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How the federal government became the real estate investor's most important "partner."

Real Estate Tax Benefits and Reforms: The Long View

Paul Zane Pilzer

DURING ONE OF THE congressional debates on the real estate provisions of the Tax Reform Act of 1984, one senator threatened that unless the real estate lobby agreed to support the change from fifteen to eighteen years in the ACRS depreciation schedule, he would introduce a bill to exempt all real estate investments from income taxation. How could this be a "threat" to the real estate lobby? How could it not be beneficial to be exempt from federal income taxes? The lobbyist for a nonprofit group had an intuitive answer when he testified that nontaxpaying entities were discriminated against in real estate investments because the majority of the return from real estate investing was in the form of federal tax benefits that nonprofit organizations could not use.

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The investment analyses that appear so regularly in REAL ESTATE REVIEW all reveal that even a moderately leveraged income-producing real estate investment derives the overwhelming majority of its current return from a *phantom depreciation* benefit. Phantom depreciation is the difference between the statutory allowable (accounting) depreciation deduction and any real (economic) depreciation of the property. Because most of the return of most real estate investment consists of tax benefits, the real estate industry has become totally dependent on the federal tax incentive. An understanding of this dependence is important for anyone who wishes to "reform" the tax system by substantially altering real estate tax benefits. This article analyzes the evolution of this relationship and draws some conclusions about the implications of reform.[1]

THE ORIGIN OF THE REAL ESTATE TAX BENEFIT

Prior to the introduction of the federal income tax in 1913, investment in income-producing property was motivated solely by economic (nontax) factors. The early federal income tax applied equally to all investments and gave no special consideration to real estate. The current real estate tax preference emerged as the result of three developments: (1) a recognition of the business concept of depreciation, (2) the decision to tax capital gains income at reduced rates, and (3) the advent of regular monetary inflation.

Phantom Depreciation

Accountants introduced the concept of depreciation in order to report more fairly net business income for both annual report and tax purposes. In theory, a business reports periodically, as operating expense, a fair estimate of the actual amount of economic depreciation that is incurred by its plant and equipment. Before World War II, when there was little monetary inflation but when buildings did experience rapid economic obsolescence, buildings actually depreciated. (Their market values declined despite increases in the value of their locations or modest monetary inflation.) Gradually, the federal government and the accounting industry established statutory guidelines for the fair depreciation of all real property. (Examples include a forty-year depreciation schedule for real property and a component depreciation schedule for fixtures.)

Since the 1940s, however, the country has experienced regular monetary inflation, and there has been a decrease in the number of technological improvements to buildings. (The differences between the windows, elevators, and air-conditioning systems of 1940 and 1980 office buildings are smaller than the differences perceivable between 1920, 1930, and 1940 office buildings.) Consequently, after the 1940s, many commercial properties actually began to appreciate in monetary value due to rising reproduction costs and decreasing economic obsolescence. But the accounting and taxing authorities continued to allow the statutory deduction for depreciation even though it had become "phantom."

Capital Gains Exclusion

The initial tax benefit of the phantom depreciation that resulted from unrealistic statutory depreciation schedules was merely an interest-free tax deferral. The investor received an annual ordinary income tax deduction for the amount of phantom depreciation, but he received an equal amount of taxable income (as a capital gain) when he sold the property. The tax that the government lost as a result of the interest-free tax deferral was insignificant because, initially, the capital gain upon sale was taxed at the ordinary income tax rate.[2] Indeed, the value of the tax deferral was modest in a low-interest-rate economy.

A windfall tax benefit was created when Congress extended the capital gains exclusion to real estate in 1942. The capital gains exclusion created a tax incentive for long-term real estate investment by excluding 50 percent (the 1942 capital gain exclusion amount) of any capital gains from income taxation. However, a side effect of this provision for depreciable investments (like real estate) that also experienced long-term economic gains was that any phantom depreciation was now also recaptured at the much lower capital gains tax rate.[3] In mid-1984, 60 percent of the tax deductions taken for phantom depreciation were permanently forgiven from taxation.

