NEW TAX INCENTIVES FOR REHABILITATED REAL ESTATE INVESTMENT

by James P. Gaines and Edward J. Schnee

For several years conditions have been developing that foster reinvestment in older, declining properties and neighborhoods, both residential and commercial. Businesses and individuals are facing higher land and construction costs. Concern is growing over higher transportation costs to commuters because of rapidly escalating gasoline prices.

Recent government policies and actions have also contributed to the new outlook in revitalization and rehabilitation of older properties in central urban areas. In addition to the housing and residential neighborhood reinvestment programs contained in the 1974 and 1977 Housing Acts, new tax laws were enacted in 1978.

In fact, the most significant tax incentive for real estate investors in many years may be a special provision written into the Revenue Act of 1978. For the first time a direct investment tax credit is available for rehabilitating qualified commercial properties. The Energy Tax Act of 1978 also contained provisions which should further encourage reinvestment in older properties. Prior to the acts, a property owner's benefit was limited to the depreciation or amortization of these expenditures.

These 1978 laws continue the swing in national real estate policy (if such a thing exists) toward encouraging the revitalization of urban areas. This shift was shown in the 1974 Housing Act created by the National Commission on Neighborhoods and particularly by the Housing and Community Development Act of 1977, including Title VIII known as the Community Reinvestment Act. Indeed, the National Commission on Neighborhoods has recently concluded an extensive study on declining neighborhoods and has strongly recommended that government policy should encourage the repair of older neighborhoods rather than new construction.

Prior to the 1978 tax legislation, revitalization was focused on residential rehabilitation. The principal tools for encouraging residential reinvestment were direct community block grants and special low interest rate rehab loans. The 1969 Tax Reform Act provided the first tax incentive by allowing rapid depreciation write-offs of rehabilitation expenses over five years rather than actual expected life. However, the 1969 tax laws applied only to rehabilitation expenses connected to low- and moderate-income housing. The 1969 TRA did nothing to encorage reinvestment in older, nonresidential real estate.

The most significant provisions of the Revenue Act of 1978 and the Energy Tax Act of 1978 for nonresidential real estate investors are the new investment tax credit allowance and the new alternate minimum tax. For residential rehabilitated properties, the new laws extend the accelerated depreciation provisions of the 1969 and 1976 Tax Reform Acts plus allowing a tax credit for energy conservation expenditures.

Investment Tax Credits

Revenue Act of 1978. This Act makes an investment tax credit of up to ten percent available for rehabilitation expenditures on qualified buildings.[1] To be a qualified building a structure must be rehabilitated after having been placed in service, and the rehabilitation process must leave at least seventy-five percent of the external walls in place as external walls.[2] In addition, the building must have been in existence for at least twenty years since construction or last re-

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habilitation.[3] Effectively, this limits the qualification of a building to once every twenty years starting twenty years after original construction.

Rehabilitation expenses are any expenditure that can be capitalized and that is incurred after October 31, 1978 on a qualified, rehabilitated building with a useful life of at least five years.[4] Rehabilitation expenses include reconstruction but do not include:

- The cost of any property which would qualify for the investment credit under the other definition of qualified property;
- The cost of acquiring the building; and
- Expenditure on certified historic structures unless it meets the rigorous tests under Section 191(d)(4).[5]

In order to maximize the investment credit on rehabilitation expenses, the expenditures are defined as new property.[6] Defining the expenditures as new property removes them from the limitation that only $100,000 per year of used property may qualify. Consequently, a taxpayer may include all of the rehabilitation expenses in his investment credit computation as well as up to $100,000 of used property purchased during the year.

The limitation on qualified buildings to ones with a useful life of at least five years means that the taxpayer can claim at least two-thirds of the ten percent on all expenditures. For buildings with a useful life of at least seven years, the full ten percent credit is available.

Although there are no other direct limitations on rehabilitation expenses, other provisions limit the qualifying properties. The first additional requirement is that the rehabilitated building may not be used to furnish lodging.[7] Hotels and motels, however, are specifically exempted from the exclusion for property used for lodging.

The second requirement deals with leased property. For the property owner to claim the investment credit, the property must be leased for less than fifty percent of the property's useful life, and the expenses deductible as ordinary and necessary business expenses must exceed fifteen percent of the rental income.[8]

The final additional requirement is that the taxpayer may not have elected the special short-term amortization under Sections 167(K) or 191.[9] These special provisions deal with accelerated depreciation write-offs for low-income residential properties and rehabilitated historical properties and are discussed under the heading of depreciation.

