\textsuperscript{147} The problem, however, is that section 704(b) (2) rather plainly applies not to a tax-motivated provision for allocating taxable income or loss generally (i.e., taxable income or loss as described in section 702(a) (9)), but only to a tax-motivated provision for allocating a particular item in a manner different from the allocation of taxable income or loss generally. This is shown by the fact that the section refers specifically to an "item" of income, gain, loss, deduction, or credit (while the general rule in section 704(a) omits the word "item"), and also by the fact that if the tax-motivated provision is disregarded, the consequence is an allocation of the particular item in accordance with the allocation of taxable income or loss generally. If the provision in the agreement respecting the allocation of taxable income or loss generally is itself disregarded as tax-motivated, the statute makes no sense, because it provides no alternate to such allocation.\textsuperscript{148} Thus, assuming that the A-B partnership

\textsuperscript{147}Code §§ 704(a), 704(b) read in full as follows:

(a) **Effect of Partnership Agreement.**—A partner's distributive share of income, gain, loss, deduction, or credit shall, except as otherwise provided in this section, be determined by the partnership agreement.

(b) **Distributive Share Determined by Income or Loss Ratio.**—A partner's distributive share of any item of income, gain, loss, deduction, or credit shall be determined in accordance with his distributive share of taxable income or loss of the partnership, as described in section 702(a) (9), for the taxable year, if—

(1) the partnership agreement does not provide as to the partner's distributive share of such item, or

(2) the principal purpose of any provision in the partnership agreement with respect to the partner's distributive share of such item is the avoidance or evasion of any tax imposed by this subtitle.

\textsuperscript{148}There is some dicta in Smith v. Commissioner, 331 F.2d 298 (7th Cir. 1964), which may be read as implying that § 704(b) (2) can be applied to a provision respecting taxable income or loss generally, but the later
agreement clearly allocates the total loss for each year to A, rather than just particular items reflected therein such as depreciation or interest expense, the allocation should withstand an attack under section 704(b)(2).

A second argument which the Service might advance is that although the allocation of losses in the A-B partnership agreement is determinative for tax purposes, the true nature of this agreement is that any actual losses are to be borne equally by A and B rather than all by A. Suppose, for example, that the partnership actually loses $125,000, and thus at liquidation has $375,000 of assets and $400,000 of liabilities. Can one really believe (the Service might ask) that B will then receive back his full contribution of $50,000 (so that he will sustain no loss), while A will contribute $75,000 so that the indebtedness may be fully repaid (and so that A will bear the full loss of $125,000)? The simple way for A and B to defeat the Service’s argument is to provide in the partnership agreement for an express and unambiguous “yes” answer to the foregoing question. The necessary provisions are that all losses or profits allocated to a partner will be charged or credited to his capital account, that all distributions to him during the term of the partnership will be charged to his capital account, and that, upon liquidation, he will be entitled to distribution of any amount remaining in his capital account or will be required to contribute the amount of any deficit in his capital account. A need not oppose this approach, because the large losses allocable to him in the partnership’s early years are very likely to be only paper losses deductible for tax purposes rather than genuine declines in the partnership’s net worth. The value to A of his current tax deductions for these losses will probably exceed substantially the after-tax cost of any actual loss of the partnership which he might eventually have to bear, and the tax deductions are certain and immediate while the actual loss is at most a future contingency.

case of Jean V. Kresser, 54 T.C. 1621 (1970), while not ruling specifically on the issue, finds the better view to be that the section cannot be so applied, and this conclusion is confirmed by both the legislative history and the regulations interpreting the section. The House and Senate Committee Reports both use the term “particular item,” and the Senate Report expressly excludes taxable income or loss generally from the term “item” for purposes of § 704(b)(1), thus implying the same exclusion for purposes of § 704(b)(2) since the term “item” appears in the introductory language of § 704(b) for application in both §§ 704(b)(1) and 704(b)(2). H.R. Rep. No. 1337, 33d Cong., 2d Sess. A223 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess. 379 (1954).
C. Two Recent Cases Regarding Allocations

Two recent Tax Court cases illustrate the difficulties faced by the Service in the area of allocations of profits and losses among partners. Although both cases were won by the Service, both appear to have been won on account of planning errors which could have been avoided by the partners.

In Jean V. Kresser,14 the dominant partner of a loosely managed, oral real estate partnership caused one year’s taxable income of the partnership to be allocated entirely to him so that he could use it to absorb nearly expired net operating loss carry-overs from earlier years. The court disregarded this allocation and required the year’s income to be allocated as in prior years, partly on the ground that the change in allocation constituted an amendment to the partnership agreement which was neither approved by all the partners nor adopted in any other manner provided by the partnership agreement (as required by Code section 761(c)), and partly on the ground that the proposed change in allocation was unreal in view of the dominant partner’s apparent undertaking to restore to the other partners their shares of the current year’s income either from future income of the partnership or from his own funds. It seems probable that if the proper formalities for amending the partnership agreement had been followed, and if the right of the other partners to restoration had been expressly limited to the allocation of future partnership profits (if any), the change in allocation for the current year would have been accepted under Code sections 704(a) and 761(c).

In Stanley C. Orrisch,15 an amendment to a partnership agreement between four equal partners provided for all subsequent depreciation deductions on the partnership’s two apartment houses to be allocated to two of the partners (they having large taxable income and the other two having no taxable income), and for any gain from sale of the partnership property to be allocated to the first two partners to the extent of such depreciation. This amendment was disregarded by the court under section 704(b) (2), to a large extent on the ground that there was no evidence of an agreement to decrease the first two partners’ distributions from the partnership (or increase their liability to the partnership in the case of a deficit in their capital accounts) by the amount of any excess of the subsequent depreciation deductions allocated to them over any

gain on sale. If the partners had expressly recorded such an agreement, this ground for the court's decision would have been removed, while if the new allocation had been of taxable losses as a whole rather than just depreciation deductions, there would probably have been no ground at all for applying section 704(b) (2).

