

MILLENNIAL HOUSING COMMISSION
TAX ISSUES TASK FORCE
BACKGROUND PAPER: TAX POLICY REVERSALS
AFFECTING INVESTORS IN AFFORDABLE RENTAL HOUSING

OVERVIEW

This paper summarizes the tax policy aspects of the financing of the HUD and RHS privately owned, federally assisted stock, how policy was implemented, the policy shifts that occurred along the way, and the largely adverse effects those shifts had on investors. This paper does not cover the Low Income Housing Tax Credit (LIHTC) program.

It is clear that investment in the assisted stock was pursued largely, perhaps almost exclusively, because of tax benefits. It is also clear that the actual tax benefits received by many investors were typically less than were anticipated at the time the investments were made.

Appendix 1 provides an illustrative example of the tax benefits expected by a typical investor and the tax benefits actually received. This Appendix is based on an earlier version, included in the Commission's background paper on the Preservation Tax Incentive.

TAX BENEFITS WERE CENTRAL

Negligible Potential for Cash Flow. Properties were heavily leveraged, rents were regulated, distributions were limited for most properties, and in many partnerships the first dollars of distributable cash flow went not to the investor limited partners but for other partnership expenses. As a result, there was little or no potential for a typical limited partner investor to receive a cash return on his or her investment.

Tax Shelter Syndication. Under prevailing (pre-1986) tax law, syndication of tax-shelter benefits was the primary vehicle for funding the portion of development cost not funded by mortgage debt¹. The tax-shelter strategy had disadvantages that caused a series of problems, some immediate and some whose effects did not become apparent until later:

- **Focus on tax losses.** Investors derived the great bulk of their economic return from tax losses. As a consequence investors, who in normal real estate transactions are aggressive monitors of financial performance, had few operational concerns other than that the property continue to make its mortgage payments.
- **Sensitivity to marginal tax rates.** The amount an investor was willing to pay varied directly with the investor's marginal income tax bracket. Thus, expected and actual investor returns dwindled as marginal tax rates were reduced after the 1970s.

¹ Tax shelter syndication of HUD-assisted housing began in earnest after the 1969 Tax Act established favorable income tax treatments for low-income housing investments. Tax shelter syndication became even more attractive after the 1981 tax bill dramatically accelerated depreciation deductions, and then was ended by the 1986 tax bill.

- **Tax-on-sale problems².** An integral feature of the tax-shelter approach was that investors recognized losses that were a multiple of their original cash investment³. The excess took the form of a ‘negative capital account’ that generated taxable income when the property was sold (or foreclosed, or otherwise transferred). This large tax-on-sale liability proved later to be a powerful force against later sale of the property, even when a sale was in the best interest of the property, the residents, and the government. Because the negative capital account evaporated upon death, many owners would say to themselves “I just hope the property makes it longer than I do.”

TAX POLICY SHIFTS ALONG THE WAY

1969 Tax Act: Favorable Provisions for Low-Income Housing Investments. The 1969 Tax Act created Section 167(k) five-year write-offs for rehab expenditures on low-income housing, and granted favorable depreciation recapture provisions for investments in low-income housing. When combined with favorable financing available from HUD and RHS, these tax advantages incentivized development of significant amounts of low-income housing.

1981: Rapid Depreciation for Assisted Housing Investments. The 1981 Economic Recovery Tax Act provided for very rapid depreciation of assisted housing under the 15 year ACRS method. Under this approach, the entire investment in the buildings could be deducted over the initial 15 years of the investment period, with the deductions significantly front-loaded to the early years. Prior to 1981, assisted housing could be depreciated under a “component life” method under which the different building components were assigned useful lives, generally between 5 and 33 years (resulting in a weighted average life between 18 and 25 years, depending on how components were classified). Prior to 1981, a variety of accelerated and straight-line depreciation methods were allowable for low-income housing investments. The 1981 changes increased depreciation deductions by shortening the useful life and providing a highly accelerated depreciation method.

1986 to the Present: Changes in Ordinary Income Tax Rates. The maximum individual tax rate for ordinary income remained at 50% through 1986, then dropped to 38.5% in 1987 and 28% for 1988-1990. The top rate then rose to 31% for 1991-1992 and 39.6% thereafter. Investors who expected to receive 50 cents in tax benefit for each dollar of losses instead received significantly lower tax benefits.