The Revenue Act of 1978 made another very important change in the investment credit, which, although it does not affect rehabilitation expenses directly, increases the amount of credit claimed. Prior to the Act, the maximum tax credit permitted in any year was limited to the first $25,000 of tax liability plus fifty percent of the liability above that amount. Starting in 1979 the percentage is increased by ten percent annually until 1982 when the maximum credit becomes the first $25,000 plus ninety percent of the excess liability.[10] Increasing the tax liability percentage to ninety percent, plus the fact that carryovers are used on a first-in, first-out basis (a result of the 1976 Reform Act), should eliminate any loss of the investment credit due to the limitation based on tax liability.

Energy Tax Act of 1978. An investment tax credit was included in the Energy Act which applies to expenditures that do not qualify for an investment credit under the 1978 Revenue Act. The Energy Act provides for an investment tax credit for energy property expenditures made by a property owner. It also changed part of the definition of property qualifying for the investment credit. These changes may increase or decrease the amount of the investment credit.

One important change that will decrease the amount of investment credit is that the definition of property eligible for the investment credit now excludes air conditioning and heating units.[11] Also excluded from the definition of eligible property are boilers fueled by petroleum and petroleum products such as natural gas.[12] Petroleum fueled boilers will not be exempt, however, if the burning of coal is prohibited by air pollution regulations or the boilers are used for an exempt purpose. Exempt purposes include residential facilities, farming, shopping centers, office buildings, and facilities which are not a part of the manufacturing or mining process.[13]

The Energy Act made expenditures for energy property from October 1, 1978 through December 31, 1982 eligible for the investment credit.[14] The expenditures can be for either commercial or residential property.

Energy property includes solar or wind energy property, alternate energy property and specially defined energy property.[15] Solar or wind energy property is equipment which generates electricity, heats, cools or provides hot water from solar or wind energy.[16] Alternate energy property is a boiler, burner or other equipment which produces energy from a source other than oil, natural gas or a product from oil or natural gas.[17] Specially defined energy property includes: a recuperator, a heat wheel, a regenerator, a heat exchanger, a waste heat boiler, a heat pipe, an automatic energy control system, a turbulator, a preheater, a combustible gas recovery system, an economizer, and any other property specified in the regulations to be issued.[18]

In order to implement the investment credit for energy property, the computation of the allowable tax credit was restructured. The total allowable credit is the sum of the regular percentage, the energy percentage and the Employee Stock Ownership Plan (ESOP) percentage.[19] The regular percentage is ten

percent of the property which qualifies because of applicable sections other than the energy property section. The Code states "... the regular percentage shall not apply to any energy property which but for section 48(l)(1) would not be section 38 property."[20] It appears that property that qualifies for the investment credit as energy property, and that is also eligible under another subsection, qualifies for the regular percentage. The ESOP percentage is only for corporations which have special employee ownership plans.

In addition, the law was changed so that the credit computation and the carryover rules are to be applied separately for energy property and all other investment credit property with the other property going first.[21] In applying this rule energy property is divided into solar or wind energy property and all other property. For nonsolar or wind property the computation of the credit and carryover is the same as nonenergy property except the percentage of tax which can be offset by this credit is increased to 100 percent of the tax liability.[22]

The credit for solar and wind energy property is a refundable credit.[23] This means that if the credit exceeds the tax liability the government will send the taxpayer a refund for the excess rather than requiring the excess be carried over and used to reduce the liability in an alternate year. This is the first time that any part of the investment credit is refundable and only the second time that any credit is refundable.[24]

Depreciation Allowances under 1978 Legislation

Rehabilitation expenditures must be capitalized (added to the asset basis) rather than deducted in the year incurred or paid. The taxpayer may then claim a depreciation deduction ratably over the life of the asset.

The Tax Reform Act of 1969 granted the taxpayer an option to elect to depreciate the cost of rehabilitation expenditures for low income housing over sixty months using the straight line rate.[25] Each subsequent tax act increased the date that the expenditure can be incurred. The Revenue Act of 1978 permits expenditures through December 31, 1981 to qualify for the election.

Low-income housing is defined as housing which is rented to low- and moderate-income families as defined in the Leased Housing Program under Section 8 of the United States Housing Act of 1937.[26] It does not include hotels, motels and other rental property in which more than one-half the units are used by transients.[27] Qualified rehabilitation expenditures are capitalizable and apply to a property addition or improvement which has a useful life of at least five years.[28] Qualified expenditures do not include the acquisition of the property or a partial interest in the property. The maximum amount which will qualify for the accelerated amortization is $20,000 per unit provided at least $3,000 is expended within a two-year period.[29]

The Tax Reform Act of 1976 permitted the amortization of qualified rehabilitation expenses of certified historic structures over sixty months using the straight line method.[30] The Revenue Act of 1978 expands and modifies the law to include historic districts certified by state and local governments as well as ones listed in the National Register. The Act continues the restriction on depreciation to the straight line method for demolition and substantial alterations of structures within historic districts unless they meet the tests as certified rehabilitation expenditures.[31] The Act also makes clear that the taxpayer can elect either the sixty-month amortization or accelerated depreciation, but not both.[32]