D. Amount of Deductions for Losses

A partner may deduct his share of his partnership's loss for a given partnership taxable year only to the extent of his adjusted basis in his partnership interest as of the end of such year (with the nondeductible amount being deductible at the end of any subsequent year to the extent of his adjusted basis at that time). A partner's adjusted basis for his partnership interest reflects not only the amount of his cash contributions to the partnership (plus the adjusted basis of any property he has contributed), but also his share of the partnership's indebtedness, and for this purpose such indebtedness is normally allocated among the partners in the same proportions as losses are allocated among them. Thus, in the A-B partnership described above, the entire $400,000 of partnership indebtedness will be allocated to A, giving A an initial basis of $450,000 in his partnership interest (i.e., a $50,000 cash contribution plus a $400,000 share of indebtedness), and enabling him to deduct up to $450,000 of partnership losses (assuming no changes in his adjusted basis other than decreases for the losses).

Suppose that partnership indebtedness is of the "non-recourse" variety, i.e., indebtedness for which no partner has any personal liability. For basis purposes, such indebtedness is allocated in proportion to the partners' shares of profits, rather than losses, which in the A-B partnership would presumably mean half to A and half to B (in view of the partners' agreement to share profits equally after A has recovered his losses). Thus A will have an adjusted basis of $250,000 in his partnership interest (i.e., a $50,000 cash contribution plus a $200,000 share of indebtedness), and will be able to deduct up to $250,000 of partnership losses, even though the nonrecourse character of the indebtedness effectively protects both A and B from sustaining any losses in excess of their contributions totaling $100,000.

Nonrecourse indebtedness is particularly important to a

151 Code § 704(d); Treas. Reg. § 1.704-1(d) (1956).
152 Code §§ 722, 752; Treas. Reg. § 1.752-1(e) (1956).
153 Treas. Reg. § 1.752-1(e) (1956).
limited partnership because of the special rule for allocating such indebtedness among the partners for basis purposes. In general, any indebtedness of a limited partnership for which the general partners have personal liability is allocated entirely to the general partners, presumably because the general partners will bear the full amount of any losses resulting from a decline in the value of the partnership's assets below the amount of such indebtedness.\textsuperscript{154} However, any nonrecourse indebtedness of a limited partnership is allocated among all the partners, limited as well as general, in the same proportions as profits are allocated among them.\textsuperscript{155} Thus the partnership's use of nonrecourse indebtedness may enable the limited partners to increase the adjusted bases of their partnership interests substantially above their contributions (both made and pledged). The effect is to permit the limited partners to deduct shares of the partnership's losses substantially in excess of their contributions (both made and pledged), although as limited partners they can under no circumstances be required to bear any losses in excess of such contributions.

E. Capital Gains for Dealer-Partners

The partnership form may often be used by a dealer in real estate to convert ordinary income from real estate sales into capital gains.

Although partners must report separately their distributive shares of their partnership's taxable income or loss, the tax character of each item reflected in such income or loss is determined by its character to the partnership as though the partnership were a separate entity.\textsuperscript{156} For example, it has been held that a partner must report as ordinary income his share of the gains realized by his partnership from real estate sales if the partnership as an entity is a dealer in real estate, without regard to whether the partner is a dealer.\textsuperscript{157} Similarly, it has been held that a partner who is a dealer in real estate should report as a "section 1231" loss his share of a loss sustained by his partnership from a sale of real estate constitut-

\textsuperscript{154} Id. The one exception in this regulation is that the limited partners may share in the allocations of such indebtedness to the extent of any contributions which they have pledged to make but have not yet made to the partnership. Presumably the indebtedness is allocated entirely to the limited partners to the extent of such pledges, while the remainder of the indebtedness is allocated entirely to the general partners.

\textsuperscript{155} Id.

\textsuperscript{156} Code § 702(b); Treas. Reg. § 1.702-1(b) (1962).

ing section 1231 property to the partnership.\textsuperscript{158} Thus, if a dealer becomes a partner in a partnership which conducts its affairs so as to avoid dealer status (e.g., by investing in only one parcel of real estate and later selling that parcel to one buyer in one transaction), the dealer's share of the partnership's sales gain will be treated as capital gain, although such gain if realized directly by the dealer would be treated as ordinary income.

There seems no reason why a dealer may not participate in two or more partnerships so as to obtain capital gain treatment for the gains from two or more real estate sales. Perhaps if the multiple partnerships have substantially the same partners and partnership interests, the Service could treat them as a single partnership which is a dealer because of its multiple sales. Perhaps if any one partnership has only partners who are dealers, or has one or more dealer-partners who participate actively in management of the partnership, the Service could treat the partnership as itself a dealer, or could ignore the partnership entity. However, even in these most favorable situations for Service attack, careful attention to the formalities of separate partnership entities may defeat the attack, as is shown by the taxpayer victory in a recent case involving multiple trusts having a dealer in real estate as a primary beneficiary.\textsuperscript{159}

\textbf{F. Capital Gains for Promoter-Partners}

1. In General

The partnership form may also be used by the "promoter" of a real estate investment venture in order to convert ordinary income into capital gain. The term "promoter" refers to the individual or corporate organizer who conceives the plan for the venture, seeks out investment real estate and arranges