1986: Slower Depreciation. Assisted housing investments placed in service after 1986 could be depreciated only on the straight-line method, generally with a 27.5 year useful life. The effect of this change was that capital improvements made to after 1986 pre-1986 assisted housing resulted in much lower depreciation deductions than originally expected.

² See the Commission’s separate background paper on the Preservation Tax Incentive.

³ Because marginal tax rates are somewhat less than 100%, each dollar of losses generates somewhat less than one dollar of tax savings, thus investors will pay somewhat less than one dollar for each dollar of expected losses. A rule of thumb in the 1970s was that investors would pay – in installments over a three to four year period -- an amount equal to the first five years’ projected losses times 50%. This “two to one” structure implied that, at the end of five years, the investor would have a negative capital account equal in size to his or her total investment (x dollars invested minus 2x dollars of losses equals negative x dollars in the investor’s capital account at the end of five years).

1986: “Passive Loss” Rules. The ability of investors to deduct tax losses in excess of the amount invested was virtually eliminated starting after 1986⁴. For 1987, only 65% of those losses could be deducted, dropping to 40% in 1988, 20% in 1989, 10% in 1990, and 0% thereafter. Losses not deducted in the year incurred could be used to offset future “passive” income (including taxable income from the operation and sale of investment real estate). Passive losses not yet used by the investor to offset passive income are termed “suspended losses.” As a result, typical investors have been unable to utilize losses that were originally expected to be used to offset salary, business or investment income.

1986 and 1992: Changes in Capital Gains Tax Rate. The capital gains tax rates for the tax on sale calculation stayed at 28% through 1985, then dropped to 20% through 1992, and rose thereafter to 25% (for depreciation recapture⁵). Accordingly, investors face roughly the same tax on sale as originally expected, after a brief period of lower than expected rates.

AUTHOR

This paper was prepared by Charles S. Wilkins, Jr., principal of The Compass Group, LLC, under contract to The Millennial Housing Commission.

⁴ Beginning with the 1986 tax act, and continuing to this day, “passive losses” can be used only to offset “passive income”, for example from a real estate investment that is producing “phantom income” (as discussed in the Appendix), or from sale of a real estate investment. Accordingly, the ability to deduct passive losses was not eliminated entirely. However, the actual ability to utilize passive losses is now so limited that tax shelter syndication is no longer feasible.

⁵ Economic analysis by The Compass Group suggests that, for a typical pre-1986 assisted housing investment, it is likely that the entire gain on sale will be taxable at the depreciation recapture rate. Gain on sale in excess of depreciation taken in prior years would be taxed at the normal 28% capital gains rate.

APPENDIX 1: THE TAX ON SALE PROBLEM: AN ILLUSTRATIVE EXAMPLE⁶

Summary. In a tax-shelter syndication, investors contribute \$1 of capital in the expectation of more than \$1 of income tax savings (generated, in turn, by an even larger amount of expected tax losses) over the investment period. Rules of thumb from the 1970s and 1980s predicted that investors would contribute \$1 of capital for each \$1.60 to \$2.00 of expected tax losses over the first few years of the investment period⁷. Obviously, the ratio between investment amount and expected losses depended on a great many factors, including without limitation: the timing of the expected losses, the investor's marginal tax rate, the level of tax risk in the sponsor's projections, the perceived level of governmental risk associated with any subsidies, the sponsor's reputation and capability, and the real estate merits of the property (location, management, ...).

Example: An investor might have expected the following results over a 25-year investment period, for a HUD or RHS assisted housing property developed in the mid 1970s.

Initial Investment (in stages over a 4-6 year pay-in period)	\$50,000
Expected taxable income (loss):	
Years 1-5	(\$100,000)
Years 6-10	(\$50,000)
Years 11-15	(\$20,000)
Years 16-20	(\$5,000)
Years 21-25 ("crossing over" to taxable income)	\$5,000
Total	(\$170,000)
Expected tax savings (marginal 50% tax rate in 1975)	\$85,000
Cash distributions received:	\$20,000
Capital Account at year 25:	
Original Investment	\$50,000
Plus taxable income (minus losses)	(\$170,000)
Minus cash distributions	(\$20,000)
Capital Account	(\$140,000)
Taxable Income Upon Sale = \$140,000 plus amount of any net proceeds of sale	
Minimum "Tax on sale" (marginal 28% tax rate in 1975)	\$39,200

Original Expectation of Investor. The investor therefore expected to recoup his or her \$50,000 investment from tax savings over the first five years, to receive an additional \$35,000 in tax

⁶ This example is based on a presentation by Nancy Trick of Reznick, Fedder & Silverman.

