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## Current Tax Trends Affect Historic Rehabilitation: Catalyst or Obstacle to the Preservation of Our Nation's History?

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# CURRENT TAX TRENDS AFFECTING HISTORIC REHABILITATION: CATALYST OR OBSTACLE TO THE PRESERVATION OF OUR NATION'S HISTORY?

## I. Introduction

Over the past decade, there has been a growing awareness of the need to restore structures of historic significance on both national and local levels.<sup>1</sup> Both Presidents Carter and Reagan have supported the adoption of extensive federal tax legislation which would provide owners of historic investment property with tax incentives to rehabilitate rather than to raze such property.<sup>2</sup> Unfortunately, these tax enactments have not provided the type of incentive for rehabilitation which was desired. Today in Congress, there is a growing school of thought that the current tax provisions foster the promotion of abusive tax shelters which allow investors to obtain tax benefits greater than their investments warrant. Some members of Congress feel that these provisions should be limited, if not eliminated, in their application to historic rehabilitation property.<sup>3</sup> Legislation which would severely limit tax incentives to restore historic structures already has been proposed in the House and Senate, and it is feared

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1. Note, *Federal Tax Incentives for Historic Preservation: A Strategy for Conservation and Investment*, 10 HOFSTRA L. REV. 887, 887-88 (1982) (noting strong progressive federal program to utilize taxing power to achieve conservation and preservation goals) [hereinafter cited as Silver].

2. In his Urban Message to Congress on March 27, 1978, President Carter stated that, "[c]ities contain trillions of dollars of public and private [real estate] investments—investments which we must conserve, rehabilitate, and fully use." See Carlin & Engelberg, *The American Phoenix—New Incentives for Old Buildings*, 7 J. OF REAL EST. TAX'N 241 (1980) [hereinafter cited as Carlin & Engelberg]. As a result, the Congress, under the Carter administration, enacted the Tax Reform Act of 1976 and the Revenue Act of 1978 to accomplish this goal. See *infra* notes 35-57 and accompanying text.

President Reagan has echoed these goals, most recently in a televised news conference on July 24, 1984 in which he noted, "[t]here isn't anything that can be proven that we have not been meeting fully our responsibilities with regard to the protecting of the [ecological, recreational, and historical] environment." See N.Y. Times, July 25, 1984, at A14, col. 5. The Reagan administration has provided tax incentives for historic rehabilitation in both the Economic Recovery Tax Act of 1981 (ERTA) and the Tax Reform Act of 1984 (1984 Act). See *infra* notes 62-165 and accompanying text.

3. See Sampson, *The Economic Recovery Tax Act Rehabilitates New York Real Estate Industry*, 20 PRACTICING L. INST. 2, 7 (1983); Whitebread, *Historic Preservation Tax Incentives—The Impact of Recent Legislation*, 61 TAXES 243, 243 (Apr. 1983) [hereinafter cited as *Tax Incentives*].

that other, similar legislation, is likely to follow.<sup>4</sup> This Note explores the possible ramifications of such legislation on the incentives to rehabilitate historic property,<sup>5</sup> refutes the contention that such incentives promote abusive tax shelters in the area of historic rehabilitation,<sup>6</sup> and advocates the extension of such incentives to individual taxpayers beyond those who hold historic buildings for use in the ordinary course of their business or as income producing property by enacting new legislation similar to the Residential Energy Credit.<sup>7</sup>

## II. Historical Background and Legislation

### A. Significant Historical Preservation Legislation

The development of the law regarding preservation of historic structures prior to the enactment of The Economic Recovery Tax Act (ERTA)<sup>8</sup> evidences the changing attitude of Congress from favoring new real estate construction to favoring the rehabilitation of historic structures.<sup>9</sup> The first major legislation to foster the preservation of historically significant property was the Antiquities Act of 1906<sup>10</sup> which authorized the President to designate historic landmarks, located on land controlled by the United States, as national monuments.<sup>11</sup> The Antiquities Act was followed by the creation of the National Park Service in 1916,<sup>12</sup> whose principal function was

4. See *infra* notes 330-44 and accompanying text.

5. See *infra* notes 235-329 and accompanying text.

6. See *id.* for a discussion of various provisions of the Internal Revenue Code [hereinafter referred to as Code] enacted to curtail the use of abusive tax shelters.

7. See *infra* notes 345-69 and accompanying text.

8. The Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 172 (1981) (to be codified in various sections of 26 U.S.C.) [hereinafter cited as ERTA].

9. See Carlin & Engelberg, *supra* note 2, at 241-42; Silver, *supra* note 1, at 887-89; Weber, *Tax Incentives for Historic Preservation: An Economic Analysis*, 7 J. REAL EST. TAX'N 31, 31-32 (1979) [hereinafter cited as Weber]; Whitebread, *Tax Incentives for the Preservation of Historic Properties*, 60 TAXES 446, 446-47 (1982) [hereinafter cited as Whitebread].

10. Ch. 3060, § 2, 34 Stat. 225 (1906) (codified at 16 U.S.C. § 431 (1982)).

11. 16 U.S.C. § 431 provides in pertinent part:

The President of the United States is authorized, in his discretion, to declare by public proclamation historic landmarks, historic and pre-historic structures, and other objects of historic or scientific interest that are situated upon the lands owned or controlled by the Government of the United States to be national monuments . . . .

*Id.*

12. Act of Aug. 25, 1916, ch. 408, § 1, 39 Stat. 535 (1916) (codified at 16 U.S.C. § 1 (1982)). The National Park Service is under the control of the Department

to aid in the preservation of the country's historic environment.<sup>13</sup>

Congress subsequently established a national policy which advocated historic preservation in the Historic Sites, Buildings, and Antiquities Act of 1935.<sup>14</sup> In order to implement this policy, Congress chartered the National Trust for Historic Preservation,<sup>15</sup> which, for the first time, provided federal funds for historic preservation<sup>16</sup> by fostering "grass-roots"<sup>17</sup> participation in the preservation of nationally significant historic structures.<sup>18</sup> However, these legislative measures did little to prevent the erosion of the historic environment resulting from the rapid urban growth which characterized the post-World War Two era.<sup>19</sup> Major national and local concerns, such as

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of the Interior. *Id.* The National Park Service:

shall promote and regulate the use of the Federal areas known as national parks, monuments, and reservations . . . by such means and measures as conform to the fundamental purpose of the said parks, monuments, and reservations, which purpose is to conserve the scenery and the national and historic objects and the wild life therein and . . . to leave them unimpaired for the enjoyment of future generations.

*Id.*

13. *Id.*

14. 16 U.S.C. §§ 461-467 (1982). The act declared "a national policy to preserve for public use historic sites, buildings, and objects of national significance for the inspiration and benefit of the people of the United States." *Id.* § 461. In addition, the act gave the Secretary of the Interior the authority to identify historic structures of national significance which came within the purview of the National Park Service or which had been declared eligible for designation as national landmarks under the Antiquities Act of 1906. *Id.* § 462. Once identified, the Secretary of the Interior could restore, preserve, maintain, and operate the structures for the benefit of the public. *Id.*

15. Act of Oct. 26, 1949, ch. 755, § 1, 63 Stat. 927 (1949) (codified at 16 U.S.C. § 468 (1982)) [hereinafter cited as the National Trust].

16. 16 U.S.C. § 468 (1982).

17. "Grass roots" has been defined as "society at the local level especially in rural areas as distinguished from the centers of political leadership." WEBSTER'S NEW COLLEGIATE DICTIONARY 502 (1978).

18. See *supra* note 16. The National Trust is a charitable, educational, and non-profit corporation whose purpose is

to receive donations of sites, buildings, and objects significant in American history and culture, to preserve and administer them for public benefit, to accept, hold, and administer gifts of money, securities, or other property of whatsoever character [from the public] for the purpose of carrying out the preservation program . . . [set forth in 16 U.S.C. §§ 461-467].

*Id.*

19. Silver, *supra* note 1, at 891. Historic preservation activities were left in the hands of private agencies and individuals who were given little assistance from the federal government. *Id.* Silver notes that "[f]or at least a decade, federal efforts toward historic preservation were weak in the face of a swift and powerful wrecking ball." *Id.*

urban renewal and road construction, created an atmosphere which was not conducive to the preservation of historic property.<sup>20</sup>

Congress remedied the adverse consequences of urban renewal on historic preservation by enacting the National Historic Preservation Act of 1966 (NHPA).<sup>21</sup> The NHPA afforded structures of historic significance protection against destruction due to urban renewal, public roads projects and other federally funded or licensed projects.<sup>22</sup> The NHPA created the National Register of Historic Places<sup>23</sup> which would include structures "worthy of protection because of their

20. *Id.* The effect of urban growth and expansion on historic preservation was rectified somewhat by the passing of the Housing and Urban Development Act of 1965, 42 U.S.C. § 1460(c) (1976) (repealed by 42 U.S.C. § 5316) (requiring urban renewal projects to relocate structures of historical significance but only if public or non-profit organization would undertake responsibility for renovating and maintaining structure), and the Federal-Aid Highway Act of 1966 (requiring Federal Highway Administration to avoid projects which would harm identified historic structures unless "no feasible and prudent alternatives" exist). 23 U.S.C. § 138 (1982); *see also* Stop H-3 Assoc. v. Coleman, 533 F.2d 434 (9th Cir.), *cert. denied*, 429 U.S. 999 (1976); Thompson v. Fugate, 347 F. Supp. 120 (E.D. Va. 1972).

21. Pub. L. No. 89-665, 80 Stat. 915 (1966) (codified at 16 U.S.C. §§ 470-470w (1982)) [hereinafter cited as the NHPA]. The NHPA created a partnership between all levels of government and the private sector. The Act was designed to protect, restore, and maintain structures of historical significance to the United States. Silver, *supra* note 1, at 892, *citing* 16 U.S.C. § 470a(a)(1) (1976). The NHPA found it

necessary and appropriate for the Federal Government to accelerate its historic preservation programs and activities, to give maximum encouragement to agencies and individuals undertaking preservation by private means, and to assist state and local governments and the National Trust for Historic Preservation in the United States to expand and accelerate their historic preservation programs and activities.

16 U.S.C. § 470(f) (1982).

This federal power was enhanced by President Nixon in Executive Order No. 11593, "Protection and Enhancement of the Cultural Environment," which set forth a policy that "[t]he Federal Government shall provide leadership in preserving, restoring, and maintaining the historic and cultural environment of the Nation." Exec. Order No. 11593, 3 C.F.R. 154 (1971), *reprinted in* 16 U.S.C. § 470 (1982).

22. Silver, *supra* note 1, at 893 n.40.

23. 16 U.S.C. § 470a(a)(1) (1982). To merit listing on the National Register, property must meet one of the four criteria set forth in 36 C.F.R. § 60.4 (1984):

The quality of significance in American history, architecture, archeology, engineering, and culture is present in districts, sites, buildings, structures, and objects that possess integrity of location, design, setting, materials, workmanship, feeling, and association and (a) that are associated with events that have made a significant contribution to the broad patterns of our history; or (b) that are associated with the lives of persons significant in our past; or (c) that embody the distinctive characteristics of a type, period, or method of construction, or that represent the work of a master, or that possess high artistic values, or that represent a significant and distinguishable entity whose components may lack indi-

historical, architectural, or cultural significance . . . ."<sup>24</sup> In addition, the NHPA provided for the formation of the Advisory Council on Historic Preservation<sup>25</sup> and for programs of matching grants-in-aid to the states<sup>26</sup> and to the National Trust.<sup>27</sup>

While the NHPA was a major improvement over prior preservation legislation,<sup>28</sup> it still suffered from one significant shortcoming.<sup>29</sup> The major criticism of the NHPA was the lack of an express provision creating federal tax incentives to foster historic preservation.<sup>30</sup> The omission of an incentive for taxpayers to incur the costs of historic rehabilitation and preservation<sup>31</sup> caused many owners of historic property to opt for the demolition of their property rather than bearing the expense of having it certified as historically significant.<sup>32</sup>

vidual distinction; or (d) that have yielded, or may be likely to yield, information important in prehistory or history.

*Id.*

24. See Silver, *supra* note 1, at 893 n.40.

25. 16 U.S.C. § 470i (1982) ("There is established as an independent agency of the United States Government an Advisory Council on Historic Preservation . . ."). The major functions of the Advisory Council are: (a) to coordinate preservation activities under 16 U.S.C. § 470; (b) to provide training and education in historic preservation to the public; and (c) to advise Congress and the President on measures which would fulfill the purpose of the NHPA (including the possible ramifications of any tax policies which were adopted). *Id.* § 470j(a)(1)-(3) (1982).

26. *Id.* § 470a(d)(1) (1982) ("Secretary shall administer a program of matching grants-in-aid to the States for historic preservation projects, and State historic preservation programs, approved by the Secretary and having as their purpose the identification of historic properties and the preservation of properties included on the National Register").

27. *Id.* § 470a(d)(2) (1982) ("Secretary shall administer a program of matching grant-in-aid to the National Trust for Historic Preservation in the United States . . . for the purposes of carrying out the responsibilities of the National Trust").

28. See *supra* notes 8-20 and accompanying text.

29. See Silver, *supra* note 1, at 894-97 (delineating time-consuming application requirements and mandatory review procedures set forth in NHPA).

30. *Id.*; Carlin & Engelberg, *supra* note 2, at 242-43.

31.

Certified historic rehabilitation of a building is likely to cost more than noncertified rehabilitation of the same building. Simply filling out the necessary application forms and seeking the financial and legal advice necessary to understand the complicated options . . . [available] can be costly. Moreover, the certification process, although designed to move quickly, can in fact be rather lengthy and fraught with uncertainty. In addition, the Interior Department sometimes suggests rehab techniques and approaches that are different from and more costly than what would otherwise be done.

Gensheimer, *Rehabilitation Tax Credits: A Real Estate Tax Shelter of the 1980s*, 9 J. REAL EST. TAX'N 299, 313-14 (1982).

32. See Carlin & Engelberg, *supra* note 2, at 242; Silver, *supra* note 1, at 894-95; Weber, *supra* note 9, at 31-32; Whitebread, *supra* note 9, at 446.

Congress failed to rectify this problem when it enacted the Housing and Community Development Act of 1974 (HCDA).<sup>33</sup> While the HCDA provided a newly-recognized federal policy which viewed rehabilitated historic structures as a viable source of commercial and residential real property and recognized that expenditures for their preservation served social as well as historic goals,<sup>34</sup> it failed to provide for federal tax incentives to foster historic preservation.

### B. Significant Tax Provisions Prior to ERTA

The Internal Revenue Code (IRC or Code),<sup>35</sup> as it existed when the NHPA and the HCDA were enacted, encouraged the demolition of historic structures by allowing owners and developers to write off demolition expenses<sup>36</sup> and to use accelerated depreciation methods for the new structures they erected on the sites of razed buildings.<sup>37</sup> Congress remedied this situation by promulgating significant federal tax incentives for historic preservation in the Tax Reform Act of 1976 (TRA).<sup>38</sup> The tax provisions in the TRA provided the means to be used to implement the federal policy favoring historic preservation which had been set forth in the HCDA.<sup>39</sup>

Congress intended to implement this historic preservation policy by providing both tax incentives for rehabilitation and tax disincentives against the demolition of historically significant structures.<sup>40</sup> First, the TRA created a new class of real property known as "certified historic structures."<sup>41</sup> Second, it implemented tax disin-

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33. 42 U.S.C. § 1441(a) (1982).

34. *Id.*; see also S. REP. No. 693, 93rd Cong., 2d Sess. 4487 (1974).

35. The Internal Revenue Code of 1954 and all amendments thereto are codified in 26 U.S.C. (1982).

36. See I.R.C. § 162 (1982) (allowing deduction for ordinary and necessary business expenses). Under the law prior to the TRA, if the building was not acquired with a view toward demolition, any demolition expenses for the old structure and the remaining undepreciated basis of the demolished structure were deductible by the owner. See Silver, *supra* note 1, at 899 nn.74-75, citing Day, *Federal Income Tax Reform: An Important Tool for Historic Preservation*, 16 WAKE FOREST L. REV. 315, 329 (1980). However, most old buildings during this era were acquired with a view toward demolition. *Id.* Demolition expenses, therefore, were capitalized and became part of the depreciable basis of the new building that had been erected in place of the old structure. *Id.*

37. *Id.*; see also I.R.C. § 167(b),(c) (1982) (providing various accelerated depreciation methods allowed by Code prior to enactment of ERTA).

38. Pub. L. No. 94-455, 90 Stat. 1520 (1976) (codified in various sections of 26 U.S.C.) [hereinafter referred to as the TRA].

39. Silver, *supra* note 1, at 887-88, 898-99.

40. *Id.* at 888.

41. I.R.C. § 191(d)(1) (1976) (repealed 1981) (currently codified at I.R.C.

centives which provided that an owner who demolished either a certified historic structure or a structure within a "historic district"<sup>42</sup> would be disallowed any tax deduction for the cost of demolition.<sup>43</sup> The owner of the demolished structure was also prohibited from taking a depreciation deduction above the straight-line method<sup>44</sup> on any replacement structure built on the site of the demolition.<sup>45</sup> Finally,

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§ 48(g)(3)(A) (1982)) defines a "certified historic structure" as "any building (and its structural components) which (i) is listed in the National Register; or (ii) is located in a registered historic district and is certified by the Secretary of the Interior to the Secretary as being of historical significance to the district." *Id.*; see also Carlin & Engelberg, *supra* note 2, at 246 (noting creation of new class of real property in TRA).

42.

The term "registered historic district" means—(i) any district listed in the National Register, and (ii) any district —(I) which is designated under a statute of the appropriate State or local government, if such statute is certified by the Secretary of the Interior to the Secretary as containing criteria which will substantially achieve the purpose of preserving and rehabilitating buildings of historic significance to the district, and (II) which is certified by the Secretary of the Interior to the Secretary as meeting substantially all of the requirements for the listing of districts in the National Register.