How Big Was the Benefit Before 1981?

The federal government did not acknowledge the existence of permanent long-term inflation until well into the late 1970s, and it did not acknowledge that its statutory straight-line depreciation schedules for real estate had become fictional.[4] However, the real estate

[1] This article was written before Congress initiated its debate on the Reagan Administration's tax reform proposals.

[2] The partial capital gains tax exclusion (currently 60 percent) was not expanded to include real estate until the Revenue Act of 1942.

[3] The taxable capital gain upon sale of an investment is the sale price less (depreciated) book value. Thus, any ordinary income tax deduction from phantom depreciation is converted to capital gain income upon sale and 60 percent (currently) is permanently excluded from taxation.

[4] The Revenue Act of 1964 provided that the excess of accelerated over straight-line depreciation should be recaptured at ordinary income tax rates at the time of sale. This approach implied that only the excess component of accelerated depreciation was phantom (and that the straight-line depreciation component was real economic depreciation).

industry recognized its advantage. Real estate investors began to accept as an inherent benefit of real estate investment both the interest-free tax deferral and the permanent forgiveness from taxation of most of the phantom depreciation that arose from the capital gains exclusion.

Exhibit 1 provides an example in which all of the forty-year straight-line depreciation taken on a commercial real estate investment was phantom. Assume further that 90 percent of the investment is depreciable. Each year, the 50 percent tax bracket investor takes $23 of depreciation for each $1,000 of investment. If we assume a 12 percent discount rate, the present value of the tax deferral plus the capital gains exclusion that was available prior to 1981 amounted to $90.81 per $1,000, or 9.08 percent of total asset value. A benefit equal to 9.08 percent of asset value is extremely significant for leveraged property. The typical commercial real estate investment was leveraged with 75 percent debt. The $90.81 benefit per $1,000 of valuation also amounted to 36.32 percent of the $250 of equity in a typical investment.

EXHIBIT 1

PRESENT VALUATION @ 12% OF 40-YEAR DEPRECIATION FOR EACH $1,000 OF PROPERTY

Total real estate value	$1,000
Depreciable value	$900
Annual depreciation	$23
Tax bracket	50%

(1)	*(2)*	*(3)*	*(4)*
	Annual	*Annual*	*Tax Benefit*
Year	*Depreciation*	*Tax Benefit*	*Upon Sale*
1	$23	$11	$0
2	$23	$11	$0
3	$23	$11	$0
4	$23	$11	$0
5	$23	$11	$0
6	$23	$11	$0
7	$23	$11	$0
8	$23	$11	$0
9	$23	$11	$0
10	$23	$11	$0
11-39	$23	$11	$0
40	$23	$11	($180)

Net present value @ 12% of (3) + (4) = $90.81

THE GOVERNMENT ACKNOWLEDGES THE PHANTOM DEPRECIATION BENEFIT

As the benefits of phantom depreciation became an accepted part of real estate investment, the government began to look at phantom depreciation as a potential tool of public policy. In the Tax Reform Act of 1969, Congress specified that rehabilitated low-income housing could be depreciated over a five-year period, creating massive phantom depreciation and a corresponding tax benefit for investors who made such a socially desirable investment. The federal government had found a new muscle to use in implementing economic policy that was not as obvious (and therefore not as objectionable) to the nonbusiness community as direct government subsidies for socially desirable programs or simple income tax rate changes.

The Effect of the 1981-1984 Legislation

This new muscle was flexed in the Economic Recovery Tax Act of 1981 (ERTA), which changed the real property straight-line depreciation schedule from a forty-year schedule to the fifteen-year ACRS (accelerated cost recovery system) schedule. ERTA allowed the owner of a real asset an ordinary income tax deferral equal to one fifteenth of his depreciable asset value each year plus a permanent forgiveness (capital gains exclusion) of 60 percent of the deferred tax. The net economic effect of ERTA (using our previous assumption) was a subsidy to a new purchaser that had a present value of $202.39 per $1,000, or 20.24 percent of total asset value. (See Exhibit 2.) If the investment were 75 percent leveraged, this $202.39 benefit represented 80.96 percent of the $250 equity investment.