⁷ The ratio, and the length of the pay-in period, varied depending on tax law in effect at the time. Needless to say, expert practitioner opinions differed.

savings and \$20,000 in cash distributions over the next twenty years. If the property were sold in year 25 for \$1 above the mortgage balance, the investor would expect to pay a \$39,200 tax on sale.

Surprises Along The Way.

- **Lower Cash Flow.** Typical assisted housing investments did not produce the projected level of cash distributions. See the separate Historical Context paper produced by The Compass Group for the Commission for a discussion of the various reasons for lack of cash flow in these properties. If the investor received half the projected cash flow, the investor's return would be reduced by \$10,000.
- **Changes in Ordinary Income Tax Rates.** The maximum individual tax rate for ordinary income remained at 50% through 1986, then dropped to 38.5% in 1987 and 28% for 1988-1990. The top rate then rose to 31% for 1991-1992 and 39.6% thereafter. Thus, instead of a 50% marginal tax rate, the investor actually had an average 42% marginal tax rate over the 25-year investment period. Instead of \$85,000 of tax savings from \$170,000 of losses, the investor would only realize \$71,400 of tax savings, a \$13,600 reduction of the investor's return.
- **Changes in Capital Gains Tax Rates.** The capital gains tax rates for tax on sale was 28% until 1986, dropped to 20% through 1992, and thereafter was 25% (for depreciation recapture) or 28% (for capital gain, if any, in excess of depreciation deductions previously claimed). As a result, the tax on sale, originally estimated to be \$39,200, will actually be \$37,500 or perhaps higher, roughly the same as originally projected (although not as favorable as if the 1986-1992 rates had continued).
- **"Passive Loss" Rules.** The ability of investors to deduct tax losses in excess of the amount invested was virtually eliminated starting after 1986⁸. For 1987, only 65% of those losses could be deducted, dropping to 40% in 1988, 20% in 1989, 10% in 1990, and 0% thereafter. Losses not deducted in the year incurred could be used to offset future "passive" income (including taxable income from the operation and sale of investment real estate). Passive losses not yet used by the investor to offset passive income are termed "suspended losses." As a result, the investor was not able to deduct \$30,000 of his or her tax losses, which remain suspended. The inability to use those suspended losses delayed \$12,600 of the investor's return for many years.

In summary, the investor received less cash flow (for governmental and real estate reasons), less tax savings (as a result of lower ordinary tax rates and elimination of passive-loss deductions), and faces higher tax on sale upon sale (as a result of higher capital gains tax rates), than originally expected.

Original Expectation vs. Actual Result

Using the example above, the investor expected to invest \$50,000 and receive \$65,800⁹ over the

⁸ See footnote 4.

⁹ \$85,000 of tax savings plus \$20,000 of cash flow minus \$39,200 of tax on sale.

life of the investment. Instead, the investor invested the expected \$50,000, has received \$68,800 of tax savings and cash flow so far¹⁰, faces tax on sale of \$37,500, and may or may not be able to realize a further \$12,600 of tax savings from suspended losses. Over the life of the investment, the investor will be lucky to break even.

The Investor's Current Situation. The investor is receiving little if any cash flow. The property is generating increasing amounts of taxable income (the term "phantom income" denotes taxable income in excess of cash distributions; see discussion below). The investor is facing tax on sale of \$37,500 or more upon sale (or donation, or foreclosure) of the property. However, the investor has \$30,000 of suspended passive losses that can be used to offset future taxable income (from operation or sale of this property or other properties).

If the investor could hold his or her interest in the property until death, the tax on sale could be eliminated¹¹. Similarly, the owning partnership could dispose of the property by exchanging it for a similar property, without triggering the tax on sale¹².