I.R.C. § 191(d)(2), as amended by the Revenue Act of 1978, Pub. L. No. 95-600, § 701(f)(1), 92 Stat. 2900-01 (1978) (repealed 1981) (currently codified at I.R.C. § 48(g)(3)(B) (1982)).

43. I.R.C. § 280B (1982); see *infra* notes 122-25 and accompanying text for the amendment of § 280B under the Tax Reform Act of 1984.

44. See *infra* note 45 for a discussion of the straight-line depreciation method.

45. I.R.C. § 167(n) (1976) (repealed 1981). Depreciation is used to distribute the cost or other basic value of tangible capital assets over the estimated useful life of the asset in a systematic manner. D. KIESO & J. WEYGANDT, *INTERMEDIATE ACCOUNTING* 523 (3d ed. 1980). The straight-line method of depreciation assumes that depreciation will occur at a constant rate throughout the estimated useful life of the asset. *Id.* The accelerated depreciation method proceeds on the hypothesis that capital assets depreciate more at the start of their useful life and less over time. *Id.* Accelerated methods provide greater deductions when the asset is first placed into service and lesser deductions toward the end of the asset's useful life. *Id.* at 524. Under the Accelerated Cost Recovery System [hereinafter referred to as ACRS] created by ERTA, various classes of property have been established, and depreciation tables provide the applicable yearly percentage depreciation deduction for each class of property. I.R.C. § 168(b)(1),(c) (1981). The percentage amount, which is multiplied by the unadjusted basis of the property in order to determine the allowable deduction, was calculated by using an accelerated method of depreciation (175% declining balance) for the early years and then switching to the straight-line method in later years to enable the taxpayer to maximize his depreciation deduction. I.R.C. § 168(b)(2) (1981) (amended 1984); PRENTICE-HALL, 1982 FEDERAL TAX COURSE SUPPLEMENT 22 (1981). However, a taxpayer still may elect to use the straight-line method under § 168(b)(3) and may be required to use straight-line depreciation in order to obtain other tax benefits. See *infra* note 92 and accompanying text. However, it is not always advantageous to depreciate a building using an accelerated method due to the applicability of the depreciation



the TRA created two significant tax incentives. The first allowed owners to compute the depreciation deduction attributable to "substantially rehabilitated"<sup>46</sup> historic property as though the original use of the property had commenced with the current owner.<sup>47</sup> This incentive allowed current owners to use an accelerated depreciation method<sup>48</sup> rather than the straight-line method which was required when the original use of the property did not commence with the taxpayer in question.<sup>49</sup> The second incentive allowed owners to use accelerated amortization to deduct over a sixty-month period the cost of "qualified rehabilitation expenditures"<sup>50</sup> incurred in conjunction with the rehabilitation of historical commercial and income-producing structures in lieu of the accelerated depreciation deduction.<sup>51</sup>

The provisions of the TRA were then augmented by the Revenue

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recapture rules. These rules provide that on the subsequent sale of nonresidential (commercial) real property for a gain, all depreciation which has been deducted is subject to recapture and will be taxed as ordinary income rather than at the capital gains rates set forth in § 1202. I.R.C. § 1250(a) (1982).

46. I.R.C. § 167(o) (1976) (repealed 1981) (currently codified at I.R.C. § 48(g)(1)(C) (1984)). See *infra* note 91 and accompanying text for a definition of "substantially rehabilitated" property.

47. I.R.C. § 167(o) (1976) (repealed 1981). Section 167(o) applied only to certified rehabilitation expenditures incurred after June 30, 1976, and before January 1, 1984, which could be capitalized and exceeded the greater of the adjusted basis of the property or \$5000. *Id.*

48. *Id.*

49. I.R.C. § 167(c) (1982) (providing limitations on use of certain depreciation rates and methods).

50. I.R.C. § 191(a) (1976) (repealed 1981) (currently codified at I.R.C. § 48(g)(2)(A) (1984)). See *infra* note 68 and accompanying text for the definition of "qualified rehabilitation expenditures."

51. I.R.C. § 191(a) (1976) (repealed 1981). The advantage of accelerated amortization and accelerated depreciation is that they allow a taxpayer to shift deductions closer to the present, thereby postponing tax liability so that a return can be earned on the funds not paid out as taxes during the intervening period. Weber, *supra* note 9, at 36. The choice to be made under the TRA (as augmented by the Revenue Act of 1978, *infra* note 52) was either to "[t]ake the investment credit on the rehabilitation expenditures and accelerated depreciation on the entire depreciable basis, or take rapid amortization on the rehabilitation expenditures, straight-line depreciation on the acquisition cost [of the building], and forego the investment credit." Carlin & Engelberg, *supra* note 2, at 255.

When a taxpayer owned a building for many years and had been depreciating it over this period of time, the rehabilitation expenditures incurred would be substantial in relation to the adjusted basis of the building, and the taxpayer would benefit more by using accelerated amortization. *Id.* at 256. On the other hand, when a taxpayer had a large adjusted basis in the building and incurred rehabilitation expenditures, he would benefit more by capitalizing the rehabilitation expenditures and using accelerated depreciation. *Id.*

Act of 1978<sup>52</sup> which provided for an investment tax credit<sup>53</sup> of ten percent of the qualified rehabilitation expenditures for business buildings<sup>54</sup> which had been in use for at least twenty years.<sup>55</sup> The investment tax credit could not be used in conjunction with the accelerated amortization election,<sup>56</sup> but it provided a substantial rehabilitation incentive in the form of a real estate tax shelter when combined with one of the allowable accelerated depreciation methods.<sup>57</sup>

Although the TRA and the Revenue Act of 1978 provided federal tax incentives for historic rehabilitation, some felt that there was room for further improvement.<sup>58</sup> The feeling was that the accelerated amortization and depreciation deductions for the rehabilitation of certified historic structures were too complicated to calculate and too difficult to obtain.<sup>59</sup> Some commentators suggested that these deductions be simplified and liberalized to benefit owners of personal residences as well as high tax bracket owners of commercial and income producing property.<sup>60</sup> It was further suggested that the 1984 expiration dates either should be extended or preferably be eliminated in favor of the permanent enactment of these provisions.<sup>61</sup>

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52. Pub. L. No. 95-600, § 315(a)-(d), 92 Stat. 2828 (1978).

53. The advantage of an investment tax credit is that it reduces tax liability dollar for dollar in the year of expenditure rather than operating as a deduction from income over a period of years, in which case it reduces tax liability in proportion to the taxpayer's tax bracket. See Carlin & Engelberg, *supra* note 2, at 246. However, when the property is sold, a portion of any gain recognized will be taxed as ordinary income rather than as a capital gain if the investment tax credit is taken. Silver, *supra* note 1, at 905-07.

54. Eligible buildings included factories, offices, warehouses, hotels, retail and wholesale stores, and buildings held for the production of income, but not apartment buildings or personal residences. Drymalski, *Preservation of Old Buildings as a Tax Shelter*, 60 CHI. B. REC. 294, 297 (1979) [hereinafter cited as Drymalski].

55. I.R.C. § 48(g)(1)(B) (1978) (amended 1981).

56. I.R.C. § 48(a)(8) (1978) (amended 1981).

57. Silver, *supra* note 1, at 906. See *infra* notes 166-234 and accompanying text for a discussion of rehabilitation tax shelters under current law.

58. See Carlin & Engelberg, *supra* note 2, at 259; Drymalski, *supra* note 54, at 299; Silver, *supra* note 1, at 911-16.

59. See Drymalski, *supra* note 54, at 299.

60. See Carlin & Engelberg, *supra* note 2, at 258-59; Drymalski, *supra* note 54, at 299; Silver, *supra* note 1, at 913; Weber, *supra* note 9, at 49. As noted by Carlin and Engelberg, these tax incentives were designed to remedy the abuses found within real estate tax shelters. Carlin & Engelberg, *supra* note 2, at 259. They expressly cite the Code provisions requiring the recapture of excess amortization and depreciation as ordinary income and the provisions establishing these items as tax preferences for minimum tax purposes as provisions which may limit the effectiveness of the rehabilitation tax provisions. *Id.* at 258.

61. See Carlin & Engelberg, *supra* note 2, at 259; Drymalski, *supra* note 54, at 299-300; Weber, *supra* note 9, at 49.

## C. ERTA and Subsequent Tax Legislation

### 1. *The Economic Recovery Tax Act of 1981—ERTA*

Despite the desire for improvement of and permanence in federal tax incentives for historic preservation,<sup>62</sup> some commentators felt that the Reagan administration may have legislatively “undermined” the TRA’s provisions by advocating the enactment of ERTA.<sup>63</sup> TRA provisions repealed by ERTA include: (1) those which disallowed the use of a depreciation method above the straight-line method for a replacement structure built on the site of a demolished historic structure;<sup>64</sup> (2) those which provided that the original use of a substantially rehabilitated structure commenced with the current owner thereby allowing him to depreciate the structure using an accelerated depreciation rate;<sup>65</sup> and (3) those which allowed owners to use accelerated amortization to deduct the cost of qualified rehabilitation expenditures.<sup>66</sup>

ERTA retained only the definitions of a qualified rehabilitated building,<sup>67</sup> a qualified rehabilitation expenditure,<sup>68</sup> and a certified

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62. See *supra* notes 58-61 and accompanying text.

63. See Silver, *supra* note 1, at 888.

64. I.R.C. § 167(n) (1976) (repealed by Pub. L. No. 97-34, Title II, § 212(d)(1), 95 Stat. 239 (1981)).

65. I.R.C. § 167(o) (1976) (repealed by Pub. L. No. 97-34, Title II, § 212(d)(1), 95 Stat. 239 (1981)).

66. I.R.C. § 191 (1976) (repealed by Pub. L. No. 97-34, Title II, § 212(d)(1), 95 Stat. 239 (1981)). However, a similar provision still exists with respect to low-income housing which allows qualified rehabilitation expenditures on such structures to be written off over a sixty-month period rather than over the ACRS period. I.R.C. § 167(k)(1) (1984). If the rehabilitation has begun before January 1, 1987, up to \$20,000 of qualified rehabilitation expenditures per unit will qualify for this special treatment (\$40,000 if the rehabilitation is conducted pursuant to a program certified by the Secretary of Housing and Urban Development). I.R.C. § 167(k)(2) (1984).

67. I.R.C. § 48(g)(1)(A) (1981) defines “qualified rehabilitated building” as “any building (and its structural components)—(i) which has been substantially rehabilitated, (ii) which was placed in service before the beginning of the rehabilitation, and (iii) 75 percent or more of the existing external walls of which are retained in place as external walls in the rehabilitation process.” *Id.* See *infra* notes 153-58 and accompanying text for an explanation of an alternative test of a qualified rehabilitated building as described in the Tax Reform Act of 1984.

68. I.R.C. § 48(g)(2)(A) (1984) defines a “qualified rehabilitation expenditure” as:

any amount properly chargeable to capital account which is incurred after December 31, 1981—(i) for real property (or additions or improvements to real property) which have a recovery period (within the meaning of section 168) of 18 years (15 years in the case of low-income housing

historic structure.<sup>69</sup> No analogous provisions were included in ERTA to replace these repealed TRA provisions. ERTA also replaced the ten percent investment tax credit allowed for qualified rehabilitation expenditures by the Revenue Act of 1978.<sup>70</sup>

While ERTA failed to replace the repealed historic preservation provisions of the earlier tax enactments with analogous provisions, it did provide extensive new measures in the area of historic rehabilitation.<sup>71</sup> ERTA implemented a new, albeit complicated, "rehabilitation credit"<sup>72</sup> for qualified rehabilitated buildings.<sup>73</sup> The rehabilitation credit provided a twenty-five percent tax credit of the qualified rehabilitation expenditures incurred in conjunction with the rehabilitation of a certified historic structure.<sup>74</sup> This credit could be claimed on certified historic structures used for residential, rental or lodging purposes<sup>75</sup> or as hotels or motels<sup>76</sup> in addition to traditional

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property), and (ii) in connection with the rehabilitation of a qualified rehabilitated building.

*Id.* This statute incorporates the extension of the recovery period for real property to "18 years" as enacted under the Tax Reform Act of 1984. I.R.C. § 168(b)(2) (1984). Expenditures which are not deemed to be qualified rehabilitation expenditures include the cost of acquiring the building or an interest therein and any expenditure attributable to the enlargement of the building. I.R.C. § 48(g)(2)(B)(ii), (iii) (1981). Any expenditure attributable to the rehabilitation of a certified historic structure or a building in a registered historic district will not be a qualified rehabilitation expenditure unless the rehabilitation is a "certified rehabilitation" as defined in I.R.C. § 48(g)(2)(C) (rehabilitation certified by Secretary of the Interior as being consistent with historic character of such property or district in which such property is located).

69. See *supra* note 41 and accompanying text for a definition of a "certified historic structure."

70. I.R.C. § 48(g)(1)(B) was amended by Pub. L. No. 97-34, § 212(b), Title II, 95 Stat. 239 (1981).

71. See *infra* notes 72-121 and accompanying text for a detailed explanation of tax provisions regarding the rehabilitation of historic structures as set forth in ERTA.

72. I.R.C. § 48(o)(3) (1984) ("rehabilitation investment credit" means that portion of the credit allowable by I.R.C. § 38 which is attributable to the rehabilitation percentage as set forth in I.R.C. § 46(b)(4)(A) (1984)).

73. I.R.C. § 48(g) (Supp. III 1979) was replaced by I.R.C. § 46(a)(2)(F) (1981) (currently codified at I.R.C. § 46(b)(4)(A) (1984)).

74. I.R.C. § 46(b)(4)(A) (1984). The new rules are generally applicable to qualified rehabilitation expenditures made after December 31, 1981. Where expenditures occurred both before and after January 1, 1982, the taxpayer can elect to take either the ten percent investment credit for structures over twenty years old plus accelerated depreciation or sixty-month accelerated amortization under § 191 for the expenditures incurred before 1982. However, the taxpayer can only qualify for the new rehabilitation credit incurred after 1982.

75. I.R.C. § 48(a)(3)(D) (1981).

76. I.R.C. § 48(a)(3)(B) (1981).

nonresidential uses in trades or businesses or for the production of income.<sup>77</sup> Rehabilitation credits of fifteen and twenty percent also were added for qualified rehabilitated buildings<sup>78</sup> which were at least thirty and forty years old respectively,<sup>79</sup> even though they had not been certified by the Secretary of the Interior<sup>80</sup> as having historic significance. The building's age is measured from the date that it is first placed into service by "any" taxpayer, not necessarily the taxpayer claiming the credit.<sup>81</sup> A building is first placed into service on the date it was first used in a trade or business or for the production of income.<sup>82</sup> Therefore, the structure will not qualify for the rehabilitation credit unless the age requirement is met before the rehabilitation begins.<sup>83</sup> As under prior law,<sup>84</sup> the fifteen and twenty percent rehabilitation credits apply only to rehabilitated buildings used for nonresidential purposes<sup>85</sup> or transient lodging.<sup>86</sup> When the taxpayer elects to claim the rehabilitation credit, he may not claim the "regular," ten percent investment credit<sup>87</sup> or the energy

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77. See *supra* note 54 for a discussion of the traditional uses of a structure in a trade or business or for the production of income.

78. I.R.C. § 46(a)(4)(A) (1984) (formerly codified at I.R.C. § 46(a)(2)(F)(i)).

79. I.R.C. § 46(b)(4)(C) (1984) (formerly codified at I.R.C. § 46(a)(2)(F)(iii)) provides the definition of a "30-year building" and a "40-year building." A 30-year building is a "qualified rehabilitated building other than a 40-year building and other than a certified historic structure." *Id.* at (i). A 40-year building is "a qualified rehabilitated building (other than a certified historic structure) which would meet the requirements of section 48(g)(1)(B) if '40' were substituted for '30' each place it appears in subparagraph (B) thereof." *Id.* at (ii).

80. The Secretary of the Interior obtains his authority in these matters because the certification of rehabilitation projects on the federal level is administered by the National Park Service of the United States Department of the Interior. See *supra* note 12 and accompanying text; see also Hild, *Certified Historic Rehabilitation: The Economic Recovery Tax Act of 1981*, 64 CHI. B. REC. 322 (1983).

81. I.R.C. § 48(g)(1)(B) (1981). Subparagraph (B) applies to both 30-year buildings and 40-year buildings and must be satisfied in order for the structure to qualify as a qualified rehabilitated building. See *supra* note 67 for the definition of a "qualified rehabilitated building."

82. I.R.C. § 168(c)(1), (e)(1) (1981) (buildings used in trade or business or held for production of income are "recovery property" under § 168(c)(1) and are placed into service when first used in trade or business or held for production of income).

83. I.R.C. § 48(g)(1)(B) (1981). The Code provides that the "30" or "40" year period must occur "between the date the physical work on the rehabilitation began and the date the building was first placed into service." *Id.*

84. See *supra* note 54 and accompanying text for a discussion of the nonresidential use requirement under the Revenue Act of 1978.

85. See *supra* note 54 for a discussion of nonresidential purposes.

86. See *supra* note 76 for the Code provision relating to "transient lodging."

87. I.R.C. §§ 46(b)(1) (1984) (formerly codified at I.R.C. § 46(a)(2)(B)) and 48(o)(1) (1980) (dealing with regular investment credit of 10% which may be taken on § 38 property).

credit<sup>88</sup> for any portion of the rehabilitation expenditures.<sup>89</sup>

To qualify for any of the rehabilitation credits, two basic requirements must be met. First, the building must be "substantially rehabilitated,"<sup>90</sup> which means that the amount spent on the rehabilitation of the structure within a twenty-four month period must exceed the greater of the adjusted basis of the building or \$5000.<sup>91</sup> The second requirement mandates that only straight-line depreciation be used on the portion of the building's basis attributable to the qualified rehabilitation expenditures.<sup>92</sup> It is possible, however, to depreciate the original, pre-rehabilitation basis of the building using an accelerated depreciation method.<sup>93</sup> However, both of these requirements

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88. I.R.C. §§ 46(b)(2) (1984) (formerly codified at I.R.C. § 46(a)(2)(C)) and 48(o)(2) (1980). For an in-depth analysis of the energy credit and its provisions, see Friedmann & Mayer, *Energy Tax Credits in the Energy Tax Act of 1978 and the Crude Oil Windfall Profits Tax Act of 1980*, 17 HARV. J. ON LEGIS. 465 (1980).