\textsuperscript{159} Estelle Morris Trusts, 51 T.C. 20 (1968), aff'd per curiam, 427 F.2d 1361 (9th Cir. 1970). A grantor established 20 nearly identical trusts for his son and daughter-in-law and their issue, the son being a dealer in real estate, and the trusts being used principally to purchase and sell real estate, often from or to enterprises in which the son was interested. Because each trust was formally maintained as a separate entity, both the Tax Court and the Ninth Circuit Court of Appeals accepted the trusts as separate entities for tax purposes, despite the Tax Court's express finding that the primary purpose for creation of the trusts was tax avoidance through the splitting of income and the conversion of ordinary income into capital gains. In addition to offering significant benefits to real estate dealers through the use of multiple trusts, the \textit{Estelle Morris Trusts} case supports (by analogy) dealer use of non-dealer partnerships even in situations high in tax motivation (since the applicable Code sections suggest no more ground for ignoring tax-motivated partnerships than for ignoring tax-motivated trusts).
for its purchase, solicits the various investors and negotiates their entry into the partnership, supervises any construction of improvements on the real estate, and generally manages the partnership after it has been formed. Quite commonly the promoter will himself become a partner (in the case of a limited partnership he will often be a general partner), and will receive a profits interest, e.g., 15 percent or 20 percent of the partnership's profits, as compensation for the services which he has rendered and will render to the partnership. If the partnership realizes a capital gain from an eventual sale of its property or from any other source, the promoter's share of such profit will be taxed to him as a capital gain in accordance with the general rule (discussed above) that the character of each partner's share of the partnership's income is determined at the partnership level as though the partnership were a separate entity. Thus, the promoter will succeed in obtaining capital gain treatment for income which is given to him as compensation for his services, even though the payment to him of such compensation in almost any other form would be treated as ordinary income to him.\textsuperscript{160}

The other partners are unlikely to object from a tax viewpoint to the compensation of the promoter by means of a profits interest. Although the partnership (and hence all the partners) might be able to deduct compensation paid to the promoter in a form constituting ordinary income to him,\textsuperscript{161} it is likely that such compensation would have to be capitalized to the extent (probably substantial) that the promoter's services were for the organization of the partnership or the purchase of its property.\textsuperscript{162} Under the profits interest approach, any share of the partnership's capital gains or ordinary income which is taxed to the promoter will reduce the shares taxable to the other partners.\textsuperscript{163}

2. Problem of Immediate Income

One problem for the promoter is that the value of his

\textsuperscript{160}Although \textit{Code} § 707(c) provides that a partner realizes ordinary income if he receives payments which are for services and are "determined without regard to the income of the partnership," this section can be avoided by providing precisely in the partnership agreement that the promoter-partner's interest is a right to share in "income" (presumably meaning net or taxable income) rather than in "gross proceeds," "cash flow," or other amounts. A further precaution might be to provide that no distributions (e.g., from "cash flow") will be made to the promoter-partner in excess of his share of income actually received and reported by the partnership.

\textsuperscript{161}\textit{Code} §§ 707(c), 162(a).

\textsuperscript{162}\textit{Id.} § 263; Treas. Reg. §§ 1.263(a)-1 (1959), 1.263(a)-2 (1958).

\textsuperscript{163}\textit{Code} § 702(a).
profits interest (as distinguished from his share of the partnership's actual profits when realized) may be taxed to him as ordinary income at the time he receives it. One common approach to this problem is to provide clearly in the partnership agreement that the promoter's interest is solely in profits and not at all in capital, so that reliance may be placed on regulation 1.721-1(b)(1), which appears to provide that the transfer of a profits interest (as distinguished from a capital interest) to a partner as compensation for his services does not constitute income to such partner. A second frequently used approach is for the promoter to form the partnership with one investor and to receive his profits interest at that time, before any other persons have agreed to enter and invest in the partnership. Then even if the promoter is deemed to realize income when he receives his partnership interest, he can claim that the value of this interest (and hence the amount of his income) is quite small, because the only partnership assets capable of producing profits are the investment made by the one investor. This approach is similar to that used successfully in Bruce Berckmans by the promoter of a new corporation who acquired initially issued stock for a low price (equal to the stock's then fair market value) at a time when a sale of additional stock to the public at a much higher price was still contingent, and whose stock then increased sharply in value (without the realization of income by him) when the sale to the public was actually made 7 weeks later.

The first of the two approaches outlined above (i.e., reliance on regulation 1.721-1(b)(1)) appears to have been weakened by new Code section 83 (introduced by the Tax Reform Act of 1969), and by the recent case of Sol Diamond. Section 83 provides various rules under which a person realizes income if he performs services and (in connection therewith) receives "property," a term which may include a partnership profits interest (although the committee reports accompanying section

164 This regulation is under Code § 721, which provides for nonrecognition of gain or loss upon the contribution of property to a partnership in exchange for a partnership interest. The key sentences of the regulation are as follows:

To the extent that any of the partners gives up any part of his right to be repaid his contributions (as distinguished from a share in partnership profits) in favor of another partner as compensation for services (or in satisfaction of an obligation), section 721 does not apply. The value of an interest in such partnership capital so transferred to a partner as compensation for services constitutes income to the partner under section 61.

166 56 T.C. 530 (1971).
83 do not state an intention to overrule the implication of regulation 1.721-1(b)(1) that receipt of such an interest as compensation for services does not constitute the receipt of income\textsuperscript{167}. The Sol Diamond case holds that even before section 83, regulation 1.721-1(b)(1) did not prevent an individual from realizing income under section 61(a)(1) and regulation 1.61-2(d)(1) when he received a partnership profits interest as compensation for services (although this seemingly strained interpretation of regulation 1.721-1(b)(1) may have resulted from the court's desire to find some way to impose ordinary income treatment on the individual because he sold his interest for cash less than 3 weeks after he received the interest).