In this situation, it is hardly surprising that most investors decide to retain the property rather than sell it. Moreover, it is hardly surprising that most investors are unhappy with how their investments have turned out, reluctant to enter into new affordable housing agreements with the government, and reluctant to devote time and attention to what seems to have been a bad investment that has little upside potential and a great deal of downside risk.

"Phantom Income"

Phantom income results from non-deductible expenditures, chief among which are mortgage principal payments, deposits to the reserve for replacements. In addition, capital expenditures are virtually non-deductible; they generate deductions but only over a very long period of time.

Conversely, phantom income is reduced by non-cash deductions, primarily depreciation and amortization. Because the non-deductible expenditures rise as the property ages, at the same time the non-cash deductions are declining, phantom income typically arises some time after year fifteen and accelerates as the property ages.

¹⁰ \$10,000 of cash flow plus \$71,400 of tax savings at 42% minus \$12,600 of savings not yet realized because of suspended losses.

¹¹ The deceased is not subject to normal income taxes in the year of death. Instead, the estate of the deceased is subject to estate tax. The estate tax is based on the amount (value) of the estate. For estate tax purposes, generally assets are carried at their fair market value as of the date of death. Typically, the estate of a limited partner investor will request that the general partner make an election under Section 754 of the Internal Revenue Code. This election has the effect of converting the investor's negative capital account (the day prior to death) into a positive capital account based on the fair market value of the property (as of the date of death). By eliminating the negative capital account, this process eliminates the tax on sale. Conversely, if the limited partner does not request, or the general partner does not make, the Section 754 election, the result is much less favorable.

¹² Section 1031 of the Internal Revenue Code provides for the tax-free exchange of "like kind" property. Suppose that a taxpayer owns an apartment property with a fair market value of \$2 million and in which the taxpayer has a negative \$500,000 capital account. The taxpayer wishes to exchange the apartment property for another apartment property. If the acquired apartment property has a fair market value of at least \$2 million, and the transaction otherwise met the requirements under Section 1031, the exchange would not generate taxable income, and the taxpayer's negative \$500,000 capital account would carry over to the acquired property. This is a complex area of tax law, with a number of aspects that have been ignored or simplified for purposes of this example.

To some extent, phantom income can be reduced or eliminated if the property can be refinanced, because doing so typically reduces the non-deductible mortgage principal payments. Phantom income is particularly painful if the tax liability exceeds the cash distributions. Thus, phantom income is an especially serious problem for older properties that cannot readily be refinanced and that lack cash flow

The following is an example showing how the cash flow and taxable income of a property can be vastly different in the later years of the property's life:

Comparison of Cash Flow and Taxable Income, Late in the Property's Life	Cash Flow	Taxable Income	Comment
Gross Potential Rent	\$540,000	\$540,000	
Vacancy and Collection Loss	(\$37,800)	(\$37,800)	
Other Income	\$10,000	\$10,000	
Operating Expenses	(\$250,000)	(\$250,000)	
Actual Reserve Deposit	(\$65,000)	(\$32,500)	50% expensed
First Mortgage P&I	(\$185,236)	(\$135,676)	interest portion
Credit Enhancement	(\$8,592)	(\$8,592)	
Depreciation (original buildings)		\$0	fully depreciated
Depreciation (capital improvements)		(\$32,500)	prior yr reserves
Amortization		(\$1,375)	of loan costs
Reserve Interest Income		\$3,000	
Operating Cash Flow	\$3,372		
Taxable Income		\$54,557	

If there were ten limited partners, each owning a 9.9% share, and having 40% marginal tax rates, each limited partner would owe some \$2,000 in taxes, over and above his or her share of the distributed cash flow. Moreover, once phantom income begins, it tends to become a more severe problem with each passing year. It is easy to see why the presence of a severe phantom income problem is a powerful incentive to sell (or refinance, or otherwise solve the problem).

Other Potential Tax Issues

Alternative Minimum Tax. This analysis does not consider the potential effects of the alternative minimum tax.

Estate Tax. Some ownership interests will have a significant fair market value (the amount on which estate tax is based). For taxable estates, that value will be subject to tax at relatively high marginal rates starting at 45%. An investor who expects his or her estate to be subject to estate tax might make different decisions than are discussed in this paper. Such an investor might consider selling during his or her lifetime, in response to a preservation tax incentive.