89. I.R.C. § 46(b)(4)(B) (1984) (formerly codified at § 46(a)(2)(F)(ii)).

90. See *infra* note 91 and accompanying text for an explanation of the "substantially rehabilitated" test.

91. I.R.C. § 48(g)(1)(C)(i) (1981). If the rehabilitation is reasonably expected to be completed in phases which are determined in architectural plans before the rehabilitation begins, then a sixty-month period may be used in lieu of the twenty-four month period. I.R.C. § 48(g)(1)(C)(ii) (1981).

92. I.R.C. § 48(g)(2)(B)(i) (1981) requires the taxpayer, under I.R.C. § 168(b)(3), to use the straight-line method of depreciation on the basis of the property attributable to the qualified rehabilitation expenditures.

93. Gensheimer, *Rehabilitation Tax Credits: A Real Estate Tax Shelter of the 1980s*, 9 J. REAL EST. TAX'N 299, 301 n.6 (1982) [hereinafter cited as Gensheimer]; Schmulde, *Real Estate Investments*, 1 J. TAX'N OF INVESTMENTS 258, 259 (1984) [hereinafter cited as Schmulde].

In determining whether or not a building is substantially rehabilitated under I.R.C. § 48(g)(1)(C), the adjusted basis of the structure prior to the rehabilitation effort is determined as of the first day of the twenty-four month period selected by the taxpayer or the holding period of the building as determined under I.R.C. § 1250(e), whichever is later. Since this amount is not attributable to any qualified rehabilitation expenditure, *supra* note 68 and accompanying text, it is not subject to the straight-line limitation imposed by I.R.C. § 48(g)(2)(B)(i). See *supra* note 91 and accompanying text. It may therefore be depreciated under the ACRS found in I.R.C. § 168, or, if the building was placed into service before January 1, 1981 (and does not qualify as recovery property under I.R.C. § 168(e)(1)), under an accelerated method allowed under § 167(b). This rule does not permit an owner who has held a building for a number of years, depreciating it under § 167, to switch to the ACRS simply because he has undertaken a rehabilitation project. It merely allows a taxpayer who purchases a building for the purpose of rehabilitating it to depreciate his original cost (investment) in the structure under the ACRS. There is a valid argument that the above rule applies only if the amount of qualified rehabilitation expenditures also constitutes a "substantial improvement" under I.R.C. § 168(f)(1)(C) due to the abandonment of component depreciation by the Internal Revenue Service. See Whitebread, *supra* note 9, at 447-48; Martin & Tang, *Tax Benefits in Rehabilitating Historic Structures*, Nat'l L.J., Dec. 12, 1983, at 58, col.

have been criticized.<sup>94</sup> The substantially rehabilitated rule has been criticized because it favors long-term property holders who own buildings which are almost fully depreciated over new purchasers of historic property thereby acting as a deterrent to real estate sales in the already depressed urban market.<sup>95</sup> The straight-line depreciation requirement has been criticized because it negates the use of accelerated depreciation as a further tax incentive for historic preservation.<sup>96</sup> It has been argued that if owners of historic property are not allowed to use accelerated depreciation methods on the portion of the building's basis attributable to the qualified rehabilitation

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1 [hereinafter cited as Martin & Tang].

"A 'substantial improvement' is made with respect to a building whenever the capitalized expenditures during any 24-month period equal or exceed 25 percent of the adjusted basis of the property as of the first day of the 24-month period, determined without regard to depreciation deductions." Martin & Tang, *supra* at 60, col. 1. Such improvements must be made at least three years after the building is placed into service by the taxpayer. *Id.*; I.R.C. § 168(f)(1)(C)(iii) (1981). The substantial improvement rationale will prohibit investors who wish to begin a rehabilitation project within three years after purchasing a building (which is the case in most rehabilitation tax shelters) from depreciating the building's cost under ACRS and may act as a deterrent to entering such projects.

94. See *infra* notes 95-97 and accompanying text for a discussion of the criticisms made by various commentators.

95. Whitebread, *supra* note 9, at 449-50. Whitebread argues that an owner who has held a building for a substantial period of time may not want to undertake a major rehabilitation project, while new purchasers of older buildings probably have bought the structure with just such a project in mind. *Id.* at 450. He suggests two measures which would reduce the adjusted basis of the property and thereby decrease the harshness of the "substantially rehabilitated" requirement. The first is to "take several years' depreciation before commencing a rehabilitation." *Id.* at 449. This action, however, would seem to negate the tax shelter effect sought by purchasers of old property when anticipating a rehabilitation because no tax liability can be reduced through a combined use of depreciation and the rehabilitation credit until the rehabilitation begins.

The second measure suggests that the owner make a charitable contribution of a conservation easement in his property under I.R.C. § 170. The contribution would entitle the owner to a charitable deduction based on the value of the easement and also would require him to reduce his basis in both the land and the building in the same proportion that the value of the easement bears to the predonation value of the property. *Id.* The major limitation on this suggestion is that it only would apply to certified historic structures. I.R.C. § 170(h)(4)(A)(iv), (B) (1983).

96. I.R.C. § 48(g)(2)(B)(i) (1984); Silver, *supra* note 1, at 922. Silver notes that the depreciation method allowable for the rehabilitation of certified historic structures is no different from that which is permitted for noncertified structures. Silver, *supra* note 1, at 922. If owners of potential certified historic structures were given the additional benefit of accelerated depreciation on the portion of the building's basis attributable to the qualified rehabilitation expenditures in addition to the rehabilitation credit, there might be a further incentive for them to incur the costs of certification, which can be a time consuming and tedious process. Gensheimer, *supra* note 93, at 313-14; Hild, *Certified Historic Rehabilitation: The Economic*

expenditures, they may decide that it is to their advantage to demolish the historic structure and forego the rehabilitation credit in order to obtain the long-run benefit of an accelerated depreciation deduction calculated on the higher basis of the replacement structure.<sup>97</sup>

The final prerequisite to claiming the rehabilitation credit is that the structure be a "qualified rehabilitated building"<sup>98</sup> which means that at least seventy-five percent of its existing external walls must be retained.<sup>99</sup> Once these requirements have been satisfied and the credit claimed, the maximum rehabilitation credit allowable under ERTA in a taxable year cannot exceed \$25,000 plus eighty-five percent of any tax liability in excess of \$25,000.<sup>100</sup> In no case, may the rehabilitation credit exceed the taxpayer's tax liability for the taxable year.<sup>101</sup> Any unused credit first could be carried back to the earliest of the preceding three taxable years and then carried forward for up to fifteen taxable years.<sup>102</sup>

As under the TRA, the costs of demolition or loss sustained due to the demolition of a certified historic structure were not deductible under ERTA.<sup>103</sup> Rather, these costs had to be added to the capital account of the "land" on which the demolished structure had been located, thereby precluding any depreciation or amortization benefits because land does not qualify as depreciable real property under

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*Recovery Tax Act of 1981*, 64 CH. B. REC. 322 (1982-83) [hereinafter cited as Hild]; Whitebread, *supra* note 9, at 453-54.

Hild provides an excellent summary of the procedures for certification of historic significance (when property is not listed as part of an historic district or individually listed in the National Register), certification of non-significance when an owner wants to avoid the tax consequences of I.R.C. § 280B (this now appears unnecessary due to the amendment of § 280B by the Tax Reform Act of 1984, *infra* notes 159-63 and accompanying text), and certification of the contemplated rehabilitation. Hild, *supra* at 327-29.

97. Gensheimer, *supra* note 93, at 303-18; Silver, *supra* note 1, at 922.

98. See *supra* note 67 and accompanying text for a definition of "qualified rehabilitated building."

99. *Id.*

100. I.R.C. § 46(a)(3) (1982) (repealed 1984). See *infra* note 140 and accompanying text for an explanation of how this provision applies under the Tax Reform Act of 1984.

101. I.R.C. § 46(b)(1) (1981) (repealed 1984). See *infra* note 141 and accompanying text for an explanation of how this provision applies under the Tax Reform Act of 1984.

102. *Id.* "Although the benefit of an investment tax credit may be carried forward, this defeats, to a considerable extent, the primary benefit of the investment tax credit: immediacy." Silver, *supra* note 1, at 923.

103. See *supra* note 43 and accompanying text for a discussion of this rule's use as a disincentive to the demolition of certified historic structures under the TRA.



the IRC.<sup>104</sup> The original basis of a qualified rehabilitated building, however, is increased by the amount of any qualified rehabilitation expenditures used to calculate the rehabilitation credit.<sup>105</sup> The depreciable basis of the structure attributable to the qualified rehabilitation expenditures is reduced by the full amount of any rehabilitation credit claimed with respect to "30-year" and "40-year" buildings.<sup>106</sup>

As originally enacted, ERTA did not require a basis reduction when a building was a certified historic structure and the twenty-five percent rehabilitation credit had been claimed.<sup>107</sup> However, the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA)<sup>108</sup> added a new Code section which required the depreciable portion of the building's basis attributable to qualified rehabilitation expenditures to be reduced by fifty percent of any rehabilitation credit claimed on a certified historic structure placed into service after 1982.<sup>109</sup> Thus, another tax advantage was lost to owners and developers of certified historic structures because, under TEFRA, they would receive smaller depreciation deductions and would recognize greater gains on the subsequent sale of the certified historic structure.<sup>110</sup>

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104. B. BITTKER & L. STONE, FEDERAL INCOME TAXATION 380 (5th ed. 1980) (land costs may be recovered only as deductions from proceeds in event of sale and may not serve as basis for deductions against income taken in form of depreciation).

105. I.R.C. § 1016(a)(24) (1984) (statute provides for adjustment to basis of property to extent provided in I.R.C. § 48(q) in cases of expenditures with respect to which credit has been allowed under I.R.C. § 38).

106. I.R.C. § 48(q)(3) (1984) (formerly codified at I.R.C. § 48(g)(5)(A)).

107. *Tax Incentives*, *supra* note 3, at 243-44; Tucker, *How TEFRA Affects Real Estate Investments: Analyzing Direct and Indirect Consequences*, 58 J. TAX'N 66, 67 (1983) [hereinafter cited as Tucker].

108. Pub. L. No. 97-248, § 205, 96 Stat. 427 (1982) (codified at I.R.C. § 48(q)) [hereinafter cited as TEFRA]. TEFRA cut back the Congressional priority for increased capital formation by businesses which had been the basis of many of the provisions enacted in the ERTA. *Tax Incentives*, *supra* note 3, at 243, citing Staff of Joint Committee on Taxation, 97th Cong., 1st Sess., General Explanation of the Economic Recovery Tax Act of 1981, at 18-19 (Dec. 29, 1981).

109. I.R.C. § 48(q)(1) (1984).

110. See Whitebread, *supra* note 9, at 448 (noting that "due to this basis reduction, a taxpayer will receive less depreciation allowances than he otherwise would have been entitled to and correspondingly will recognize more gain on a subsequent sale of the building"). *Id.* The adoption of the fifty percent basis reduction rule also may cause owners of historically significant buildings to forego the extra steps which must be taken in order to obtain certification of the structure by the Interior Department. *Tax Incentives*, *supra* note 3, at 246. Due to the time-consuming review conducted by the Interior Department and the administrative costs associated with submitting Parts 1 and 2 of the Interior Department's Certification Application, the increased credit for certified historic structures may be inadequate to offset

ERTA also implemented credit recapture rules which were applicable to structures claiming the rehabilitation credits.<sup>111</sup> If the historic property on which the rehabilitation credit was claimed were held by the owner for a full five years after the structure was placed into service, the owner would not have to recapture any portion of the credit as additional tax upon the subsequent sale of the building.<sup>112</sup> If, however, the building were sold before the full five years elapsed, the amount of the credit subject to recapture as additional tax liability would be twenty percent of the amount of the credit claimed multiplied by the number of years that ownership of the structure fell below five years.<sup>113</sup> The amount of recaptured tax would be added in full to the taxpayer's tax liability in the year of disposition.<sup>114</sup> Under TEFRA, the taxpayer would no longer be allowed to increase his basis in the portion of the building's basis attributable to qualified

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the negative effect of the fifty percent basis reduction rule. *Id.*

111. Pub. L. No. 97-34, § 211(g)(1), 95 Stat. 233 (1981) (codified at I.R.C. § 47 (a)(5)).

112. I.R.C. § 47(a)(5)(E) (1981) (defining "recapture period" cited in text). Silver, *supra* note 1, at 921-22, provides an excellent example of how the rehabilitation credit may lose some of its benefit due to the five-year holding requirement which must be met in order to avoid recapture:

[A]ssume A has a \$10,000 rehabilitation expenditure on a certified historic structure and that she is in the fifty percent tax bracket. Under the ERTA, if A elects to take a twenty-five percent investment tax credit, she simply deducts \$2500 from her tax liability at the end of the tax year in which the expense occurs. Prior to the ERTA, however, A might have elected rapid amortization. The same \$10,000 expenditure (under the TRA) would have been amortized over five years, creating a \$2000 deduction from gross income in each year. A's tax savings would have been \$1000 per year for five years for a total of \$5000. Although A's benefit in the first year would have only been \$1000 in order to keep the full \$2500 benefit that the twenty-five percent investment tax credit would yield, A would have to hold the property for the full five years. At the end of five years, the investment tax credit would amount to only one-half the tax benefit A would have accrued taking rapid amortization under the TRA. Yet, some investors prefer the smaller but more immediate return provided by an investment tax credit . . . [because it] can provide the investor with both ready cash to finance new investments and a hedge against inflation.

*Id.*

113. I.R.C. § 47(a)(5)(A) (1981). The "recapture percentage" defined in the text amounts to 100% if the property is disposed of within one full year after being placed into service; 80% if disposed of between one and two years; 60% if disposed of between two and three years; 40% if disposed of between three and four years; and 20% if disposed of between four and five years. I.R.C. § 47(a)(5)(B) (1981).

114. I.R.C. § 47(a)(5)(A) (1981). Tax liability in the year of distribution will be increased only with respect to credits used to reduce tax liability. In the case of a credit not allocable to a reduction in tax liability, any carrybacks or carryforwards will be adjusted to reflect recapture. I.R.C. § 47(a)(5)(D) (1981).

rehabilitation expenditures by the amount of any recaptured credit.<sup>115</sup>

ERTA also permitted lessees who had incurred qualified rehabilitation expenditures to claim the rehabilitation credit provided that the lessee had the permission of the lessor/owner<sup>116</sup> and, that at the time the rehabilitation was completed, the lease had at least fifteen years remaining to run.<sup>117</sup> The rehabilitation credit also has been extended to include purchasers of condominium units in rehabilitated buildings.<sup>118</sup>

While the historic preservation provisions of ERTA have provided a substantial investment incentive, their application has left many

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115. I.R.C. § 48(g)(5)(B) (1981) (repealed 1982). This section is subject to the transitional rules set forth in I.R.C. § 48(m) and applies to expenditures incurred after December 31, 1981, and before December 31, 1982. The repeal of § 48(g)(5)(B) may prove to be another disincentive to claiming the rehabilitation credit. When an owner plans to hold the property only for a short period of time, he will be subjecting himself to the recapture rules without a commensurate increase in the basis of the property. *See supra* notes 106-10.

116. *See* Schmudde, *supra* note 93, at 261; *Tax Incentives, supra* note 3, at 244-45, 250.

117. I.R.C. § 48(g)(2)(B)(v) (1981) was amended by Pub. L. No. 98-369, § 111(e)(8)(C) (1984) to conform this section with the Tax Reform Act of 1984 which extended the recovery period for real property under ACRS to 18 years. *See* I.R.C. § 168(c)(2)(D) (1984). Under the Tax Reform Act of 1984, a lease must have at least 18 years to run (15 years in the case of low-income housing) on the date that the rehabilitation is completed in order to qualify for the rehabilitation credit and for the credit to be passed through to the lessee from the lessor. Section 48(g)(2)(B)(v) also provides that the remaining term of the lease is to be calculated "without regard to any renewal period." I.R.C. § 48(g)(2)(B)(v) (1981). This requirement may create the issue of whether or not a lessee may exercise a renewal option before the rehabilitation is completed in order to satisfy the "18 years remaining" requirement of the statute. By exercising a renewal option, a lease which may not have qualified under the I.R.C. prior to the option being exercised might now satisfy the 18 year test "without regard to any renewal period" because no such renewal period exists at the time the rehabilitation is completed.

It also is unclear how the "substantially rehabilitated" test, *supra* note 91 and accompanying text, applies to lessees who have no cost basis in their leaseholds. *See* Martin & Tang, *supra* note 93, at 58, col. 4.

By the most liberal view, such a tenant need only capitalize \$5,000 within the selected 24-month (or 60-month) period to qualify. The Internal Revenue Service may take the position, however, that the tenant must expend at least as much as the lessor's basis, adjusted for depreciation, as of the beginning of the selected period.

*Id.* at 58, 60; *see also* Ltr. Rul. 8248021 (December 15, 1982) (holding that substantially rehabilitated test is satisfied if lessee's rehabilitation expenditures exceed lessor's adjusted basis in building).