This massive 123 percent increase in the tax benefit (from $90.81 to $202.39) granted to real estate in 1981

EXHIBIT 2

PRESENT VALUATION @ 12% OF ACRS 15-YEAR DEPRECIATION FOR EACH $1,000 OF PROPERTY

Total real estate value	$1,000
Depreciable value	$900
Annual depreciation	$60
Tax bracket	50%

(1)	*(2)*	*(3)*	*(4)*
	Annual	*Annual*	*Tax Benefit*
Year	*Depreciation*	*Tax Benefit*	*Upon Sale*
1	$60	$30	$0
2	$60	$30	$0
3	$60	$30	$0
4	$60	$30	$0
5	$60	$30	$0
6	$60	$30	$0
7	$60	$30	$0
8	$60	$30	$0
9	$60	$30	$0
10	$60	$30	$0
11	$60	$30	$0
12	$60	$30	$0
13	$60	$30	$0
14	$60	$30	$0
15	$60	$30	$0
16-39	$0	$0	$0
40	$0	$0	($180)

Net present value @ 12% of (3) + (4) = $202.39

was far too generous. Unfortunately, the tax benefit also included features that were contrary to the public interest, because the subsidy was granted to purchasers of older properties as well as to developers who undertook new construction. There was a tremendous increase in the value of existing properties, creating windfall profits for their owners even though they did not produce the social benefits of new construction. Congress recognized this error in the Tax Reform Act of 1984, but (partially because of the efforts of a powerful real estate lobby) it increased the depreciable life of real estate only a token amount, to an eighteen-year ACRS schedule. As illustrated in Exhibit 3, the 1984 change to the eighteen-year ACRS schedule reduced the present valuation of the phantom depreciation benefit from $202.39 (or 20.24 percent) per $1,000 total asset value to $179.31, or 17.93 percent. This token 11 percent decrease in 1984 still left the benefit 100 percent greater than the benefit that had been available just three years earlier. Exhibits 1, 2, and 3 are summarized in the following table:

Method of Depreciation	*Value of Depreciation Benefit vs. Total Real Estate Value*	*Value of Depreciation Benefit vs. 25% Equity Investment*
40-year pre-1981	9.08%	36.32%
1981 15-year ACRS	20.24%	80.96%
1984 18-year ACRS	17.93%	71.72%

EXHIBIT 3

PRESENT VALUATION @ 12% OF ACRS 18-YEAR DEPRECIATION FOR EACH $1,000 OF PROPERTY

Total real estate value	$1,000
Depreciable value	$900
Annual depreciation	$50
Tax bracket	50%

(1)	*(2)*	*(3)*	*(4)*
Year	*Annual Depreciation*	*Annual Tax Benefit*	*Tax Benefit Upon Sale*
1	$50	$25	$0
2	$50	$25	$0
3	$50	$25	$0
4	$50	$25	$0
5	$50	$25	$0
6	$50	$25	$0
7	$50	$25	$0
8	$50	$25	$0
9	$50	$25	$0
10	$50	$25	$0
11	$50	$25	$0
12	$50	$25	$0
13	$50	$25	$0
14	$50	$25	$0
15	$50	$25	$0
16	$50	$25	$0
17	$50	$25	$0
18	$50	$25	$0
19-39	$0	$0	$0
40	$0	$0	($180)

Net present value @ 12% of (3) + (4) = $179.31

THE PUBLIC POLICY IMPACT OF ACRS

Rents rose steadily during the inflationary late 1970s. The massive increase in the tax benefits granted to real estate in 1981 slowed the spiraling rent increases, but at the expense of the American public. ACRS depreciation caused an increase in new construction of both apartments and nonresidential property by increasing property values (particularly for residential property, which received far greater benefits than those that were illustrated above because investment in residential property could be depreciated by an accelerated ACRS schedule).