The second approach outlined above (i.e., valuation of the profits interest upon formation of the partnership between the promoter and one investor) may remain stronger than the first, provided the two-member partnership is formed as a bona fide, functioning entity before the promoter performs the services which cause the other investors to commit and the promoter's interest to rise in value (e.g., the services of seeking and acquiring investment real estate for the partnership, and of seeking and negotiating with the prospective investors).\textsuperscript{168} In any event, even if both approaches fail, the amount of the promoter's compensation income will almost certainly be equal to the value of his profits interest at or before the time all the investors have made their contributions, rather than at a later time when appreciation in the partnership's property and/or the realization of partnership profits may have caused the value of the profits interest to have increased very substantially.\textsuperscript{169} Presumably any compensation income realized by


\textsuperscript{168} See William H. Husted, 47 T.C. 664 (1967) acquiesced in, 1968-1 CUM. BULL. 2, appeal dismissed, (2d Cir., April 7, 1969). Stock purchased by a corporate promoter for a low price in advance of a public offering was valued by the court in part by reference to the much higher public offering price, so as to cause the promoter to realize "bargain purchase" compensation income. In justifying its approach (which differs markedly from that used in Bruce Berckmans, 20 T.C.M. 458 (1961)) the court stressed that the promoter had already performed substantial services and created a valuable plan which was reflected in the value of his stock when he purchased it, and that in view of various circumstances his purchase was not really completed until the settlement date on which all the transactions (including the public offering) were completed.

\textsuperscript{169} If the partnership agreement (or applicable partnership law) restricts transfer of the profits interest and creates a substantial risk of forfeiture thereof (e.g., for nonperformance of future services by the promoter), § 83(a) may cause the profits interest to be valued and taxed (if at all)
the promoter on account of his profits interest will be matched by a corresponding deduction to the partnership (subject to any required capitalization) and by a corresponding basis to the promoter for his interest, with the promoter then reporting his share of partnership income as and when realized by the partnership, and with partnership capital gains retaining that character to the promoter even though the only consideration furnished by him is services.

G. Limited Partnerships

1. In General

The limited partnership form provides nearly all the significant legal and organizational advantages of a corporation plus all the tax advantages of a partnership, and therefore has become a popular vehicle for investments in open land either for sale to developers or for the construction of buildings for rental, particularly where large numbers of high-bracket investors and large sums of money are involved.

The key corporate characteristic of centralized management, so important to a larger venture, is achieved by designating the intended managers as general partners and the other participants (usually a considerable majority) as limited partners, since the general partners will have virtually exclusive power to manage the partnership (and thus will actually be much more independent of the limited partners than corporate directors are of corporate shareholders). Limited liability is the general rule for limited partners just as for corporate shareholders, while a considerable degree of de facto limited liability can be achieved for the general partners by causing them to be corporations (so that only the corporation's assets and not the shareholders' assets are exposed to the partnership's liabilities), by nonrecourse borrowing by the partnership, and/or by various forms of liability and casualty loss insurance. Continuity of life may be achieved by establishing several general partners and providing that upon the retirement, death or insanity of any one, the remaining ones may continue the partnership, or (still more effectively) by establishing a corpo-

upon the lapse or removal of either the transfer restrictions or the forfeiture provisions. However, in this situation the promoter can cause the interest to be valued and taxed (if at all) upon his receipt of the interest, by filing a protective election under § 83(b) within 30 days after such receipt.

170 Uniform Limited Partnership Act §§ 9, 10.
171 Id. § 7.
172 Id. § 20.
rate general partner with full authority to continue the partnership for as long as such partner continues in existence. Free transferability of interests may be given to the limited partners (who are normally the ones primarily interested in this corporate characteristic) by permitting their assignees to become substituted limited partners, although for tax reasons (as explained below) the formality of approval by the general partners is often made a requirement for such substitution.

2. Tax Treatment of Limited Partnerships

In view of the obvious resemblance of a limited partnership to a corporation, one might suppose that a limited partnership would be treated as a corporation for tax purposes, so that, for example, losses sustained in the early years could not be deducted by the partners but could only be carried forward for deduction from future profits of the enterprise in accordance with the loss carryover rules of Code section 172. The Code section defining a "corporation" indicates that the term includes "associations," and the Code sections defining a "partnership" indicates that such term does not include any entity falling within the "corporation" definition, thus suggesting that a limited partnership could be treated as an "association" (and hence taxed as a corporation) because it more nearly resembles a corporation than it does an ordinary partnership. Such an approach finds support in the Supreme Court case of *T. A. Morrissey*, which holds that an "association" is an organization not necessarily identical to an ordinary corporation, but only resembling an ordinary corporation more nearly than it resembles some other type of entity. At least, one might expect that a limited partnership would be treated as an association (and hence as a corporation) if the limited partners owned a high proportion of the partnership interests, since it is the relationship between the limited partnership

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173 *Id.* § 19.

174 Another major consequence of corporate status might be taxation of later years' profits first to the enterprise and then again to the individuals upon distribution of such profits or upon sale of the enterprise. *Code* §§ 11, 61, 301, 331, 1001. Another consequence would be possible exposure to the accumulated earnings or personal holding company penalty tax. *Id.* §§ 531-37, 541-47. A "subchapter S" election enables a corporation to be treated substantially like a partnership, but there are obstacles to the effectiveness of such an election, notably the general rule that not more than 20% of a subchapter S corporation's gross receipts may consist of rents or other "passive investment income." *Id.* §§ 1371-79.

175 *Id.* § 7701(a) (3).

176 *Id.* § 761(a), 7701(a) (2).

177 296 U.S. 344 (1935).
and the limited partners which so plainly resembles that between a corporation and its shareholders.