118. *See* Schmudde, *supra* note 93, at 261 (citing Ltr. Rul. 8217034 (January 27, 1982); Ltr. Rul. 8123060 (March 12, 1981)); *see also* Dlugasch & Simon, *Investment Tax Credit for Certified Historic Structures Converted to Condominiums*, 61 TAXES 208, 208-10 (1983); Goldsmith & Glazer, *Condo Investors Benefit From Historic Rehabilitation: Real Estate Tax Analysis*, 5 PA. L.J. REP. 3 (1982).

unanswered questions.<sup>119</sup> Proposed Treasury Regulations have been issued relating to some areas of the rehabilitation credit,<sup>120</sup> but there is still a need for a definitive body of law to explain the rehabilitation credit under ERTA.<sup>121</sup>

## 2. *The Tax Reform Act of 1984*

The Tax Reform Act of 1984 (1984 Act)<sup>122</sup> created various provisions<sup>123</sup> which impinge directly on the application of the qualified rehabilitation credit.<sup>124</sup> The major change promoted by the 1984 Act was the adoption of a systematic plan intended to simplify the operation of the Code's various income tax credits.<sup>125</sup> This plan prioritized the use of income tax credits in offsetting income tax liability.<sup>126</sup> The income tax credits have been divided into four cat-

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119. See *Tax Incentives*, *supra* note 3, at 248.

120. Proposed Treas. Reg. § 1.48-11, Proposed T.D. published Oct. 28, 1980.

121. The following problem areas could be avoided and clarified if Treasury Regulations were adopted:

(1) in what year the rehabilitation credit may be claimed when the rehabilitation of a certified historic structure has satisfied the substantially rehabilitated test, but the project itself has not yet been certified by the Interior Department;

(2) whether the "progress expenditure" rules set forth in § 46(d) can be used to allow the rehabilitation credit to be claimed in the first year of a rehabilitation project when the substantially rehabilitated test has not been satisfied but the owner is reasonably certain that he will meet the test the following year;

(3) what constitutes completed architectural plans and specifications for the purpose of electing the alternative 60-month period in order to satisfy the substantially rehabilitated test and whether amendment of the plans due to factors discovered during the rehabilitation will be allowed;

(4) whether "soft" costs, including architectural and engineering fees, site survey fees, attorney's fees may be capitalized and thus qualify for the rehabilitation credit as qualified rehabilitation expenditures;

(5) problems of lessees qualifying for the credit, *supra* note 117; and

(6) problems as to transferees/purchasers qualifying for the credit (extension of rehabilitation credit to purchasers of condominiums, *supra* note 118, is illustrative of this area). *Tax Incentives*, *supra* note 3, at 248-50.

122. Pub. L. No. 98-369, § 5, 98 Stat. 494 (1984) (codified in various sections throughout 26 U.S.C.) [hereinafter cited as 1984 Act]. The 1984 Act, a division of the Deficit Reduction Act of 1984, *id.* § 1(b)(1), is a collection of provisions designed to increase taxes and to impose additional compliance requirements on taxpayers much like TEFRA did on ERTA. See, e.g., *Tax Incentives*, *supra* note 3, at 247 (citing Technical Corrections Act of 1982).

123. See *infra* notes 125-64 and accompanying text for a discussion of the provisions of the 1984 Act that effect the rehabilitation credit.

124. See *supra* note 72 and accompanying text.

125. Pub. L. No. 98-369, §§ 471-475, 98 Stat. 825-47 (1984); see Act of July 18, 1984, Pub. L. No. 98-369, 1984 U.S. CODE CONG. & AD. NEWS (98 Stat.) 507-08.

126. Pub. L. No. 98-369, §§ 471-475, 98 Stat. 825-47 (1984).

egories:<sup>127</sup> nonrefundable personal credits,<sup>128</sup> foreign and miscellaneous tax credits,<sup>129</sup> refundable credits,<sup>130</sup> and business-related credits.<sup>131</sup> The rehabilitation credit falls into the last category along with the regular investment tax credit, the energy credit, the targeted-jobs credit, the alcohol fuels credit, and the employee stock ownership credit.<sup>132</sup>

Nonrefundable personal credits are to be used first to offset an individual's "tax liability."<sup>133</sup> These credits are not limited by any

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127. *Id.* § 471(a).

128. *Id.* § 471(b). The credits in this category as they are codified today include: expenses for household and dependent care services necessary for gainful employment, I.R.C. § 21 (1984) (formerly § 44A); credit for the elderly and the permanently and totally disabled, I.R.C. § 22 (1984) (formerly § 37); the residential energy credit, I.R.C. § 23 (1984) (formerly § 44C); and the credit for contributions to candidates for public office, I.R.C. § 24 (1984) (formerly § 41). *Id.* § 471(c)(1). The 1984 Act also includes I.R.C. § 25 in this category. I.R.C. § 25 allows a credit for interest incurred or paid by the taxpayer on certain home mortgages. Pub. L. No. 98-369, § 612, 98 Stat. 494, 905 (1984). I.R.C. § 26 also was added by the 1984 Act and provides that the aggregate amount of any nonrefundable personal credits allowed shall not exceed the taxpayer's "tax liability" for the taxable year. *Id.*

129. Pub. L. No. 98-369, § 471(b), 98 Stat. 494, 826 (1984). The credits in this category as they are codified today include: credit for taxes of foreign countries and possessions of the United States and the possession tax credit, I.R.C. § 27 (1984) (formerly § 33); credit for clinical test expenses for certain drugs for rare diseases or conditions, I.R.C. § 28 (1984) (formerly § 44H); credit for producing fuel from a nonconventional source, I.R.C. § 29 (1984) (formerly § 44D); and the credit for increasing research activities, I.R.C. § 30 (1984) (formerly § 44F). Pub. L. No. 98-369, § 471(c)(1), 98 Stat. 494 (1984).

130. Pub. L. No. 98-369, § 471(b), 98 Stat. 494, 825-26 (1984). The credits in this category as they are codified today include: credit for taxes withheld on wages, I.R.C. § 31 (1984); earned income credit, I.R.C. § 32 (1984) (formerly § 43); credit for tax withheld at source on nonresident aliens and foreign corporations, I.R.C. § 33 (1984) (formerly § 32); credit for certain uses of gasolines and special fuels, I.R.C. § 34 (1984) (formerly § 39); and a credit for overpayments of tax as set forth in § 6401, I.R.C. § 35 (1984) (formerly § 45). Pub. L. No. 98-369, § 471(c)(1), 98 Stat. 494, 826 (1984).

131. Pub. L. No. 98-369, § 471(b), 98 Stat. 494, 825-26 (1984). This category includes: the general business credit, I.R.C. § 38 (1984); the provisions for the carryback and carryforward of unused credits, I.R.C. § 39 (1984); the alcohol fuels credit, I.R.C. § 40 (1984) (formerly § 44E); and the employee stock ownership credit, I.R.C. § 41 (1984) (formerly § 44G). Pub. L. No. 98-369, § 471(c)(1), 98 Stat. 494, 826 (1984).

132. I.R.C. § 38(b) (1984).

133. Act of July 18, 1984, Pub. L. No. 98-369, 1984 U.S. CODE CONG. & AD. NEWS (98 Stat.) 827; see also I.R.C. § 26(b)(1) (1984) (defines "tax liability" as tax imposed by Internal Revenue Code for taxable year subject to certain exceptions provided for by I.R.C. § 26(b)(2)). The language in I.R.C. §§ 28(d)(2), 29(b)(5), and 30(g)(1) also indicates that nonrefundable personal credits are to be used first in offsetting an individual's tax liability. These sections provide that any credit allowed under the foreign and miscellaneous tax credit category cannot exceed the

other provision in the Code and are allowable to decrease one-hundred percent of an individual's tax liability.<sup>134</sup> Refundable credits are recoverable even if there is no income tax liability which they can be used to offset.<sup>135</sup> Foreign and miscellaneous credits are used next by the taxpayer in reducing his overall tax liability.<sup>136</sup> When all of these credits have been consumed, the taxpayer may use his business-related credits, which are combined into one "general business" credit.<sup>137</sup> The general business credit is composed of the current year's business credit plus any carryforwards and carrybacks attributable to the taxable year.<sup>138</sup> The amount of the general business credit which can be claimed in a taxable year is limited in the same way that the rehabilitation credit was limited under ERTA.<sup>139</sup> The general business credit is allowed in full against the first \$25,000 of "net tax liability" and at a rate of eighty-five percent for any "net tax liability" in excess of \$25,000.<sup>140</sup> If a taxpayer offsets all of his tax liability in a particular year using the aforementioned procedure and still has an excess general business credit remaining, he can carry the excess back three taxable years and forward fifteen taxable years on a first-in, first-out basis as under prior law.<sup>141</sup>

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taxpayer's tax liability reduced first by the sum of the credits allowable under the nonrefundable personal credits category. I.R.C. §§ 28(d)(2), 29(b)(5), 30(g)(1) (1984).

134. See *supra* note 128 for a discussion of I.R.C. § 26.

135. 67 FED. TAX GUIDE REP. (CCH) 214 (July 9, 1984) (refundable credits continue to be recoverable even though there may be no income tax liability against which they can be offset).

136. See *supra* note 133 for a discussion of I.R.C. §§ 28(d)(2), 29(b)(5), and 30(g)(1).

137. I.R.C. § 38 (1984).

138. I.R.C. § 38(a) (1984). The "current year business credit" is the sum of the investment credit determined under § 46(a), the targeted jobs credit determined under § 51(a), the alcohol fuels credit determined under § 40(a), and the employee stock ownership credit determined under § 41(a) for the taxable year. I.R.C. § 38(b). The investment credit is composed of the regular 10% investment credit under § 48(o)(1), the energy investment credit under § 48(o)(2), and the rehabilitation investment credit under § 48(o)(3). I.R.C. § 46(a) (1984).

139. See *supra* note 100 and accompanying text for a discussion of the limitation under ERTA.

140. I.R.C. § 38(c)(1) (1984). "Net tax liability" is defined as "tax liability" (as defined in § 26(b), see *supra* note 133) reduced by the sum of the credits allowable under both the nonrefundable personal credit and foreign and miscellaneous tax credit categories. I.R.C. § 38(c)(2) (1984). In the case of married individuals who file separate returns, the limitation specified in § 38(c)(1) will be \$12,500 in lieu of \$25,000, unless the spouse of the taxpayer has no current year business credit and no business credit carryforward or carryback for the taxable year in question. I.R.C. § 38(c)(3) (1984).

141. I.R.C. § 39(a). The first-in, first-out method requires a taxpayer to claim the earliest earned business credits first when computing the amount of any carryback

These credit-ordering rules are effective for taxable years beginning after 1983.<sup>142</sup> Any business-related credit earned prior to 1984 may still be carried forward to post-1983 years using the rules which were in effect at the time the credit was earned.<sup>143</sup> However, the amount of the pre-1984 business credit carried forward will be subject to the \$25,000 plus eighty-five percent limitation imposed by the 1984 Act.<sup>144</sup> Any business credit earned after 1983 may be carried back not more than three years to a pre-1984 tax year.<sup>145</sup> The amount of the carryback is also subject to the \$25,000 plus eighty-five percent limitation imposed on the general business credit and to the credit-ordering rules that apply to the carryback of unused credits as set forth in the 1984 Act.<sup>146</sup>

Two basic rationales were given for simplification of the operation of the income tax credits.<sup>147</sup> The first rationale was that the former income tax credit mechanism was complex and not rationally structured.<sup>148</sup> The second and more important rationale was that Congress believed that "taxpayers should not generally be able to eliminate their entire tax liability by use of the credits which provide business incentives."<sup>149</sup> However, by aggregating the business-related credits and including carryovers therein as the means by which to rectify the problems identified in the rationales, the value of the credits will be decreased and an increase in the taxpayer's overall tax liability

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or carryforward under I.R.C. § 39(a) thereby allowing the most recent credits to accumulate until they can be claimed in later years. *See also* Act of July 18, 1984, Pub. L. No. 98-369, 1984 U.S. CODE CONG. & AD. NEWS (98 Stat.) 828-29. Thus, the order in which the credits are carried to and claimed in any tax year is: (1) carryforwards to the year, the earliest ones first; (2) the business credit earned in the year; and (3) the carrybacks to the year, the earliest ones first. I.R.C. § 39(a).

142. Pub. L. No. 98-369, § 475(a), 98 Stat. 494 (1984); *see also* Act of July 18, 1984, Pub. L. No. 98-369, 1984 U.S. CODE CONG. & AD. NEWS (98 Stat.) 508.

143. Pub. L. No. 98-369, § 473, 98 Stat. 494 (1984) (codified at I.R.C. § 39(d) (1984)). The unused business-related credits will be aggregated into one business credit for the purposes of carrying out this rule. I.R.C. § 39(d)(1)(A) (1984).

144. I.R.C. § 39(c) (1984); *see also* 67 FED. TAX GUIDE REP. 73 (CCH) ¶ 215 (July 9, 1984) (pre-1984 carryforwards are subject to post-1983 rules as to maximum tax liability limit and order in which carryforwards of unused credits are to be used up).

145. I.R.C. § 39(a)(1)(A) (1984).

146. *Id.*

147. *See infra* notes 148-49 and accompanying text for a discussion of the reasons given by the Conference Committee for simplifying the income tax credits.

148. Act of July 18, 1984, Pub. L. No. 98-369, 1984 U.S. CODE CONG. & AD. NEWS (98 Stat.) 507 (official legislative history).

149. *Id.*

will result.<sup>150</sup> Whether or not this will have a deleterious effect on historic rehabilitation projects cannot presently be determined,<sup>151</sup> but the fact that the rehabilitation credit will be among the last credits used to offset tax liability may cause owners and developers of historic structures to view such projects less favorably.<sup>152</sup>

The 1984 Act also liberalized the requirement for classification as a "qualified rehabilitated building."<sup>153</sup> The prior law<sup>154</sup> required retention of at least seventy-five percent of the existing external walls of the building undergoing rehabilitation to qualify for the

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150. This statement can be illustrated in an example which compares the prior law under ERTA to the current law under the 1984 Act:

PRIOR LAW

Tax Liability before Credits	\$725,000
Rehabilitation Credit - \$650,000	
Allowable Rehabilitation Credit:	
[\$25,000 + (\$725,000 - \$25,000 x 85%)]	(620,000)
Tax Liability after Rehabilitation Credit	<u>105,000</u>
Employee Stock Ownership Credit	(50,000)
Targeted Jobs Credit	<u>(15,000)</u>
Tax Liability after Tax Credits	<u>\$ 40,000</u>
Carryover of Rehabilitation Credit:	
(\$650,000 - \$620,000)	<u>\$ 30,000</u>

CURRENT LAW

Tax Liability before Credits	\$725,000
General Business Credit:	
Rehabilitation Credit	\$650,000
Employee Stock Ownership Credit	50,000
Targeted Jobs Credit	<u>15,000</u>
Aggregate Amount	\$715,000
Allowable Business Credit:	
[\$25,000 + (\$725,000 - \$25,000 x 85%)]	(620,000)
Tax Liability after Tax Credits	<u>\$105,000</u>
General Business Credit Carryover:	
(\$715,000 - \$620,000)	<u>\$ 95,000</u>

151. Because these tax provisions are so new, it is impossible at this time to determine the long range effect that they will have upon historic rehabilitation projects. As can be seen from the example *supra* note 150, there is a definite tax effect, but there is no way to determine if this tax effect will provide a substantial deterrent to rehabilitation projects in the future.

152. *Id.*

153. See *supra* notes 67 & 98-99 and accompanying text for a discussion of the alternate test for a qualified rehabilitated building.

154. See *id.* for a discussion of the prior law regarding qualified rehabilitated buildings.



rehabilitation credit.<sup>155</sup> The 1984 Act allows a building to qualify if at least fifty percent of the external walls are retained in place, provided that at least seventy-five percent of the external walls are retained in the structure as either external or internal walls and that seventy-five percent of the internal structure of the building is retained.<sup>156</sup> This alternative test provides an additional incentive for rehabilitation by allowing buildings of non-rectangular design to qualify more easily for the credit.<sup>157</sup> The alternative test is available for qualified rehabilitation expenditures incurred after December 31, 1983.<sup>158</sup>

The ERTA provision which denied deductions for demolition costs and associated losses in the case of certified historic structures<sup>159</sup> has been extended in scope under the 1984 Act to include the demolition costs of "all buildings."<sup>160</sup> The 1984 expiration date for this provision has been abolished in favor of permanence under the new law and the provision is effective for tax years beginning after December 31, 1983.<sup>161</sup> It, therefore, appears that the cost of demolition will increase the capital account of the land on which the razed building was located and the new structure is erected irrespective of the building's classification.<sup>162</sup> The revision of this tax provision

155. *Id.*, citing I.R.C. § 48(g)(1)(A)(iii) (1981).

156. Pub. L. No. 98-369, § 1043(a), 98 Stat. 494 (1984) (codified at I.R.C. § 48(g)(1)(E) (1984)).

157. 67 FED. TAX GUIDE REP. (CCH) ¶ 211, at 69 (July 9, 1984) (alternative test allows irregularly-shaped buildings to more easily qualify for rehabilitation investment credit).

158. Pub. L. No. 98-369, § 1043(b), 98 Stat. 494 (1984).

159. See *supra* notes 103-06 and accompanying text for a discussion of I.R.C. § 280B as it existed under ERTA.

160. Pub. L. No. 98-369, § 1063, 98 Stat. 494 (1984) (codified at I.R.C. § 280B (1984)). The statute, now entitled "Demolition of Structures" (as opposed to "Demolition of Certain Historic Structures" under ERTA), provides that:

In the case of the demolition of "any structure"—

- (1) no deduction otherwise allowable under this chapter shall be allowed to the owner or lessee of such structure for—
  - (A) any amount expended for such demolition, or
  - (B) any loss sustained on account of such demolition; and
- (2) amounts described in paragraph (1) shall be treated as properly chargeable to capital account with respect to the land on which the demolished structure was located.