Independently, the government subsidy of residential financing costs, which had been made effective (1) by state usury ceilings on borrowing and (2) by interest rate ceilings (Regulation Q rates, imposed on savings and loan association deposits), was virtually eliminated by 1980. However, the increase in residential financing costs caused by the coincidental emergence of these changes was counteracted by the activities of syndicators who sold off the new tax benefits and used the proceeds to subsidize rental income.[5]

An increase in real property values based on increased tax benefits also gave windfall profits to owners of existing retail, office, and industrial property without creating corresponding socially desirable offsets. A commercial property owner received a value increase equal (by our calculations) to as much as $202.39 per $1,000 of property value (an amount that may have exceeded his equity investment) only if he sold his property at the inflated "stepped-up" price. The new purchaser (syndicator) was able to pay the higher price without asking for higher rentals from corporate tenants because he could sell off the increased tax benefits.

The Creation of the Sale-Leaseback Syndication Industry

An entire sale-leaseback syndication industry was created between 1981 and 1984, which had at least two undesirable public policy results:

1. It subsidized the rents of corporate tenants (particularly Fortune 500 types whose strong credit

[5] See Paul Zane Pilzer, "Public Policy: Sheltering Subsidies," Real Estate Finance Journal 1/70 (Summer 1985).

allowed for virtually 100 percent leverage of the transactions); and

2. It allowed individual taxpayers the tax deferral and tax forgiveness benefits of real estate investment while totally insulating them (through long-term credit leases) from the vagaries of the real estate market for which Congress had allowed these tax benefits.

These corporate credit sale-leasebacks took advantage of a government-sanctioned real estate investment incentive program, operating fully within the letter of the tax code but fully outside the public policy intent. The government reacted strongly in 1984 to abusive transactions like accrual-cash sale-leasebacks in which accrual-basis tenants would pay low rent during the early years of their lease, make it up in later years, but deduct an average of the long-term rent for income tax purposes. At the same time, the cash-basis taxpayers who had purchased the corporate tenants' properties would receive massive tax deductions for "losses" during the early years of the low rent even though it was relatively certain that the "losses" would be made up by the credit tenants when the rent stepped up in later years. The Tax Reform Act of 1984 eliminated those obvious loopholes without causing major dislocations in the vital role served by the tax shelter industry in subsidizing residential housing.

CONCLUSION

The real estate tax benefit currently consists of an interest-free income tax deferral (via phantom depreciation) and a permanent forgiveness of 60 percent of the deferred tax upon sale. Phantom depreciation was created over time, not by deliberate government policy but by the failure of the federal government to adjust its statutory real property depreciation schedules to reflect changing economic and engineering phenomena. Its benefits have become a well established part of the real estate investment incentive.

The Economic Recovery Tax Act of 1981 utilized phantom depreciation as a tool to subsidize new investment. However, in its desire to get the economy moving again, Congress created several loopholes for investors, giving them risk-free permanent income tax shelters and creating windfall profit opportunities for existing property owners who merely sold their investments. The unfair loopholes were virtually eliminated in the Tax Reform Act of 1984. Unfortunately, the windfall profits created by increased phantom depreciation for existing property owners had largely been taken as property owners sold their property.

Today's property owners should not be penalized for the windfall profits taken by previous owners. Nor should former property owners (who were induced to sell by government-created windfall opportunities) be injured. Current investors who were induced to invest by government-sponsored tax benefits should not be hurt. Congress should enact fair tax reform legislation that recognizes the value of phantom depreciation in real estate investments and should use it selectively to encourage socially desirable investments without creating other windfall profits or penalties for existing owners. One method of accomplishing this is to phase in any major tax reform proposal very slowly.