The suggested approach is logical and reasonable, but a virtually impregnable obstacle to it is presented by the applicable regulations, which are drafted in such a way that an ordinary limited partnership can almost never be classified as an association and hence as a corporation for tax purposes. The regulations were adopted in 1960 (and amended in 1965) with the aim of preventing various organizations from qualifying as corporations so as to be entitled to adopt pension, profit-sharing, and other employee benefit programs available to corporate employees but not to partners (an aim which has been thwarted to a considerable degree through successful use of the "professional corporation" device by lawyers, doctors, and other professionals). The Service can now scarcely prevent use of the regulations as a splendid shield behind which large, corporate-like limited partnerships conduct real estate ventures with all the tax advantages of ordinary partnerships.

The regulations indicate that in choosing between association (and hence corporation) status or partnership status for an organization, association status will generally be chosen only if the organization has at least three of the following four characteristics which normally distinguish a corporation from a partnership: continuity of life, limited liability, free transferability of interests, and centralization of management. The regulations then proceed to define each of these characteristics so restrictively that an ordinary limited partnership will almost always be considered to have either none or, at most, one of them, even though as a practical matter (as explained above) a limited partnership can attain all of these characteristics to the same or nearly the same degree as an ordinary corporation.

For example, the regulations provide that "a limited partnership subject to a statute corresponding to the Uniform Limited Partnership Act [lacks] continuity of life" because of the provisions of such Act respecting dissolution of the partnership upon the retirement, death, or insanity of a general partner, even though de facto continuity of life can be achieved.

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179 See, e.g., United States v. Empey, 406 F.2d 157 (10th Cir. 1967), acquiesced in, Rev. Rul. 70-101, 1970-1 Cum. Bull. 278. The regulations are sometimes known as the "Kintner" regulations because they were drafted in response to United States v. Kintner, 216 F.2d 418 (9th Cir. 1954), in which a medical group succeeded in being held an "association."
181 Id. § 301.7701-2(b) (1960).
by permitting the remaining general partners to continue the partnership, or by using a corporate general partner. Similarly, the regulations indicate that a limited partnership subject to the Act lacks limited liability because the general partners have personal liability for the obligations of the limited partnership, even though the limited partners (who may own substantially all the interests in the limited partnership) have no personal liability and even though the general partners may be corporations and/or may be completely or almost completely protected by insurance plus nonrecourse financing. Again according to the regulations, a limited partnership lacks free transferability of interests if the limited partners cannot substitute others for themselves as limited partners unless they obtain the consent of the general partners, a formality which can rarely be expected to impede transfers since the general partners will rarely have any reason to withhold their consent. Centralization of management is the only one of the four characteristics which is likely in some instances to be attributed to a limited partnership by the regulations, since this characteristic is treated as "ordinarily" present "if substantially all the interests in the partnership are owned by the limited partners." Of course, the attribution of this one characteristic to a limited partnership is nearly always academic, since the lack of the other three characteristics effectively bars corporate classification.

3. Ruling Tests for Limited Partnerships

Stymied by its own regulations, the Service has developed various special tests which a limited partnership must satisfy if it has a corporation as its sole general partner, and wishes the Service to consider its request for an advance ruling hold-
ing that it (the limited partnership) will be taxed as a partnership rather than as a corporation.\textsuperscript{187} One of these tests is that the net worth of the corporate general partner (taking account of the current fair market value of its assets, but disregarding its limited partnership interest and any accounts or notes receivable from or payable to the partnership) must at all times at least equal the lower of $250,000 or 15 percent of the total contributions to the limited partnership (if such contributions are less than $2,500,000), or 10 percent of such contributions (if such contributions are $2,500,000 or more).\textsuperscript{188} If the corporate general partner has "interests in more than one limited partnership" (apparently meaning interests as either a general or limited partner), the foregoing net worth test must be met for each such limited partnership (apparently in order for any such limited partnership to have its ruling request considered, if it has the corporation as its sole general partner).\textsuperscript{189} In addition, the net worth of the corporate general partner (taking account of the current fair market value of its assets, but disregarding any interest in any limited partnership and notes or accounts receivable from or payable to any limited partnership in which the corporate general partner has any interest) must at all times at least equal the sum of the amounts of net worth required with respect to each separate limited partnership.\textsuperscript{190} Another test is that the limited partners in total must not own more than 20 percent of the stock of the corporate general partner or of any member of an affiliated group of corporations (as defined in Code section 1504(a)) to which the corporate general partner belongs, with the attribution of ownership rules of Code section 318 applying for purposes of determining the stock owned by the limited partners.\textsuperscript{191} The remaining tests are that the purchase of a limited partnership interest by a limited partner must not entail "either a mandatory or discretionary purchase or option to purchase any type of security of the corporate general partner or its affiliates,"\textsuperscript{192} and that

\textsuperscript{188}Id. §§ 2.02, 2.04.
\textsuperscript{189}Id. § 2.03.
\textsuperscript{190}Id. §§ 2.03, 2.04. The aggregate test is stricter than if the various limited partnerships were treated as one. For example, if there are three limited partnerships involved, each of which has total contributions of $1,000,000, the required net worth under the aggregate test is three times 15% of $1,000,000, or $450,000, and not 10% of $3,000,000, or $300,000. In applying either the separate or the aggregate test, any interest of the corporation as a limited partner (as well as any interest of the corporation as a general partner) in the limited partnership or partnerships involved must apparently be disregarded in determining net worth.
\textsuperscript{191}Id. § 2.01.
\textsuperscript{192}Id. § 2.05.
the limited partnership must be organized and operated in accordance with the applicable state statute relating to limited partnerships.\textsuperscript{193}

There is no basis in the regulations for the special tests described above, and the Service has neither proposed any changes in the regulations to reflect the tests nor begun a campaign of audit challenges to limited partnerships which fail to satisfy the tests. These factors indicate strongly that at least for the present the tests are being applied only for advance ruling purposes, and not as rules of substantive law. In any event, many limited partnerships having corporations as their sole general partners will be able to satisfy the tests, while other limited partnerships will be able to avoid the tests altogether by having at least one noncorporate general partner. The tests thus represent only a small cloud on the horizon to real estate limited partnerships, many of which yield more valuable tax benefits from their partnership status than non-tax returns from their investments.