*Id.* Thus, § 280B is no longer limited to just "certified historic structures" as it had been under the TRA and ERTA. See *supra* notes 43 & 103-06 and accompanying text.

161. I.R.C. § 280B(c) (1980) repealed by Pub. L. No. 98-369, § 1063(a)(2), 98 Stat. 494 (1984) is effective for taxable years beginning after December 31, 1983.

162. I.R.C. § 280B(2) (1984) provides that any amount expended for demolition "shall be treated as properly chargeable to [the] capital account with respect to the land on which the demolished structure was located." *Id.*

will provide a further disincentive to the demolition of "30-year" and "40-year" buildings because the owners of these structures will no longer be able to capitalize demolition costs as a cost of the new structure thereby precluding any depreciation or amortization benefits.<sup>163</sup>

Of the provisions of the 1984 Act which alter the rehabilitation credit, the credit-ordering rules may lead to the most deleterious results because they decrease the overall value of the business-related credits by requiring the general business credit to be used last in offsetting tax liability.<sup>164</sup> Owners and developers contemplating historic rehabilitation may avoid the project because the rehabilitation credit, as an element of the general business credit, may be limited as to its effectiveness in offsetting tax liability due to the provisions of the credit-ordering rules. When this result is balanced against the incentives for rehabilitation provided by the alternative test of a qualified rehabilitated building and the extension of the demolition rules to buildings other than certified historic structures, it appears that Congress may have decreased the overall incentive to rehabilitate historic structures in the 1984 Act.<sup>165</sup>

### III. Historic Rehabilitation Tax Shelters

#### A. The Basic Real Estate Tax Shelter

The mechanical provisions relating to the rehabilitation credit<sup>166</sup> are encountered most often in rehabilitation projects syndicated as real estate tax shelters. A tax shelter has been defined as a "transaction which accelerates tax benefits into current periods and defers the burden of tax repayment as far into the future as possible."<sup>167</sup>

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163. See *supra* notes 103-04 and accompanying text for a discussion of the effect of capitalizing demolition costs to the land on which the demolished structure stood.

164. See *supra* note 150 and accompanying text for an illustration of the credit-ordering rules and their effectiveness in offsetting tax liability.

165. Since these provisions have only been operative since July 1984, their ultimate effect is indeterminable at this point in time.

166. See *supra* notes 63-163 and accompanying text.

167. R. HAFT & P. FASS, 1984 TAX SHELTERED INVESTMENTS HANDBOOK 2-1 (1983). Proposed Treasury Regulation § 1.6661-5(b) defines a "tax shelter" for purposes of I.R.C. § 6661 (dealing with substantial understatements of income tax liability) as "(i) a partnership or other entity (such as a corporation or trust), (ii) an investment plan or arrangement, or (iii) any other plan or arrangement, if the principal purpose of the entity, plan, or arrangement, based on objective evidence, is the avoidance or evasion of Federal income tax." *Id.* The treasury regulations go on to say that typical tax shelters "are transactions structured with little or no motive for the realization of economic gain, which utilize the mismatching of income

Thus, "[t]he larger the amount deferred and the longer the postponement, the more advantageous the shelter."<sup>168</sup>

Most tax shelters adopt the limited partnership<sup>169</sup> mode of doing business because it allows investors to maximize their tax benefits.<sup>170</sup> "The limited partnership [itself] is not a taxpaying entity,<sup>171</sup> but [acts] merely as a conduit through which tax consequences pass to the partners/investors."<sup>172</sup> In a limited partnership, there must be

and deductions, overvalued assets or assets with values subject to substantial uncertainty, nonrecourse financing, financing techniques which do not conform to standard commercial business practices, or the mischaracterization of the substance of the transaction." *Id.* at 2-2.

168. Silver, *supra* note 1, at 906.

169. A limited partnership is a

type of partnership comprised of one or more general partners who manage business and who are personally liable for partnership debts, and one or more limited partners who contribute capital and share in profits [and losses] but who take no part in running business and incur no liability with respect to partnership obligations beyond [their capital] contribution.

BLACK'S LAW DICTIONARY 836 (5th ed. 1979), citing *Evans v. Galardi*, 16 Cal. 3d 300, 546 P.2d 313, 128 Cal. Rptr. 25, 30 (1979); see also UNIFORM LIMITED PARTNERSHIP ACT § 1 (1916). Both the Uniform Limited Partnership Act (1916) and the Revised Uniform Limited Partnership Act (1976) have been adopted by the Internal Revenue Service. Treas. Reg. § 301.7701-2(a)(5), T.D. 7889 (April 25, 1983).

However, satisfying the definition of a limited partnership under these Acts does not ensure that the entity will be taxed as a partnership for federal income tax purposes. A partnership will be deemed an "association taxable as a corporation" if it has more corporate characteristics than noncorporate characteristics. Treas. Reg. § 301.7701-2(a)(3), T.D. 7889 (April 25, 1983) applying *Morrissey v. Commissioner*, 296 U.S. 344 (1935). The corporate characteristics to be considered are: (1) associates; (2) an objective to carry on a business and divide the gains therefrom; (3) continuity of life, Treas. Reg. § 301.7701-2(b); (4) centralization of management, Treas. Reg. § 301.7701-2(c); (5) limited liability, Treas. Reg. § 301.7701-2(d); and (6) free transferability of interests, Treas. Reg. § 301.7701-2(e). Treas. Reg. § 301.7701-2(a)(1). All business entities, composed of at least two people, contain the first two corporate characteristics; therefore the analysis is limited to the remaining four corporate characteristics. If there are two corporate and two noncorporate characteristics present at the conclusion of the analysis, the entity will not be classified as an association, but rather as a partnership for Federal income tax purposes. Treas. Reg. § 301.7701-2(a)(3).

170. HAFT & FASS, *supra* note 167, at 2-4, B. BITTKER & L. STONE, FEDERAL INCOME TAXATION 959 (5th ed. 1980).

171. I.R.C. § 701 (1954) (partnership shall not be subject to income tax imposed by I.R.C.).

172. I.R.C. §§ 701 ("[p]ersons carrying on business as partners shall be liable for income tax only in their separate or individual capacities") and 702(a) (partners take into account separately their distributive share of partnership items when determining their individual income tax); see also B. BITTKER & L. STONE, *supra* note 170 (stating that publicly owned limited partnerships are business form most often used in tax shelters because they "most easily permit current income tax deductions and credits to flow through to the partners").

at least one general partner who is personally liable for the debts of the partnership.<sup>173</sup> The limited partners are, normally, the investors in the tax shelter.<sup>174</sup> The limited partnership form is particularly attractive to investors because it allows them to participate in the profits and losses of the limited partnership while having their liability for partnership debts limited to their committed investment in the tax shelter.<sup>175</sup> If, however, a limited partner takes an active role in the management of the limited partnership's affairs, he sacrifices his limited liability and is held to the obligations of a general partner.<sup>176</sup>

All tax shelters attempt to combine the following elements so that investors can maximize their tax benefits: (1) leverage;<sup>177</sup> (2) artificial losses;<sup>178</sup> (3) acceleration of artificial losses;<sup>179</sup> and (4) utilization of the accrual method of accounting so that the timing of losses for

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173. See *supra* note 169. "Typically, a real estate developer or promoter will locate a suitable project [for rehabilitation] and form a limited partnership, for which the developer or promoter will serve as general partner." Martin & Tang, *supra* note 93, at 58, col. 1.

174. See *supra* note 169. "Upon purchase of limited partnership interests, the investors become entitled to share in the partnership's income, gains, losses, deductions and credits." Martin & Tang, *supra* note 93, at 58, col. 1.

175. See *supra* note 169; see also UNIFORM LIMITED PARTNERSHIP ACT §§ 1 ("the limited partners as such shall not be bound by the obligations of the partnership") and 7 ("Limited Partner Not Liable to Creditors").

176. UNIFORM LIMITED PARTNERSHIP ACT § 7 stating: "A limited partner shall not become liable as a general partner unless, in addition to the exercise of his rights and powers as a limited partner [as set forth in § 10], he takes part in the control of the business."

177. See *infra* notes 181-99 and accompanying text for a discussion of leverage as used in real estate (rehabilitation) tax shelters.

178. Examples of artificial losses include depreciation, depletion, and amortization. HAFT & FASS, *supra* note 167, at 2-2. Artificial losses provide a substantial reduction of current income in the form of tax deductions, but do not require the taxpayer to match the accounting entry with a cash payment as is required of most tax deductions. *Id.* Therefore, artificial losses provide a significant tax benefit. *Id.*

179. In a real estate tax shelter, acceleration of artificial losses is accomplished by using one of the accelerated methods of depreciation, see *supra* note 45, which provide the partnership with greater depreciation deductions in earlier years. *Id.* By obtaining a larger depreciation deduction through the use of an accelerated method, a greater partnership loss can be generated and passed through to the partners. This can occur because most real estate tax shelters lack any substantial income in the initial years of the renovation with which to offset the accelerated depreciation deduction. See *infra* notes 188-91 and accompanying text for an example of accelerating losses through the use of a mortgage.

In the case of a rehabilitation tax shelter, the partners also want to claim the rehabilitation credit and can only use accelerated depreciation to depreciate the original basis of the building prior to the rehabilitation. See *supra* note 93. Straight-line depreciation must be used on the portion of the building's basis attributable to the qualified rehabilitation expenditures, see *supra* note 45, which creates an

deduction no longer matches the timing of the income that they generate.<sup>180</sup>

Leverage is the cornerstone of the real estate tax shelter.<sup>181</sup> Leverage is "[t]he use of a smaller investment to generate a larger rate of return through borrowing."<sup>182</sup> The initial function of a real estate tax shelter is to assemble enough capital "up front" to finance construction or rehabilitation.<sup>183</sup> The major sources of this capital are the partners' investments in the tax shelter and any money borrowed from an institutional lender.<sup>184</sup> These items increase the basis of a partner's interest in the partnership.<sup>185</sup> The adjusted basis of the partner's interest in the partnership limits the amount of the

artificial loss, but does not allow the loss to be accelerated.

Note that an entity, plan, or arrangement will not be considered to have as its principal purpose the avoidance or evasion of Federal income taxes as a result of its claiming the investment tax credit (which includes the rehabilitation credit) or taking an ACRS allowance. Prop. Treas. Reg. § 1.6661-5(b)(2) (March 15, 1983).

180. BITTKER & STONE, *supra* note 170, at 57 n.7, provide a distinction between the cash method of accounting and the accrual method of accounting:

The tax law allows two principal accounting methods. Under the cash method, the taxpayer reports income actually received and claims deductions for items actually paid. Items of income earned but not yet received and deductible items incurred but not yet paid are ignored. Under the accrual method, the time of receipt or payment is not generally relevant. Instead, income is reported when a fixed and determinable amount is owed to the taxpayer, and deductions are claimed when the taxpayer becomes liable to pay a fixed and determinable amount.

*Id.*

Thus, the taxpayer can deduct § 162 ordinary and necessary business expenses and § 212 expenses incurred for the production of income which are attributable to the activities of the tax shelter when the taxpayer becomes liable to pay a fixed and determinable amount. *See, e.g., Natco Corp. v. United States*, 240 F.2d 398, 400 (3d Cir. 1956) (taxpayer's liability to pay interest was fixed and determinable even though timing of interest payments was not and under accrual method of accounting he could deduct unpaid interest in year in which interest accrued). These types of deductions shelter current unrelated income with the result that the taxpayer may use the money saved until such time as the expenses must be actually paid. BITTKER & STONE, *supra* note 170, at 571.

181. *See Silver*, *supra* note 1, at 906 n.134 (citing A. AXELROD, C. BERGER, & Q. JOHNSTONE, *LAND TRANSFER AND FINANCE* 1092 (2d ed. 1978)).

182. BLACK'S LAW DICTIONARY 816 (5th ed. 1979).

183. *See supra* note 181.

184. BITTKER & STONE, *supra* note 170, at 571-74.

185. The adjusted basis of an investor's interest in the partnership is the amount of his or her investment (capital contribution) as determined under I.R.C. § 722, increased or decreased by his distributive share of the partnership items listed in I.R.C. § 702. This adjusted basis will be increased by the partner's share of the liabilities of the partnership which is considered to be a contribution of money under I.R.C. § 722. I.R.C. § 752(a) (1954); *see also Crane v. Commissioner*, 331 U.S. 1 (1947) (which allows amount of mortgage taken on building to be added to its basis and provided analogy for I.R.C. § 752(a)).

distributive share of partnership losses which can be passed through to a partner.<sup>186</sup> On the partner's individual tax return, these losses can be used to offset other sources of income, thereby reducing the partner's overall tax liability.<sup>187</sup>

A partnership can create a loss by borrowing money in the form of a mortgage on the structure to be rehabilitated. The building's basis would be increased by the amount of the mortgage.<sup>188</sup> This basis increase would allow for greater depreciation deductions that could be used to offset partnership income.<sup>189</sup> The interest expense paid on the mortgage loan also would be deductible and would provide a further reduction of partnership income.<sup>190</sup> During the

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186. I.R.C. § 704(d) (1978) (espousing limitation set forth in text); I.R.C. § 702(a)(8) (1954) (allowing partner's distributive share of partnership losses to pass through to partner's individual tax return).

187. The concept of leveraging can best be illustrated by applying the aforementioned principles of partnership taxation, *supra* notes 185-86 and accompanying text, to an example of a real estate tax shelter set up as a general partnership. Assume that Mr. A invests \$50,000 capital in a rehabilitation tax shelter. The partnership also borrows money from a bank in order to generate enough capital to finance the rehabilitation. Mr. A's share of the partnership liability is also \$50,000. The basis of Mr. A's partnership interest is \$100,000 (\$50,000 capital contribution under I.R.C. § 722, *supra* note 185, increased by \$50,000 pursuant to I.R.C. § 752(a), *supra* note 185). If the partnership incurs a loss from business activity and Mr. A's distributive share of partnership loss is \$100,000, he will be able to claim a \$100,000 loss on his individual tax return even though he has only made a cash outlay of \$50,000 because he falls within I.R.C. § 704(d). See *supra* notes 185-86 and accompanying text. Thus, through the use of leverage, Mr. A gets \$100,000 in deductions for a \$50,000 investment. See *infra* notes 201-05 and accompanying text for a discussion of the inapplicability of the "at-risk" rules to real estate tax shelters which permits the above result. If Mr. A is in the fifty percent tax bracket, he will save \$50,000 in tax liability and his investment will have cost him nothing.

188. *Crane v. Commissioner*, 331 U.S. 1 (1947) (holding that adjusted basis of property shall be increased by amount of any debt (mortgage) incurred on property).

189. See *supra* note 45 for a discussion of depreciation. Depreciation as set forth in I.R.C. §§ 167 and 168 is an ordinary and necessary business expense under I.R.C. § 162 and is deducted from the gross income of the partnership in order to determine the taxable income or loss of the partnership. I.R.C. § 703(a) (1982) (providing that taxable income/loss of partnership is calculated in same way as that of individual under I.R.C. §§ 62, 63(b), with certain exceptions).

190. I.R.C. § 163(a) (1954) (providing that there shall be allowed as deduction all interest paid or accrued within taxable year on indebtedness). However, when interest is paid or accrued on indebtedness incurred to purchase or carry property held for investment (as would be the case when a mortgage is taken in order to facilitate the rehabilitation project) it qualifies as "investment interest" under I.R.C. § 163(d)(3)(D) (1984) and the amount of the deduction for such interest is limited by I.R.C. § 163(d)(1) (1976). The interest might also fall within the provisions of I.R.C. § 189 (1976) rather than I.R.C. § 163(d). I.R.C. § 163(d)(4)(B) (1982). I.R.C. § 189 requires the capitalization and amortization of real property construction period interest and taxes which also reduces the tax benefit of the interest deduction.

initial stages of a real estate tax shelter, the income of the partnership is normally no greater than these depreciation and interest deductions, and the partnership will suffer a loss which will be passed through to the partners and deducted on their individual returns.<sup>191</sup>

It is, therefore, common practice in the area of tax shelters to use leverage, provided that it is not used to overvalue the structure to create excessively large deductions which will be used to offset the gross income of the tax shelter.<sup>192</sup> Leverage is an essential element of a successful real estate tax shelter because it creates a partnership loss by increasing the deductions which are used to offset partnership income. Further it increases a partner's basis in the partnership thereby allowing a greater amount of partnership loss to pass through to the partner's individual return where it can be used to offset other sources of income.<sup>193</sup>

In the case of a limited partnership, a distinction must be made between recourse and nonrecourse financing.<sup>194</sup> When recourse financing is used, the general partner is personally responsible for the partnership's liability and only he can increase the basis of his partnership interest by the amount of the liability.<sup>195</sup> The limited partners gain no tax advantage from the use of recourse financing because the basis of their interest in the partnership is not increased

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191. See *supra* note 178 and accompanying text.

192. The I.R.S. will challenge the interest deductions taken relating to property on which there exists a non-recourse mortgage if the amount of the nonrecourse mortgage exceeds the fair market value of the property. Rev. Rul. 77-110, 1977-1 C.B. 110.

Furthermore, a non-recourse mortgage in excess of the fair market value of the building does not give the borrower any incentive to pay off the mortgage to justify an increase in the basis of the property and thus, greater depreciation deductions. *Crane v. Commissioner*, 331 U.S. 1 (1947); Rev. Rul. 77-110, 1977-1 C.B. 110. For example, if the I.R.S. determines that the fair market value of the structure is \$1,000,000 and discovers that the tax shelter has taken a \$1,950,000 nonrecourse mortgage on the structure, it will not include the \$950,000 excess in the basis of the building and the tax shelter will not be able to take a depreciation deduction on the excess.

193. See *supra* note 181 and accompanying text; BITTKER & STONE, *supra* note 170, at 1002.

194. See *infra* notes 195, 198 and accompanying text for a discussion of recourse and nonrecourse financing, respectively.

195. HAFT & FASS, *supra* note 167, at 2-23, citing Treas. Reg. § 1.752-1(a)(2), T.D. 6500 (1960) ("if the general partner is personally liable on a partnership liability, the general partner, and not the limited partners, will include such liability in the basis of his partnership interest") and Treas. Reg. § 1.752-1(e), T.D. 6500 (1960) ("if the partnership assumes a liability so that the general partner becomes personally liable, only the general partner's basis for his interest in the partnership would be increased by the amount of such liability").

by their distributive share of the recourse loan.<sup>196</sup> The limited partners can deduct partnership losses only to the extent of their capital contributions to the tax shelter.<sup>197</sup> For this reason, most limited partnerships use nonrecourse financing where none of the partners have any personal obligation with respect to a partnership liability.<sup>198</sup> When non recourse financing is used, all partners, including limited partners, are deemed to share in the partnership liability in the same proportion as they share in partnership profits.<sup>199</sup> The limited partner, therefore, may include in the basis of his partnership interest his proportionate share of nonrecourse partnership liabilities and obtain the aforementioned benefits from the use of leverage.<sup>200</sup>

The tax provisions which allow partnership losses to pass through to the partners' individual tax returns provide the greatest investment incentive when used in a real estate tax shelter because the holding of real property by a taxpayer for the purpose of carrying on a trade or business or for the production of income is not subject to the "at risk" rules.<sup>201</sup> In all other types of tax shelters and investment activities, the "at risk" rules limit "the deduction of losses otherwise allowable in a particular taxable year, for certain taxpayers and specified activities,<sup>[202]</sup> to the aggregate amount with respect to which the taxpayer is 'at risk'<sup>[203]</sup> at the end of the year."<sup>204</sup> In the case of a real estate tax shelter, however, the investors/partners do not have to be "at risk" and may claim loss deductions in excess of

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196. See *supra* note 195.

197. See *supra* notes 185-87 & 195.

198. Treas. Reg. § 1.752-1(e), T.D. 6500 (1960) ("as in the case of a mortgage on real estate acquired by the partnership without the assumption by the partnership or any of the partners of any liability on the mortgage").

199. *Id.*

200. HAFT & FASS, *supra* note 167, at 2-23.

201. I.R.C. § 465(c)(3)(D) (1978).

202. I.R.C. § 465(a)(1) (1984) ("at risk" rules apply to individuals, sole proprietorships, estates, trusts, shareholders in subchapter S corporations, partners in a partnership, and subchapter C corporations where the stock ownership requirements of I.R.C. § 542(a)(2) are met); I.R.C. § 465(c)(1) (1978) (providing activities to which § 465 "at risk" rules apply).

203.

A taxpayer has "at risk" the sum of the amount of money and the adjusted basis of property contributed by him to the activity, and amounts borrowed with respect to the activity to the extent that he is personally liable for repayment or has pledged property other than property used in that activity as security (to the extent of the net fair market value of his interest in such property).

HAFT & FASS, *supra* note 167, at 9-2; see I.R.C. § 465(b) (1978).

204. HAFT & FASS, *supra* note 167, at 9-2.



their investment in the tax shelter.<sup>205</sup> The tax shelter uses leverage in the form of nonrecourse financing in order to create a greater partnership loss that can be passed through to the partners.<sup>206</sup> Most tax shelters attempt to create a situation where the loss deduction that is passed through to the partners is two to three times the taxpayer's investment in the tax shelter.<sup>207</sup> When such loss deductions are combined with the partner's distributive share of the rehabilitation credit, he is able to offset his investment in the tax shelter with tax benefits he obtains at a very early stage of the tax shelter's life.<sup>208</sup>

In time, however, a partnership loss will no longer be generated by the property because taxable income does not exceed the cash flow<sup>209</sup> of the investment. At this "cross-over point,"<sup>210</sup> the individual partners incur a tax liability rather than a tax savings and the tax shelter no longer exists.<sup>211</sup> The partners will attempt to find a buyer for their partnership interest or a buyer for the building.<sup>212</sup> In most cases, the building will be sold because the partner's partnership interest lacks appeal as an investment due to the absence of the tax shelter.<sup>213</sup> The building is likely to be sold at a gain<sup>214</sup> because real estate normally appreciates in value over time,<sup>215</sup> especially where

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205. *Id.* at 2-3.

206. *See supra* note 198 and accompanying text.

207. Interview with Donald L. Sharpe, Esq., Professor of Taxation, Fordham University School of Law (Jan. 31, 1984).

208. *Id.*; *see also* Silver, *supra* note 1, at 906 n.134.

209. "Cash flow" is a comparison between cash that is actually received by an entity against cash that actually gets paid out by the entity. *See* D. KIESO & J. WEYGANDT, *INTERMEDIATE ACCOUNTING* 1079 (3d ed. 1980). Cash flow in a real estate venture is normally computed by beginning with the net rental income generated by the real estate less taxes, interest, loan amortization, and similar items plus depreciation. *Id.*

210. Interview with Donald L. Sharpe, Esq., Professor of Taxation, Fordham University School of Law (Jan. 31, 1984).

211. A partner will incur a tax liability because the loan amortization computed on the recourse or nonrecourse financing used by the tax shelter exceeds the amount of the depreciation deduction allowable in the taxable year. *Id.* Thus, deductible items will be less than cash outlay items resulting in greater taxable income than cash flow. In this situation, a loss from operations cannot be generated and the excess taxable income will pass through to the partners, thus marking an end to the tax shelter. *Id.*

212. *Id.*

213. *Id.*

214. Gain from the sale of property shall be the excess of the amount realized from the sale (as determined under I.R.C. § 1001(b)) over the adjusted basis of the property (as determined under I.R.C. § 1011). I.R.C. § 1001(a) (1954).

215. Interview with Michael T. Madison, Esq., Professor of Property and Real Estate Financing, Fordham University School of Law (Feb. 5, 1985). Note also that "[t]here is little doubt that the prices of older buildings will rise to reflect

the rehabilitation itself will have increased the fair market value of the structure.<sup>216</sup> The building would qualify as a capital asset,<sup>217</sup> and the amount of any gain recognized on the sale of the structure would be subject to the sixty percent long-term capital gains deduction.<sup>218</sup> This deduction provides the final advantage to those investing in a real estate tax shelter that is set up in the form of a limited partnership. It allows the "character of the gain"<sup>219</sup> to pass through to a partner's individual return where he gets the benefit of the capital gains deduction.<sup>220</sup> In effect, there has been a conversion of ordinary income into capital gain which results in a lesser amount of tax eventually being paid by the partners.<sup>221</sup>

The capital gains deduction may not yield a significant benefit if either accelerated depreciation or ACRS<sup>222</sup> were used to depreciate the structure since the gain realized on its sale would be subject to the depreciation recapture rules.<sup>223</sup> The recapture rules under ACRS provide that there will be no recapture of depreciation on the sale of real estate, whether "residential"<sup>224</sup> or "nonresidential,"<sup>225</sup> if the straight-line depreciation method is used.<sup>226</sup> However, upon the sale of residential real estate under ACRS, the difference between the

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[the advantages provided by the rehabilitation credit], and rehabilitations will increase sharply." Gensheimer, *supra* note 93, at 299. "The increased demand for buildings over thirty years old will drive up the price of those buildings, and their current owners will enjoy a windfall appreciation in property values." *Id.* at 314.

216. Silver, *supra* note 1, at 907.

217. I.R.C. § 1221 (1981) (capital asset defined).

218. I.R.C. §§ 1202 (1980) (60 percent of amount of net long-term capital gain shall be deduction from gross income); 1222 (1984) (prior to 1984 Act, capital asset had to be held for more than one year before sold in order to qualify for long-term capital gains treatment; this holding period has been reduced to six months under the 1984 Act).

219. I.R.C. § 702(b) (1976) (character of any item of income, gain, loss, deduction, or credit included in partner's distributive share of partnership items shall be determined as if such item were realized directly from source from which it was realized by partnership).

220. HAFT & FASS, *supra* note 167, at 2-3 (recognizing possibility of capital gain on ultimate sale or disposition of building as one of distinct features applicable to real estate tax shelters).

221. *Id.* at 2-2; see also Explanation of Tax Reform Act of 1984, 67 FED. TAX GUIDE REP. (CCH) ¶ 601 (1984); Silver, *supra* note 1, at 907.

222. See *supra* note 45 and accompanying text for a discussion of accelerated and ACRS depreciation.

223. Martin & Tang, *supra* note 93, at 60, col. 2, 3; Silver, *supra* note 1, at 908.

224. I.R.C. § 167(j)(2) (1969).

225. See *supra* note 54 and accompanying text for a discussion of nonresidential real estate; see also HAFT & FASS, *supra* note 167, at 2-3, 2-86.

226. HAFT & FASS, *supra* note 167, at 2-3, 2-86.

accelerated depreciation taken and the amount of depreciation that would have been taken if the straight-line method had been used is recaptured to the extent of any gain realized on the sale and taxed at ordinary income rates.<sup>227</sup> Similarly, upon the sale of non-residential real estate utilizing an accelerated depreciation method under ACRS, all depreciation deductions taken will be recaptured and taxed at ordinary income rates.<sup>228</sup> These rules offset, to some extent, the tax advantages obtained by the tax shelter when it accelerated artificial losses<sup>229</sup> through the use of accelerated depreciation in order to defer tax payment to later years.<sup>230</sup> The full tax must be paid, but the tax shelter has received the interest-free use of the funds over a substantial period of time.<sup>231</sup>

The depreciation recapture rules have a unique application in the context of an historic rehabilitation tax shelter since the straight-line depreciation requirement must be met in order to qualify for the rehabilitation credit.<sup>232</sup> The recapture rules are not applicable to the portion of the building's basis attributable to the qualified rehabilitation expenditures because of the straight-line depreciation requirement,<sup>233</sup> but the rules apply to the original portion of the building's basis provided that an accelerated depreciation method was used rather than the straight-line method.<sup>234</sup>

## B. Legislative Attacks on Tax Shelters

"In the early 1970's the syndicated tax shelter limited partnership<sup>235</sup> became popular as an investment vehicle."<sup>236</sup> "The limited partnership form was used mostly where pools of capital were amassed from numbers of investors by a promotor [sic] who found and packaged the venture, sold the partnership interests, and served as general partner."<sup>237</sup> The capital received from investors was combined with additional capital obtained through the use of nonrecourse

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227. I.R.C. § 1250 (1983); *see also* HAFT & FASS, *supra* note 167, at 2-3, 2-85.

228. I.R.C. § 1245 (1984); *see also* HAFT & FASS, *supra* note 167, at 2-3, 2-86.

229. *See supra* note 179 and accompanying text.

230. *Id.*

231. A. AXELROD, C. BERGER, & Q. JOHNSTONE, *LAND TRANSFER AND FINANCE* 1093 (2d ed. 1978); Silver, *supra* note 1, at 906 n.134 ("[t]his temporary forgiveness amounts to an interest free loan or government subsidy of the venture").

232. *See supra* note 92 and accompanying text.

233. *See supra* note 226 and accompanying text.

234. *See supra* notes 227-28 and accompanying text.

235. *See supra* notes 166-234 and accompanying text.

236. BITTKER & STONE, *supra* note 170, at 1002.

237. *Id.* at 1003; *see supra* notes 164-71 and accompanying text.

financing<sup>238</sup> in order to obtain the advantages of leverage.<sup>239</sup> The partner's distributive share of the financing increased his basis in the partnership<sup>240</sup> and his share of partnership deductions,<sup>241</sup> thereby increasing the extent to which the partner could deduct losses on his individual return.<sup>242</sup> Congress and the Internal Revenue Service began to scrutinize tax shelters of all types but especially those which were characterized as "abusive tax shelters."<sup>243</sup> Beginning with the TRA, Congress enacted various measures which were designed to limit or defeat the tax advantages which could be obtained by investing in a syndicated tax shelter limited partnership.<sup>244</sup> Many of these legislative measures have had a direct impact on rehabilitation tax shelters.<sup>245</sup>

The TRA, which launched the first major attack on tax shelters employing the limited partnership form of doing business,<sup>246</sup> enacted various tax provisions which were designed to attack such tax shelters "by limiting losses,<sup>[247]</sup> by requiring capitalization of certain items that prior [to the TRA] had been currently deductible<sup>[248]</sup> and by tightening up on the recapture provisions."<sup>249</sup>

The TRA proposed to limit partnership losses by imposing a ceiling upon the retroactive allocation of partnership income or losses that occur when a partner's distributive share is altered to avoid adverse tax consequences.<sup>250</sup> The TRA also required that special allocations

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238. See *supra* notes 198-200 and accompanying text for a discussion of non-recourse financing.

239. See *supra* notes 181-93 and accompanying text for a discussion of leverage as used in real estate and rehabilitation tax shelters.

240. See *supra* note 185 and accompanying text.

241. See *supra* notes 186-91 and accompanying text.

242. See *supra* note 193 and accompanying text.

243. BITTKER & STONE, *supra* note 170, at 1003.

244. *Id.* Many of the legislative measures enacted as a means to deter the use of tax shelters are beyond the scope of this Note. This Note will develop only those measures relevant to real estate and rehabilitation tax shelters.

245. See *infra* notes 246-330 and accompanying text.

246. BITTKER & STONE *supra* note 170, at 1003.

247. See *infra* notes 250-54 and accompanying text.

248. See *infra* notes 255-57 and accompanying text.

249. BITTKER & STONE, *supra* note 170, at 1003. See *infra* notes 258-61 and accompanying text for a discussion of the provisions in the TRA dealing with the recapture of depreciation.

250. I.R.C. § 706(c)(2)(B) (1984) deals with the disposition of less than an entire partnership interest and was designed to prevent retroactive allocations. I.R.C. § 706(c)(2)(B) provides that "[t]he taxable year of a partnership shall not close. . . with respect to a partner who sells or exchanges less than his entire interest in the partnership or with respect to a partner whose interest is reduced (whether by entry of a new partner, partial liquidation of a partner's interest, gift, or otherwise)." *Id.* I.R.C. § 706(c)(2)(B) requires both the existing partner and the individual

between partners as to their distributive share of partnership gains and losses which did not reflect their interest in the partnership ultimately have "substantial economic effect"<sup>251</sup> so that such special allocations could be recognized for tax purposes.<sup>252</sup> The TRA also enacted provisions limiting the deduction of investment interest<sup>253</sup> and prepaid interest.<sup>254</sup>

Other TRA provisions required the capitalization of certain expenditures which had previously been deductible from gross income.<sup>255</sup> The major provisions affecting real estate tax shelters required the capitalization of partnership syndication and organization fees<sup>256</sup> and the capitalization of real property construction period interest and taxes.<sup>257</sup>

The final measures taken by the TRA were designed to remove any loopholes that existed in the recapture provisions of the Code.<sup>258</sup> The amount of the additional first year depreciation allowance<sup>259</sup> that could be elected by a taxpayer under the Code was limited by

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receiving all or part of the existing partner's interest in the partnership to determine their pro rata share of partnership items taking into account their "varying interests" during the taxable year. Treas. Reg. § 1.706-1(c)(4), T.D. 7286 (1973); see also HART & FASS, *supra* note 167, at 2-132 to 2-137.

251. I.R.C. § 704(b)(2) (1976) (allocation must reflect partners' capital accounts in order to have substantial economic effect).

252. I.R.C. § 704(b)(2) (1976); see *supra* note 192 and accompanying text for a discussion of the "substantial economic effect" rule as it applies to tax shelters under current law.

253. I.R.C. § 163(d) (1984) provides that for a taxpayer other than a corporation, the amount of "investment interest" (as defined in I.R.C. § 163(d)(3)(D)) otherwise allowable as a deduction, is limited in the following order to: \$10,000 *plus* the amount of "net investment income" (as defined in I.R.C. § 163(d)(3)(A)) *plus* the amount by which the deductions allowable under I.R.C. §§ 162, 163, 164(a)(1),(2), or 212 attributable to property of a taxpayer subject to a net lease exceeds the rental income produced by the property during the taxable year.

254. I.R.C. § 461(g)(1) (1976).

255. BITTKER & STONE, *supra* note 170, at 1003.

256. I.R.C. § 709(b)(1) (1976) provides that "organizational expenses" (as defined in I.R.C. § 709(b)(2)) can be treated as deferred expenses which can be amortized over a period of not less than sixty months if the partnership so elects. If the partnership fails to elect such treatment, no deduction shall be allowed for expenses paid or incurred to organize a partnership or to promote the sale of an interest in such a partnership. I.R.C. § 709(a) (1976).

257. I.R.C. § 189(a) (1982) provides that no deduction shall be allowed for "real property construction period interest and taxes" (as defined in I.R.C. § 189(e)(1),(2)) and that these expenses should be capitalized. *Id.* Such expenses, however, may be amortized according to the percentages set forth in I.R.C. § 189(b) (1981).

258. See BITTKER & STONE, *supra* note 170, at 1003.

259. I.R.C. § 179(a) (1981) allows a taxpayer to elect to treat the cost of "§ 179 property" (as defined in I.R.C. § 179(d)(1),(2)) as an expense not chargeable to the capital account of the asset and to deduct such expense in the taxable year in which the "§ 179 property" was placed into service.

applying the annual dollar limitation to both the partner and the partnership.<sup>260</sup> The amount of depreciation recapture on real property was also increased under the TRA to provide a further long range disincentive to tax shelters that had adopted an accelerated depreciation method.<sup>261</sup>

The Tax Reform Act of 1978<sup>262</sup> extended the "at risk" rules to all business activities, other than real estate, conducted by partnerships.<sup>263</sup> The "at risk" rules, therefore, do not affect tax shelters organized for the purpose of rehabilitating historic structures.<sup>264</sup> For this reason, real estate and rehabilitation tax shelters currently remain the most attractive investment because partners can deduct losses in amounts greater than that to which they are "at risk" in the investment.<sup>265</sup>

However, legislation which followed the TRA and the Tax Reform Act of 1978 provided various tax provisions and penalties designed to discourage certain practices employed by tax shelters and to prevent the understatement of a partner's tax liability.<sup>266</sup> Many of these provisions could provide disincentives to parties interested in investing in tax shelters and, thus, may indirectly affect rehabilitation projects set up as tax shelters.