III. CLOSING THE LOOPHOLES

A. Introduction

The foregoing discussion has depicted the undue bias of existing federal income tax law in favor of investments in open land, either for sale to developers or for the construction of rent-producing buildings. The tax inducements to such investments include large current deductions from ordinary income unrelated to the investment, capital gain, or nonrecognition treatment for all or a substantial portion of the gain realized upon disposition, and the extension and enlargement of the various benefits through use of the partnership (and particularly the limited partnership) form. The following paragraphs will set forth recommended changes in the law which are designed to eliminate the special tax advantages of open land investments, so as to create tax neutrality in this area.

B. Current Deductions

1. In General

In the case of "unproductive" land held for investment, i.e., land (whether open or developed) which neither yields nor is reasonably expected to yield any current gross income but which is held for gain on an ultimate sale, the interest, real estate taxes, and other expenses of acquiring and retaining the land should be capitalized as part of the investor's basis. These

\textsuperscript{193} Id. § 2.06.
expenses (together with the remainder of the investor's basis) would then be subtracted from the ultimate sales proceeds in computing the investor's taxable gain or loss from the sale. Since these expenses are incurred for the sole purpose of earning a profit from the sale, it is appropriate to offset these expenses against such profit rather than against other income which is totally unrelated to the investment. This approach is already mandatory for certain of these expenses (e.g., attorney's and broker's fees for acquiring the land and attorney's fees for defending title to it), and is already optional under Code section 266 for most of the other expenses in the case of open land and for certain of the other expenses in the case of land in the process of development. The approach should be made mandatory for all of these expenses so as to produce a realistic measuring of the overall gain or loss from the investment as a whole, as opposed to an artificial mismatching of certain costs of the investment with income from other sources.

In the case of open land which does yield or is reasonably expected to yield current gross income, any current expenses of earning or attempting to earn such income should be deductible even if they exceed the amount of such income, since presumably such expenses produce no benefit lasting beyond the taxable year. Real estate taxes should probably be included in these expenses, but only to the extent that such taxes bear a reasonable relation to the amount of current income and hence can fairly be treated as incurred in order to earn such income rather than to retain the land so as to earn a profit from its future sale. Thus an appropriate rule might be for each year's taxes to be deductible to the extent they do not produce a loss in excess of 20 percent of the year's gross income from the land, and for the remainder of such taxes to be added to the land's basis. However, even though the land is yielding or is reasonably expected to yield some current gross income, interest on funds borrowed for the purpose of purchasing (or retaining) the land still represents part of the cost of such purchase (or retention) and should be added to the land's basis rather than allowed to be deducted currently. There is no more reason to allow such interest to be deducted when paid, or when accrued over the period of the borrowing, than there is to allow attorney's or broker's fees for the land's acquisition (or attorney's fees for a subsequent title defense) to be deducted when paid, or when accrued over the period that the attorney or broker renders his services.
In the case of developed land which is yielding or is reasonably expected to yield current gross income, each year's current expenses of earning or attempting to earn such income (including that portion of each year's real estate taxes which bears a reasonable relation to the amount of such income) should be allowed as current deductions. The remaining portion of the taxes, plus the total interest expense incurred on borrowings used to purchase (or retain) the land or to construct (or retain) the developments, constitute, in a real economic sense, part of the cost incurred for the purpose of earning income from the land and developments over the period they are held. Accordingly, these amounts should be allocated in a reasonable manner between the land and the developments, and added to the basis of each. The amounts added to the basis of the developments should then be allowed to offset income in the same manner as the remaining cost (or other basis) of the developments.

The question of how and when to allow such offset for the total cost of the developments is fundamental to determining the proper federal income tax treatment of real estate investments. Since the developments (unlike the land) have a limited useful life, an offset of portions of such cost over such useful life is appropriate. However, the present system, which allows deductions for the interest and tax elements in such cost as and when the interest and taxes are paid or accrued, plus accelerated depreciation in many or most instances for the other elements in such cost, is plainly inappropriate because it allows an excessive concentration of the deductions for such cost in the early years of the useful life. The results are the bloated and artificial "tax losses" which are so fondly emphasized by promoters, but which almost never correspond in a reasonable way either to the times that gross income is earned from the developments, or to any decline in the real economic value of the developments.

Two alternatives suggest themselves, either of which would be more rational in theory and more equitable in practice than the present system. The first alternative is for the total cost of the developments (less anticipated salvage value) to be deductible from the net income produced by the developments (computed before the deductions for cost) dollar for dollar as such net income is earned. Since the cost of the developments is incurred solely for the purpose of earning net income from them, it is eminently reasonable and fair for such cost to be
offset against such net income rather than against income from other sources, at least until it is clear that the developments will yield no further net income. The investor can hardly complain that his deductions for cost would not be rapid enough under this alternative, for if his net income from the developments exceeded his cost, he could deduct his cost (less anticipated salvage value) against the earliest such income to be earned.

The second alternative is for the total cost of the developments (less anticipated salvage value) to be depreciable by the straight line method over the useful life of the developments, on the ground that income is likely to be earned evenly over such useful life, and that the removal of anticipated salvage value from the depreciable amount represents an adequate matching of part of the cost with ultimate sales proceeds. The first alternative is preferable because it produces a more precise offset of cost against related income, but either alternative is clearly preferable to the present system. As the ultimate in fairness to the investor, he might be permitted to choose between the two alternatives by means of an irrevocable election made on his return for the taxable year in which the developments are placed in service.