In 1981, ERTA set forth various provisions which assessed additional income tax liability if violated.<sup>267</sup> The first provision which dealt with "valuation overstatements"<sup>268</sup> provided that if an individual had an underpayment of income tax attributable to a valuation overstatement,<sup>269</sup> there would be added to his income tax liability an amount equal to the "applicable percentage"<sup>270</sup> of the under-

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260. I.R.C. § 179(d)(8) (1982) provides that the dollar limitation found in I.R.C. § 179(b)(1) (usually \$5000) with respect to an election made to deduct rather than capitalize the cost of certain depreciable business assets in the year they were placed into service shall apply with respect to the partnership and with respect to "each" partner.

261. I.R.C. § 1250 (1983).

262. See *supra* note 52 and accompanying text.

263. See *supra* notes 201-05 and accompanying text for a discussion of the "at-risk" rules as provided in I.R.C. § 465.

264. See *supra* note 205 and accompanying text.

265. Martin & Tang, *supra* note 93, at 58, 60.

266. See *infra* notes 267-329 and accompanying text.

267. The Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 722, 95 Stat. 172, 341 (1981) (codified in various sections of 26 U.S.C.).

268. I.R.C. § 6659 (1984).

269. See *infra* note 272 and accompanying text for a definition of "valuation overstatement."

270. I.R.C. § 6659(b) (1981) provides that the "applicable percentage" is ten percent if the valuation claimed is 150 percent or more, but not more than 200 percent of the correct valuation; twenty percent if the valuation claimed is more

payment attributable to the valuation overstatement.<sup>271</sup> A "valuation overstatement [occurs] if the value of any property, or the adjusted basis of any property, claimed on any return is 150 percent or more of the amount determined to be the correct amount of such valuation or adjusted basis (as the case may be)."<sup>272</sup> Even if there has been a valuation overstatement, the provision<sup>273</sup> will not apply "to any property which, as of the close of the taxable year for which there is a valuation overstatement, has been held by the taxpayer for more than 5 years"<sup>274</sup> or "if the underpayment for the taxable year attributable to the valuation overstatement is less than \$1000."<sup>275</sup> If the valuation overstatement provision is relevant,<sup>276</sup> the additional tax assessed will be subject to the interest rate applicable to deficiencies<sup>277</sup> compounded daily.<sup>278</sup> This provision was designed to prevent owners of structures from obtaining elevated appraisals of the value of their property in order to obtain greater deductions which could be used to offset taxable income generated by the property.<sup>279</sup>

ERTA also provided that if any part of any underpayment of income tax were due to negligence or to intentional disregard of the rules set forth in the Code or Treasury Regulations but without intent to defraud, an individual's tax liability would be increased by an amount equal to five percent of the underpayment.<sup>280</sup> Ad-

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than 200 percent, but not more than 250 percent of the correct valuation; and thirty percent if the valuation claimed is more than 250 percent of the correct valuation. *Id.*

271. I.R.C. § 6659(a) (1981).

272. I.R.C. § 6659(c)(1) (1984).

273. *See supra* notes 269-71 and accompanying text.

274. I.R.C. § 6659(c)(2) (1981), *repealed by* Pub. L. No. 98-369, § 155(c)(1)(A), 98 Stat. 693-94 (1984) (for returns filed after December 31, 1984).

275. I.R.C. § 6659(d) (1983).

276. The concept of "valuation overstatements" can be shown by the following example. Assume the correct valuation of real estate owned by a partnership is \$1 million, but the partnership claims a valuation of \$2.7 million which results in a \$100,000 tax underpayment by the partners. Since the overvaluation (\$1.7 million) is more than 150 percent but less than 200 percent of the correct valuation, the "applicable percentage" to be applied under I.R.C. § 6659(b) is ten percent. Thus, the partners must now pay: (1) the underpayment caused by the overvaluation (\$100,000); (2) the additional tax assessed under I.R.C. § 6659(a) (10% of \$100,000 = \$10,000); and (3) interest compounded daily on the \$110,000 from the date that payment was due.

277. I.R.C. §§ 6601 (1984); 6621(a),(d)(3)(A)(i) (1984).

278. I.R.C. § 6622 (1982).

279. Act of Aug. 13, 1981, Pub. L. No. 97-34, 1981 U.S. CODE CONG. & AD. NEWS (95 Stat.) 351 (codified at I.R.C. § 6659).

280. I.R.C. § 6653(a)(1) (1981).

ditionally, an amount equal to fifty percent of the interest payable under the Code<sup>281</sup> for any underpayment due to negligence or intentional disregard of the rules or regulations would be added to the taxpayer's tax liability.<sup>282</sup>

TEFRA also decreased the attractiveness of rehabilitation tax shelters through its implementation of a new alternative minimum tax,<sup>283</sup> which may have "a dramatic impact on many rehabilitation projects, especially where the credit earned is substantial."<sup>284</sup> The alternative minimum tax is imposed at a flat twenty percent rate<sup>285</sup> on an individual's "alternative minimum taxable income"<sup>286</sup> which exceeds his "exemption amount."<sup>287</sup> The excess of the alternative minimum tax over an individual's regular income tax<sup>288</sup> for the year, determines the increase in the individual's tax liability for that year.<sup>289</sup>

"Alternative minimum taxable income" is computed beginning with "the adjusted gross income<sup>[290]</sup> . . . of the taxpayer for the taxable year—(1) reduced by the sum of—(A) the alternative tax net operating loss deduction,<sup>[291]</sup> plus (B) the alternative tax itemized deductions,<sup>[292]</sup> . . . and (2) increased by the amount of items of

281. The interest is to be determined under I.R.C. § 6601 (1975) (regarding interest on underpayment, nonpayment, or extensions of time for payment of tax).

282. I.R.C. § 6653(a)(2) (1983).

283. Pub. L. No. 97-248, § 201(a), 96 Stat. 324, 411 (1982) (codified at I.R.C. § 55). TEFRA repealed the "add-on minimum tax" imposed by I.R.C. § 56(a) and significantly amended the "alternative minimum tax" imposed by I.R.C. § 55, as they each had been applied to individuals other than corporations, for taxable years beginning after December 31, 1982. Pub. L. No. 97-248, § 201(d)(1), 96 Stat. 324, 413 (1982).

284. *Tax Incentives*, *supra* note 3, at 246.

285. I.R.C. § 55(a)(1) (1982).

286. See *infra* notes 290-96 and accompanying text for a discussion of how "alternative minimum taxable income" is determined under current law.

287. The "exemption amount" is \$40,000 for married individuals filing jointly and surviving spouses, \$30,000 for single individuals, and \$20,000 for married individuals who file a separate return. I.R.C. § 55(f)(1) (1982).

288. I.R.C. § 55(f)(2) (1984) defines "regular tax" as the amount of income imposed by the Code for the taxable year (computed without regard to I.R.C. § 55 and the taxes imposed by I.R.C. §§ 47(a), 72(m)(5)(B), 72(q), 402(e), 408(f), and 667(b)) reduced by the sum of the nonrefundable personal tax credits, foreign and miscellaneous tax credits, and business related credits (which includes the rehabilitation credit). *Id.*

289. I.R.C. § 55(a) (1982).

290. I.R.C. § 62 (1984).

291. I.R.C. § 55(d) (1982).

292. I.R.C. § 55(e)(1) (1982) provides that:

The term "alternative tax itemized deductions" means an amount equal to the sum of any amount allowable as a deduction for the taxable year (other than a deduction allowable in computing adjusted gross income) under—(A) § 165(a) for losses described in subsection (c)(3) or (d) of §



tax preference."<sup>293</sup> This amount, reduced by the taxpayer's exemption amount, is multiplied by twenty percent to arrive at the amount of alternative minimum tax.<sup>294</sup> Except for the foreign tax credit,<sup>295</sup> the amount of alternative minimum tax may not be offset by any of the tax credits allowable under the Code.<sup>296</sup> Thus, while a taxpayer could offset his regular income tax liability with the rehabilitation tax credit, he may not do so with respect to any alternative minimum tax.

This rule is important under TEFRA because, "even though a taxpayer may not have any tax preference items giving rise to an alternative minimum tax liability, he still may incur a substantial alternative minimum tax if the rehabilitation credit offsets a substantial amount of his regular income tax."<sup>297</sup> As a result, the new alternative

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165, (B) § 170 (relating to charitable deductions), (C) § 213 (relating to medical deductions), (D) this chapter for qualified interest [as defined in I.R.C. § 55(e)(3)-(5) (1982)], or (E) § 691(c) (relating to deductions for estate tax).

*Id.*

293. I.R.C. § 55(b) (1982). The "items of tax preference" are found in I.R.C. § 57 (1984). "Items of tax preference" relevant to real estate and rehabilitation tax shelters include: (1) I.R.C. § 57(a)(2) (1981) (the amount of accelerated depreciation deducted on I.R.C. § 1250 real property computed under I.R.C. § 167 which exceeds the depreciation deduction which would have been allowed had the taxpayer depreciated the property under the straight-line method); (2) I.R.C. § 57(a)(9) (1978) (an amount equal to the net capital gain deduction for the taxable year determined under I.R.C. § 1202); and (3) I.R.C. § 57(a)(12)(B) (1984) (the amount by which the deduction allowed under I.R.C. § 168(a) exceeds the deduction which would have been allowable for the taxable year had the 18 year real property been depreciated using the straight-line method [without regard to salvage value] over a recovery period of 18 years).

294. See *supra* note 287 and accompanying text.

295. I.R.C. § 27(a) (1984).

296. I.R.C. § 55(c) (1984).

297. *Tax Incentives*, *supra* note 3, at 246. The main reason why a taxpayer may still incur alternative minimum tax liability when he has no items of tax preference is that the computation of alternative minimum taxable income now begins with a taxpayer's "adjusted gross income" rather than with his or her "taxable income" as it had in the past. *Tax Incentives*, *supra* note 3, at 246; Tucker, *supra* note 107, at 71. Whitebread provides an excellent example of this situation in *Tax Incentives*, which is set forth below:

Assume that in 1983 a married taxpayer spends \$300,000 in a qualified rehabilitation of a [certified historic structure], entitling him to a \$75,000 tax credit. The taxpayer's adjusted gross income is \$150,000, and his itemized deductions are \$25,000, resulting in \$125,000 of taxable income.

The taxpayer's regular tax, filing jointly with two exemptions, is \$45,502. The \$75,000 tax credit will offset \$42,427 of 1983 tax (\$25,000 plus 85 percent of \$20,502), for a total regular tax of \$3,075.

The taxpayer has no tax preference items, and \$15,000 of his itemized deductions are allowable as an offset to alternative minimum taxable

minimum tax created under TEFRA may act as a further disincentive to projects which provide large rehabilitation credits and are funded by taxpayers in high income tax brackets.<sup>298</sup>

TEFRA also contains provisions designed to curtail abusive practices in tax shelters which could affect investors in real estate and rehabilitation tax shelters.<sup>299</sup> The first provision provides that if a taxpayer substantially understates his income tax liability for any taxable year, an amount equal to ten percent of any underpayment attributable to the understatement will be added to his tax liability.<sup>300</sup> There has been a substantial understatement of income tax liability if the amount of the understatement exceeds the greater of ten percent of the tax that should have been shown on the return for the taxable year or \$5000.<sup>301</sup> Normally, an understatement results from a position a taxpayer has taken on his return.<sup>302</sup> If the taxpayer can show either substantial authority for the position or adequately disclosed relevant information on the return affecting the item's tax treatment, he might avoid the additional tax.<sup>303</sup> In the case of tax shelters,<sup>304</sup> however, these exceptions do not apply, and the taxpayer is subject to the additional tax unless he can show that he believed that his tax treatment of the item was more likely than not the

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income. His alternative minimum taxable income is \$95,000 (\$150,000 adjusted gross income, less \$15,000 allowable itemized deductions, less \$40,000 exemption amount). The alternative minimum tax is \$19,000 (\$95,000 × 20 percent) and the alternative minimum tax due is \$15,925 (\$19,000 less \$3,075 regular tax).

The alternative minimum tax has increased the taxpayer's 1983 taxes by \$15,925 because the rehabilitation tax credit may not offset this tax. Since the taxpayer lost the benefit of \$15,925 of his rehabilitation tax credit in 1983, he can add this amount back to the unused credit amount for any credit carryover purposes [under I.R.C. § 55(c)(3)].

*Tax Incentives*, *supra* note 3, at 246-47.

298. *Id.* at 247.

299. See *infra* notes 300-10 and accompanying text.

300. I.R.C. § 6661(a) (1982).

301. I.R.C. § 6661(b)(1)(A) (1982).

302. An example of where a taxpayer will take a tax position which would result in an understatement of his tax liability would be where a taxpayer overvalues an asset in order to obtain greater depreciation deductions which would reduce his tax liability. See *supra* notes 268-79 and accompanying text for a discussion of the penalty imposed upon taxpayers who make valuation overstatements.

303. I.R.C. § 6661(b)(2)(B) (1982).

304. "Tax shelter," as used in the Code, means "(I) a partnership or other entity, (II) any investment plan or arrangement, or (III) any other plan or arrangement, if the principal purpose of such partnership, entity, plan, or arrangement is the avoidance or evasion of Federal income tax." I.R.C. § 6661(b)(2)(C)(ii) (1982).

proper treatment.<sup>305</sup> This provision may act as a disincentive to a party seeking to invest in a rehabilitation tax shelter which is speculative in nature and which might deal with issues of first impression.

TEFRA also imposed a penalty for promotion of abusive tax shelters,<sup>306</sup> enabled the Commissioner of the Internal Revenue Service to seek injunctive relief against a person who seeks to promote an abusive tax shelter,<sup>307</sup> and imposed a penalty on individuals who aided or abetted in the understatement of another individual's tax liability.<sup>308</sup> The 1984 Act expanded upon these provisions and added others<sup>309</sup> which may have an effect on an individual's decision to invest in or promote a rehabilitation tax shelter.

Under the 1984 Act, the penalty which can be imposed on a tax shelter promoter or organizer who makes false or fraudulent statements or gross valuation overstatements<sup>310</sup> is an amount equal to the greater of \$1000 or twenty percent of the gross income derived by the promoter or organizer from the activity.<sup>311</sup> The Commissioner of the Internal Revenue Service's authority was also extended under the 1984 Act to allow him to obtain injunctive relief against those engaging in activities which aid and abet the understatement of tax liability.<sup>312</sup> Finally, the 1984 Act requires that interest accruing after December 31, 1984, with respect to a substantial underpayment

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305. I.R.C. § 6661(b)(2)(C)(i) (1982).

306. I.R.C. § 6700(a) (1984) (imposing penalty equal to greater of \$1000 or 20 percent of gross income to be derived by individual from promoting an abusive tax shelter).

307. I.R.C. § 7408(a) (1984) (authorizing civil action in name of United States to enjoin any person from further engaging in conduct subject to penalty for promoting abusive tax shelters under I.R.C. § 6700).

308. I.R.C. § 6701(a) (1982) imposes a penalty on any person (e.g., attorneys, accountants, investment counselors) who aids, assists, or advises in the preparation or presentation of any tax return or document in connection with any matter arising under the internal revenue laws if he knows it will result in the understatement of the tax liability of another person. *Id.* The penalty amounts to \$1000 per person per transaction with respect to which the person knowingly aided and abetted in the understatement of tax liability. I.R.C. § 6701(b)(1),(3) (1982). For example, if an attorney knowingly wrote a favorable tax opinion for an abusive tax shelter, he could have a penalty imposed on him of \$1000 multiplied by the number of investors in the tax shelter whose tax liability was understated.

309. See *infra* notes 310-26 and accompanying text for a discussion of the 1984 Act provisions imposing a penalty on certain tax sheltered transactions.

310. Pub. L. No. 98-369, § 143(a), 98 Stat. 682 (1984) (codified at I.R.C. § 6700(a)); see *supra* note 306 and accompanying text.

311. *Id.*

312. Pub. L. No. 98-369, § 143(b), 98 Stat. 682 (1984) (subjecting activities which fall under I.R.C. § 6701 to government injunction under I.R.C. § 7408); see *supra* notes 307-08 and accompanying text.

attributable to a tax sheltered activity, will be imposed at an annual rate equal to 120 percent of the normal annual interest rate on deficiencies.<sup>313</sup>

The section of the 1984 Act which may ultimately limit the effectiveness and appeal of rehabilitation tax shelters provides for the extension of the "economic performance rule"<sup>314</sup> to the prepaid expenses of cash basis tax shelters.<sup>315</sup> Thus, a tax shelter whose taxable income is computed on the cash basis method may not deduct an expense any earlier than the time that an accrual basis taxpayer would treat the expense as having been incurred under the economic performance rule.<sup>316</sup> In effect, "a cash basis tax shelter may not deduct an expense until the expense is paid and economic performance occurs under the new rule."<sup>317</sup> Under an exception to the rule, however, a tax shelter may deduct expenses in the taxable year of prepayment provided that economic performance occurs within ninety days after the close of such year.<sup>318</sup> This deduction is limited to a taxpayer's cash basis<sup>319</sup> in the tax shelter.<sup>320</sup> A partner's cash basis in a tax shelter partnership consists of the adjusted basis of his partnership interest determined without regard to the partner's distributive share of partnership liabilities and amounts borrowed by the partner that are: (a) secured by any partnership assets; or

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313. Pub. L. No. 98-369, § 144, 98 Stat. 682, 682-84 (1984) (codified at I.R.C. §§ 6214(e); 6621(d)).