2. Cost Attributable to “Nonrecourse” Indebtedness

A remaining question is whether deductions should ever be allowed for that portion of the cost of real estate developments which does not exceed the amount of “nonrecourse” indebtedness secured by the developments (i.e., indebtedness which can be collected only through foreclosure of such security interest, without personal liability to the investor). Such deductions should be barred under the traditional concept of salvage value, since the developments will always have a salvage value to the investor at least equal to this portion of their cost. For example, if an investor furnishes $100,000 and incurs $400,000 of nonrecourse indebtedness in order to construct an apartment house for $500,000, and the apartment house secures the indebtedness, the apartment house has an automatic salvage value of $400,000, in that the investor can always realize that amount simply by ceasing payments of principal and allowing the creditor to foreclose. In this example, the investor's deductions with respect to his cost should be limited to $100,000, this being the only portion of his cost which he can possibly lose. As the investor makes payments of principal on the nonrecourse
indebtedness, such payments should increase the portion of his cost for which deductions are allowed.

As a corollary to the recommendation in the preceding paragraph, nonrecourse indebtedness of a partnership should not be treated as an increase in the bases of the partners in their partnership interests (and hence as an increase in the amounts of the partnership's losses which the partners may deduct), since such indebtedness in no sense represents either an investment made or a risk of loss assumed by any partner. This new rule would go far towards eliminating large, artificial "loss" deductions by limited partners of highly "leveraged" limited partnerships in which the investments and risks of the limited partners are relatively small.

3. Demolitions

If real estate developments are demolished for the purpose of constructing new developments, the adjusted basis of the old developments (determined without regard to the intent to demolish) plus the costs of demolition should be allowed as additions to the basis of the new developments (so as to be subject to depreciation deductions if the other requirements for such deductions are satisfied), rather than (as under the present general rule) allowed only as additions to the basis of the land (so as never to be depreciable). This would remove an existing incentive to develop open land instead of redeveloping already developed land, an incentive which tends to encourage the spread rather than the improvement of urban areas.

C. Gain on Disposition

1. In General

Earlier portions of this article set forth various rules which provide for highly favorable tax treatment of gains realized by individuals, corporations, and partnerships from dispositions of real estate held for investment. A number of these rules are inconsistent with the tax treatment of other types of gains, and should be eliminated.

2. Depreciation Recapture

One such rule is that a gain from the sale of most types of depreciable real property held for more than one year is taxed as ordinary income under the "depreciation recapture" provisions only to the extent (at most) that the depreciation allowed with respect to the property exceeds the depreciation allowable under the straight line method. This rule contrasts
with the rule applicable to depreciable personal property, under which the gain is generally taxed as ordinary income to the extent of all depreciation which has been allowed with respect to the property. The personal property rule should be applied as well to real property, since the reason for this rule is the same for both types of property, namely, that all depreciation allowed with respect to the property has been deductible from ordinary income, and hence should generally be taxed as ordinary income when recovered upon a sale. The Senate committee report accompanying the real property recapture section justifies the different rule for real property by saying that the amount of gain which corresponds to allowable straight line depreciation is likely to reflect a general rise in prices rather than a lack of decline in the property's value.\textsuperscript{194} The fallacy in this is that the equivalent gains from sales of personal property, and indeed most other kinds of gains or income, either reflect or are reduced in value to a certain extent by inflation. There is no general rule (nor would there be any precise way to apply a general rule) that to this extent gains or income are not to be taxed or are to be taxed on a favorable basis, and there should be no special rule to this effect for gains on the sale of depreciable real estate.

3. Exchanges and Involuntary Conversions

Another rule inconsistent with general tax principles is that business or investment real estate may ordinarily be exchanged for other business or investment property of "like kind" (i.e., any other business or investment real estate) without the recognition of gain. In most circumstances, a gain realized from a voluntary exchange of property for other property of like kind (e.g., an exchange of stocks or bonds of one corporation for stocks or bonds of another corporation) is fully recognized for tax purposes, and there seems no reason for applying a more favorable rule for like kind exchanges of business or investment real estate.

Another special rule is that no gain is recognized upon an involuntary conversion of business or investment real estate as a result of an actual or threatened condemnation, if the conversion is into other business or investment property (or into proceeds used to purchase other such property) which is of "like kind" with the converted property (i.e., any other business or investment real estate). The general rule is that no gain is recognized upon an involuntary conversion only if the

new property is "similar or related in service or use" to the converted property, an obviously stricter requirement than the "like kind" requirement. As no adequate justification appears for the special rule for real estate condemnations, this rule should be eliminated and all involuntary conversions of real estate should be subject to the same "similar or related in service or use" requirement which applies to involuntary conversions of all other types of property.

4. Dealer-Partners and Promoter-Partners

As indicated earlier, a dealer in real estate may achieve capital gain treatment for his share of the gain from a real estate sale made by a partnership in which he is a partner but which is not a dealer in real estate. The law should be changed so as to require a partner to report as ordinary income his share of any gain from a sale or exchange of partnership property with respect to which either the partnership or the partner is a dealer. This would be consistent with the existing rule that an amount realized by a partner from a sale or exchange of his partnership interest is considered realized from the sale or exchange of property other than a capital asset, to the extent such amount is attributable to substantially appreciated partnership property with respect to which either the partnership or the partner is a dealer. ¹⁹⁵

As also indicated, the promoter of a partnership who receives a profits interest in exchange for his services to the partnership may realize capital gains rather than ordinary income for such services to the extent that the partnership's income constitutes capital gains at the partnership level. The law should be changed to provide that if a partner receives a profits interest in exchange for his services, any partnership profits allocable to him on account of such interest will be taxable to him as ordinary income. This approach is consistent with the usual rule that income derived from the rendering of services is taxable as ordinary income, not as capital gains. The suggested approach is preferable to taxing the promoter on the value of his partnership interest when received, since it avoids the problem of valuing the profits interest before profits are realized, and causes all the promoter's profits to be taxed to him as ordinary income in accordance with the economic fact that all such profits are given to him as compensation.