314. Prior to the 1984 Act, an accrual basis taxpayer was entitled to deduct the face amount of an accrued expense in the taxable year in which all of the events have occurred that determine the fact of liability and the amount of the liability can be determined with reasonable accuracy. Treas. Reg. § 1.461-1(a)(2), T.D. 6917 (1967). This test was interpreted by the courts to permit the current deduction of expenses that are related to activities to be performed or amounts to be paid in future years. Explanation of Tax Reform Act of 1984, 67 FED. TAX GUIDE REP. (CCH) ¶ 231 (July 9, 1984). Such "current deduction of future expenses, however, results in an overstated deduction to the extent that the time value of money is not taken into account." *Id.* To remedy this situation, the 1984 Act added I.R.C. § 461(h), which modifies the "all events" test espoused above and provides that "all of the amounts that establish liability for an amount, for the purpose of determining whether such amount has been incurred with respect to any item, are treated as not occurring any earlier than the time that economic performance occurs with respect to that item." *Id.*

315. Pub. L. No. 98-369, § 91(a), (g), 98 Stat. 598, 608 (1984) (codified at I.R.C. § 461(i)).

316. I.R.C. § 461(i)(1) (1984).

317. Explanation of Tax Reform Act of 1984, 67 FED. TAX GUIDE REP. (CCH) ¶ 231 (July 9, 1984).

318. I.R.C. § 461(i)(2)(A) (1984).

319. See *infra* note 321 and accompanying text for a definition of "cash basis."

320. I.R.C. § 461(i)(2)(B) (1984).

(b) arranged by the partnership or any person who participated in the organization, sale, or management of the partnership.<sup>321</sup>

The economic performance rule makes it more difficult for both cash and accrual basis tax shelters to offset current income with deductions for prepaid expenses in the case of cash basis tax shelters and future expenses in the case of accrual basis tax shelters.<sup>322</sup> Thus, the economic performance rule defeats the ability of investors in a tax shelter to defer income tax liability and makes such investments less attractive.<sup>323</sup>

The 1984 Act also added provisions requiring organizers of potentially abusive tax shelters to maintain customer lists<sup>324</sup> and to register with the Internal Revenue Service.<sup>325</sup> Failure to comply with either of these provisions results in the imposition of a penalty against the organizer.<sup>326</sup>

These legislative measures<sup>327</sup> were designed to limit the use of the limited partnership form to create a tax shelter effect.<sup>328</sup> Many of these provisions directly or indirectly reduce the tax benefits to an individual who has invested in a tax shelter or will influence an individual's decision to invest in or promote a tax shelter. While most of these provisions are limited in scope to abusive tax shelters, some impinge directly on the functioning of rehabilitation tax shelters and others may deter potential investors from participating in these shelters due to the possibility that penalties may be imposed on them. By doing so, provisions which were designed to limit abusive tax shelters may have inadvertently removed some of the incentives relied on by sizeable rehabilitation projects to attract investors.<sup>329</sup>

### C. Proposed Legislation to Reduce Incentives For Historic Rehabilitation and Use of Rehabilitation Tax Shelters

Proposed legislation before the House and Senate evidences a further reversal of the trend to using tax incentives to foster historic

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321. I.R.C. § 461(i)(2)(C) (1984).

322. Explanation of Tax Reform Act of 1984, 67 FED. TAX GUIDE REP. (CCH) ¶¶ 230, 231 (July 9, 1984).

323. See *supra* note 180 and accompanying text.

324. I.R.C. § 6112 (1984).

325. I.R.C. § 6111 (1984).

326. I.R.C. §§ 6707(a) (1984) (penalty for failure to register tax shelter); 6708 (1984) (penalty for failure to maintain lists of investors in potentially abusive tax shelters).

327. See *supra* notes 246-326 and accompanying text.

328. See *supra* notes 243-45 and accompanying text.

329. Since these provisions have only been operative since July 1984, their ultimate effect is indeterminable at this point in time.

rehabilitation.<sup>330</sup> First, a proposed Senate amendment to the 1984 Act suggested that the rehabilitation credit be reduced with respect to "30-year" and "40-year" structures.<sup>331</sup> This amendment advocated reduction of the rehabilitation credit to ten percent and fifteen percent for "30-year" and "40-year" qualified rehabilitated buildings, respectively, while still requiring a full basis adjustment<sup>332</sup> in the amount of the credit.<sup>333</sup> The Conference Committee, however, rejected this proposal, and it was not included in the 1984 Act.<sup>334</sup>

After the passage of the 1984 Act, Treasury Secretary Donald T. Regan, proposed a tax plan which would eliminate all of the current tax incentives favoring historic rehabilitation.<sup>335</sup> This tax plan proposed the repeal of the investment tax credit, accelerated and ACRS depreciation, and long-term capital gains tax provisions.<sup>336</sup> Two comparable tax plans, one sponsored by Senator William Bradley and Representative Richard Gephardt, the other sponsored by Representative Jack Kemp and Senator Robert Kasten, propose provisions virtually analogous to the Treasury Department plan.<sup>337</sup>

The major rationale given for the suggested repeal of these tax provisions is the need for a more equitable and simplified taxing system.<sup>338</sup> If the plans are adopted in their present form, however, they will eliminate the major devices<sup>339</sup> used by rehabilitation tax shelters to provide incentives to individual investors.<sup>340</sup> Were this to

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330. See *infra* notes 332-45 and accompanying text for a discussion of the proposed legislation in this area.

331. Tax Reform Bill of 1984, 71 STANDARD FED. TAX REP. (CCH) ¶ 234 (June 26, 1984).

332. See *supra* notes 107-10 and accompanying text.

333. Tax Reform Bill of 1984, 71 STANDARD FED. TAX REP. (CCH) ¶ 234 (June 26, 1984).

334. *Id.*

335. The Record, Nov. 27, 1984, at A-1, col. 4.

336. The Record, Dec. 2, 1984, at A-25, col. 3.

337. *Id.* at A-21, col. 1, A-25, col. 1. All three plans would repeal the investment tax credit (and hence the rehabilitation credit). They would also tax capital gains at ordinary income rates, but the Treasury Department plan would allow investors to index their capital gains to adjust for any appreciation in the fair market value of the property that was caused by inflation. *Id.* at A-25, col. 3. Only the Kemp-Kasten plan would retain ACRS depreciation as it was enacted under ERTA. *Id.* Both the Treasury Department plan and the Bradley-Gephardt plan would repeal ACRS under ERTA and accelerated depreciation under I.R.C. § 167 and replace them with a less generous depreciation system. *Id.*

338. The Record, Nov. 27, 1984, at A-2, col. 4.

339. See *supra* notes 177-80 and accompanying text for a discussion of the major devices used in rehabilitation tax shelters.

340. By eliminating accelerated and ACRS depreciation, the proposed tax plans would defeat the ability of taxpayers to accelerate artificial losses. See *supra* note 178 and accompanying text. By eliminating the investment tax credit, which includes

happen, the state of the tax law regarding historic rehabilitation would be thrown back to its pre-TRA position.<sup>341</sup> Preservationists, developers, and investors would once again be left with a federal policy favoring historic rehabilitation,<sup>342</sup> but would lack any tax incentives for them to undertake such projects.<sup>343</sup> In this situation,

[u]nless the added expense of preservation can be made at least reasonable, if not profitable, by use of federal tax incentives . . . , the private sector may be forced to abandon history and opt for the practicality of the bulldozer and the wrecking ball used so frequently prior to the NHPA and the TRA.<sup>344</sup>

#### IV. Extension Rather Than Repeal of the Investment Tax Credit

“To insure the choice of investment in historic preservation property, more, not less, federal tax incentives should be provided.”<sup>345</sup> By encouraging historic preservation through the use of the federal taxing power,<sup>346</sup> investors and developers will opt for historic rehabilitation rather than demolition in the current “economically progressive” environment.<sup>347</sup> Since the adoption of the TRA, this country has made a number of tax decisions and enactments which have had a significant impact on historic rehabilitation and community development.<sup>348</sup> If the federal government were to repeal these provisions in the proposed tax plan,<sup>349</sup> “the nation stands to

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the rehabilitation credit, the incentive to rehabilitate rather than raze historic structures may be lost because even though there is no accelerated depreciation, the depreciation deductions on a new building will be greater because the basis of the new building (cost under I.R.C. § 1012) will be larger than the already depreciated basis of the old structure increased by the amount of any capital improvements. See *supra* notes 45 & 51 and accompanying text. Finally, by eliminating the sixty percent long-term capital gains deduction under I.R.C. § 1202 and taxing any gain recognized on the ultimate sale of the structure as ordinary income, the proposed tax plans eliminate another incentive provided by rehabilitation tax shelters. See *supra* notes 217-21 and accompanying text.

341. See *supra* notes 8-37 and accompanying text for a discussion of the law regarding the rehabilitation of historic structures prior to the enactment of the TRA.

342. See *supra* notes 14-34 and accompanying text.

343. See *supra* note 34 and accompanying text.

344. Silver, *supra* note 1, at 889.

345. *Id.* at 925.

346. U.S. CONST. amend. XVI.

347. Silver, *supra* note 1, at 925.

348. See *supra* notes 38-165 and accompanying text; see also Zimmerman, *Tax Planning for Land Use Control*, 5 URB. LAW. 639, 640 (1973).

349. See *supra* notes 336-38 and accompanying text for a discussion of the

lose a large part of its historic property and hence a large part of its existing re-usable [sic] commercial and housing stock.”<sup>350</sup>

The extension of the rehabilitation credit to noncertified structures by ERTA<sup>351</sup> fostered the rehabilitation of historic structures in situations where owners or developers could not absorb the costs of certification<sup>352</sup> or where the property would not meet the requirements of certification.<sup>353</sup> However, other tax legislation may be necessary to ensure that the extension of the rehabilitation credit to noncertified structures does not eliminate all attempts by investors to seek listing on the National Register.<sup>354</sup> While Congress did not intend to preclude certification as a result of the extension of the rehabilitation credit to noncertified structures,<sup>355</sup> “unless an investor finds that the increased investment tax credit adequately compensates him for the expense of rehabilitating and maintaining a certified historic structure according to Department of Interior standards, he may either withhold consent to listing, or not rehabilitate at all.”<sup>356</sup>

Furthermore, provisions should be enacted to provide tax benefits to individuals who do not hold property for the production of income<sup>357</sup> or who are financially unable to invest in private placement rehabilitation tax shelters.<sup>358</sup> Under the current law, no special tax credit or deduction is allowed for the rehabilitation of an uncertified, older structure used as a taxpayer’s principal residence. However, if a taxpayer substantially improves his principal residence in order to maintain it, this substantial improvement may qualify as a “capital improvement”<sup>359</sup> and the expenses thus incurred would be added to the taxpayer’s basis in the residence for purposes of determining

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provisions repealed in the various proposed tax plans.

350. Silver, *supra* note 1, at 887.

351. See *supra* notes 77-80 and accompanying text.

352. See *supra* note 31 and accompanying text for a discussion of the various costs involved when certifying the rehabilitation of a certified historic structure.

353. See *supra* notes 23 & 41-42 and accompanying text.

354. Silver, *supra* note 1, at 923 (ERTA provides viable alternative to owners or developers who want to avoid listing in National Register).

355. *Id.* at 918, 923 (Congress assumes that despite extension of rehabilitation credit to noncertified structures, if given choice, owners and developers would consent to listing on National Register).

356. *Id.* at 923.

357. See *supra* notes 77 & 85 and accompanying text for a discussion of the nonresidential use requirement which must be satisfied in order to claim the rehabilitation credit.

358. The Record, Dec. 3, 1984, at A-11, col. 1.

359. I.R.C. §§ 263(a)(1) (1981) (no deduction allowed for any amount paid out for permanent improvements or betterments made to increase value of any property); 1016(a)(1) (1954) (proper adjustment to basis in respect of property shall in all cases be made for expenditures properly chargeable to capital account).



gain or loss on the subsequent sale of the residence.<sup>360</sup> This situation appears to run *contra* to the strong federal policy favoring rehabilitation and the need to maintain structures "worthy of protection because of their historical, architectural, or cultural significance . . . ."<sup>361</sup> The lack of any tax incentive may also lead to apathy on the part of the homeowner and result in such undesirable consequences as "urban blight"<sup>362</sup> and "urban ugliness."<sup>363</sup>

An almost analogous situation from a tax point of view, existed in 1978 when Congress enacted the "residential energy credit."<sup>364</sup> Prior to the enactment of the residential energy credit, any installation of an energy saving component would qualify as a capital improvement which would increase the taxpayer's basis in his principal residence without any commensurate credit or deduction to offset the increase in basis.<sup>365</sup> This situation existed despite the express federal policy favoring energy conservation as a result of the fuel oil shortage caused by the 1973-74 oil embargo.<sup>366</sup> The residential energy credit was enacted as a means to implement the recognized federal policy favoring energy conservation and to provide homeowners and tenants with an incentive to conserve energy through the installation of insulation and other energy-conserving components.<sup>367</sup>

This Note advocates the enactment of a similar credit<sup>368</sup> which would provide taxpayers owning principal residences over a specified

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360. *Id.*

361. Silver, *supra* note 1, at 893 n.40.

362. Urban blight arises from a desire not to make the property more valuable for tax purposes. Powers, *Tax Incentives for Historic Preservation: A Survey, Case Studies and Analysis*, 12 URB. LAW. 103, 103 n.2 (1980), citing Zimmerman, *Tax Planning for Land Use Control*, 5 URB. LAW. 639, 648 (1973).

363. Urban ugliness will result from a lack of tax incentives to rehabilitate, thereby discouraging aesthetically or socially desirable forms of buildings. *Id.*

364. The residential energy credit was enacted as part of the Energy Tax Act of 1978. Pub. L. No. 95-618, § 101(a), 92 Stat. 3175 (1978) (formerly codified at I.R.C. § 44C; currently codified at I.R.C. § 23).

365. Act of Nov. 9, 1978, Pub. L. No. 95-618, 1978 U.S. CODE CONG. & AD. NEWS (92 Stat.) 7968.

366. *Id.*

367. *Id.*

368. The residential energy credit is a refundable income tax credit for insulation and other energy-conserving component expenditures for installations in or on the principal residence of the taxpayer. I.R.C. § 23(a)(1), (c)(1),(3),(4) (1984). The credit is fifteen percent of the energy conservation expenditures made by a taxpayer in a taxable year with respect to his principal residence which do not exceed \$2000 (thus, the maximum credit allowable is \$300). I.R.C. § 23(b)(1) (1984). A taxpayer is eligible for a new \$300 maximum credit each time he changes his principal residence, but if maintains the same principal residence throughout his entire lifetime he can claim the \$300 maximum credit only once. I.R.C. § 23(c)(8) (1984). If the

age<sup>369</sup> with a tax incentive to improve and maintain such structures. Such a credit would be consistent with the federal policy favoring rehabilitation and preservation of the historic and cultural environment found in this nation's residential communities. It might also provide an effective means of preventing further urban decay.

## V. Conclusion

For almost a century, this nation has cultivated a strong federal policy favoring the preservation of its historic environment through rehabilitation.<sup>370</sup> Over the past decade, this policy was implemented by legislation which provided federal tax incentives designed to foster historic rehabilitation.<sup>371</sup> Owners and developers of historic structures have taken advantage of these tax incentives by syndicating tax sheltered investment packages organized to rehabilitate historically significant structures.<sup>372</sup> In 1984, however, legislation was passed which placed many restrictions on tax sheltered investments.<sup>373</sup> Furthermore, proposed legislation seeks to eliminate all tax incentives for the rehabilitation of historic structures that are currently employed by rehabilitation tax shelters.<sup>374</sup>

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credit exceeds the taxpayer's tax liability in a particular taxable year, the excess is refunded to the taxpayer and will be carried forward until the \$300 limitation is used up. I.R.C. § 23(b)(5) (1984). The increase in basis of the property which would result from the capital expenditure is reduced by the amount of the credit claimed. I.R.C. § 23(e) (1984).

Hypothetically, such a credit could be enacted to provide an incentive to owners of older or historic principal residences to restore such structures. For example, a once in a lifetime credit per principal residence (as defined in I.R.C. § 1043) per taxpayer could be promulgated allowing a credit of fifteen percent of the renovation expenditures made by a taxpayer which do not exceed \$10,000 (a maximum lifetime credit of \$1500 per principal residence) which could be carried over to subsequent taxable years if the credit claimed exceeded the taxpayer's tax liability. The increase in the basis of the property that would result from the capital improvement would be reduced by the amount of the credit claimed and in order to avoid administrative burdens which could result from only a small amount of qualified renovation expenditures in a year, a minimum credit amount could be established as in I.R.C. § 23(b)(4). Treasury Regulations could be promulgated by the Secretary which would establish the criteria for: (1) what amounts to a qualified renovation expenditure; (2) what determines when a qualified renovation expenditure has been made and the amount of such expenditure; and (3) what procedures will be implemented to review or provide advice as to renovation expenditures.

369. The age requirements for a non-certified, "30-year" historic structure could be used as a guideline for these purposes. *See supra* notes 78-83 and accompanying text.

370. *See supra* notes 8-165 and accompanying text.

371. *See supra* notes 40-165 and accompanying text.

372. *See supra* notes 167-234 and accompanying text.

373. *See supra* notes 246-329 and accompanying text.

374. *See supra* notes 330-44 and accompanying text.

These recent developments have created concern among historic preservationists because this nation's historic structures provide unique evidence of our country's cultural development.<sup>375</sup> In addition, they provide a viable source of reusable commercial and residential property.<sup>376</sup> To ensure the continued existence of this nation's historic structures as they battle time and the elements, the federal government must continue to provide tax incentives to individuals to incur the extensive cost of maintenance and rehabilitation of these structures.<sup>377</sup>

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375. Silver, *supra* note 1, at 887.

376. *Id.*

377. See *supra* notes 345-69 and accompanying text.