¹⁹⁵ Code §§ 751(a) (2), 751(d) (1), 751(d) (2) (A), 751(d) (2) (D).
5. Capital Gains for Any Sales

There remains the question of whether capital gain treatment should be allowed at all for any portion of the gains realized from sales of real estate held for investment. Here it cannot be said that present law treats real estate more favorably than other property, since nearly all types of property may qualify for capital asset and hence capital gain treatment, and if anything the cases establish that a taxpayer becomes a dealer (and hence loses his right to capital gain treatment) with respect to real estate more readily than with respect to other types of property, notably corporate stocks. However, the magnitude of the tax benefits resulting from capital gain treatment for real estate gains, as illustrated by the examples set forth in this article, should focus attention on the general question of whether such treatment should be available for any type of income or gain. No really satisfactory answer has ever been given to the question of why a dollar of income earned from investments in real estate or other property should be taxed more favorably than a dollar of income earned from work. When one considers that this distinction not only discriminates against working as opposed to investing, but also provides strong incentives to rapid and widespread real estate development which may be harmful to the environment, the case for an urgent reconsideration of the whole capital gains question becomes compelling.

6. "Stepped-up" Basis

A final point is that neither real estate nor any other property held by an individual should receive a "step-up" in basis to the property's fair market value at the death of the individual (or at the alternate federal estate tax valuation date, if elected). This "step-up" rule arbitrarily exempts large amounts of appreciation in the value of property from ever being subject to income taxation, and arbitrarily encourages individuals to invest in real estate and other property which is expected to appreciate rather than to yield a current return.

D. Partnerships

Most of the special problems in the area of real estate investments by partnerships would be eliminated by adoption of the reforms proposed above. Thus, for example, the allocation of the partnership's "tax losses" to high-bracket partners would be sharply curtailed by the reforms aimed at curtailing the current deductions which create these "losses," and the
special capital gain advantages to the partnership form would be eliminated by the reforms respecting the treatment of dealer and promoter partners.

One remaining question is whether a limited partnership should continue to enjoy the various tax benefits of a partnership despite its obvious resemblance to a corporation. It is submitted that in view of the many significant ways in which a typical limited partnership constitutes a separate entity to at least the same extent as a corporation, a limited partnership should be taxed in the same manner as a corporation. At most, the items of gain or loss allocable to the general partners might be reportable directly by them rather than by the limited partnership, to reflect the lesser degree of separation which may exist between the general partners and the limited partnership than between the limited partners and the limited partnership. The taxation of limited partnerships as corporations would eliminate the present special incentives for the use of such partnerships as real estate investment vehicles, particularly for high-bracket individuals.

CONCLUSION

This article has discussed in detail the federal income tax incentives for real estate investments, especially the purchase by investors of open land for future sale to developers or for the construction of rent-producing buildings. These incentives are, however, only one illustration of the wide variety of incentives whereby current federal income tax laws encourage the development of open land.

Another important illustration is the rule that the owner of a home may deduct his interest expenses and real estate taxes with respect to his home, even though he uses the home exclusively for personal and not for business purposes. This rule helps to finance the extensive subdividing of open land near cities and the construction of single-family homes on this land. The construction of single-family homes rather than apartment houses (which normally use far less land per resident than single-family homes) is encouraged by the contrasting rule which denies deductions to apartment dwellers for any portion of their rent. An individual may deduct interest and taxes not only with respect to the home which is his primary residence, but also with respect to one or more weekend or vacation homes which he may own. This rule offers strong encouragement to the residential development of scenic rural areas which might otherwise be preserved in their natural state.
for use by the general public. Whatever justification there may be for tax incentives to home ownership, there surely is no justification for tax incentives to the ownership of more than one home per family.

Another illustration is the rule that long-term capital gain treatment applies to any net gain (i.e., an excess of gains over losses) realized and recognized during the taxable year from certain transactions including the sale or exchange of real property used in the trade or business and held for more than 6 months, while ordinary loss treatment applies to any net loss sustained and recognized during the taxable year from such transactions.\textsuperscript{196} It is difficult to conceive of the rationale for allowing this "heads-I-win, tails-you-lose" approach by owners of business real estate, with the consequent encouragement of the development of open land for business purposes. Other illustrations include the accelerated depreciation allowed with respect to new business real estate,\textsuperscript{197} the current deductions allowed for interest on funds borrowed to acquire or retain new or used business real estate,\textsuperscript{198} the capital gain treatment allowed to subdividers of real estate under certain circumstances,\textsuperscript{199} and the elimination of nearly all corporate income tax on "real estate investments trusts" although such trusts are substantially identical to corporations in legal and organizational characteristics.\textsuperscript{200}

At a time when the spread of our cities and the disappearance of our countryside is a recognized national problem, there can be no excuse for federal income tax laws which create a series of special incentives for the development of open land. The appropriate changes should be made which will place these laws in a posture of neutrality with respect to the basic policy question of whether the rapid urbanization of the nation should or should not continue.

\textsuperscript{196} Id. §§ 1231(a), 1231(b) (1).
\textsuperscript{197} Id. §§ 167(a) (1), 167(j) (1) (B), 167(j) (1) (C).
\textsuperscript{198} Id. § 163(a).
\textsuperscript{199} Id. § 1237.
\textsuperscript{200} Id. §§ 856-58.