If real property is sold at a gain, then the gain, to the extent it is the result of accelerated depreciation in excess of the amount which would have been allowed under the straight line method, is ordinary income rather than capital gain. Since 1969, the election to amortize rehabilitation expenses over sixty months has caused the gain on the sale to be ordinary to the extent the amortization deduction exceeded the amount that would have been deducted if the actual useful life had been used. The Revenue Act of 1978 includes the sixty-month amortization of certified historical structure expenses under this recapture rule.[33]

As discussed earlier, the Energy Tax Act of 1978 prohibits the claiming of the investment credit on certain boilers fueled by oil and gas. In calculating the deduction for depreciation on these boilers the taxpayer is limited to the straight line method.[34] In addition, the useful life will be equal to the listed class life without the twenty percent reduction which was permitted as part of the asset depreciation range method. In other words, the taxpayer is limited to the old guideline life for the boiler.

Alternately, the Energy Act permits the taxpayer to shorten the useful life of a boiler fueled by oil, gas or other petroleum product which is already in operation.[35] If the taxpayer can establish that he is going to retire or replace a petroleum boiler before the expiration of the selected useful life, then he can determine the depreciation deduction based on this shorter life. However, if the boiler is not retired or replaced, he will be liable for interest on the tax benefit which resulted from the shortened life.

Alternate Minimum Tax

In addition to the changes in investment credit and depreciation, the Revenue Act of 1978 will cause a taxpayer to incur an increase in minimum tax as a result of rehabilitation expenses.

Included in the list of tax preferences is accelerated depreciation on real property. This is defined as the amount of depreciation claimed in excess of the amount that would have been allowed under the

straight line method. In calculating the amount of straight line depreciation, the taxpayer was not permitted the rapid write-off of rehabilitation expenses of low income housing. Therefore, if the taxpayer elected the sixty-month amortization, he or she had tax preferences equal to the difference between the amount claimed and the amount that would have been allowed if the actual useful life rather than the shorter life was used. The Revenue Act of 1978 added the sixty-month amortization of certified historical rehabilitation expenses to the list of tax preferences.[36]

The above change is the only direct one made by the 1978 Act. There is, however, a significant indirect change. The Act added a new alternate minimum tax.[37] This alternate minimum tax is payable if it is larger than the regular tax plus the old add-on minimum tax. This new minimum tax is a replacement of the regular tax plus add-on minimum and is payable instead of the old taxes.

The computation of the new alternate minimum tax starts with gross income. From gross income there is subtracted all deductions permitted in arriving at taxable income. To this is added the amount of tax preferences as a result of capital gains and itemized deductions.[38] The result of the addition and subtraction is alternate minimum taxable income.

The alternate minimum tax is calculated on a progressive rate scale. The rates are ten percent for alternate minimum taxable income from $20,000 to $60,000, plus twenty percent for the amount between $60,000 and $100,000, plus twenty-five percent on the amount above $100,000.[39] This alternate tax is reduced to the amount of the allowable foreign tax credit.[40] No other credits are permitted.

If the taxpayer is liable for this new alternate minimum tax he will not receive the benefit of the investment credit. Specifically, a taxpayer entitled to the credit as a result of rehabilitation expenditures will not have a reduced tax liability if his alternate minimum tax exceeds his regular tax minus all credits plus the old add-on investment credit.

If the taxpayer does not get to use the investment credit because of the alternate minimum tax he will be able to carry over the unused amount. The carryover period is the three years preceding the current one plus the seven succeeding years. This ten-year carryover period plus the fact that the credit is used on a first-in/first-out basis should aid in minimizing the loss of investment credits.

Future Impact

As with any new laws, particularly new tax laws, some problems exist. First, until the IRS issues its regulations clarifying and expanding the definitions of many key terms, a great deal of uncertainty will remain about eligible expenditures and qualifying properties.

A marked tendency on the part of property owners to have their properties or immediate neighborhoods registered as historical districts may also result. It remains to be seen how much pressure will be exerted to limited historical registry.

The refundable tax credit now available, together with the new alternate minimum tax, may cause a shift away from the high tax bracket investor toward middle and upper middle-income investors seeking immediate cash returns. A "secondary market" may develop from investors who initially purchase older properties, provide the rehabilitation capital, and take the immediate tax advantages and resell the property on a short term basis to a "permanent" owner seeking the longer term cash flows and depreciation allowances.

Finally, until a body of case law is developed to supplement forthcoming regulations, investors seeking to take advantage of the new tax incentives will be facing far more uncertainty and be subject to future interpretations of allowable expenditures.

NOTES

1. Section 48(a)(i)(E).
2. Section 48(g)(i)(A).
3. Section 48(g)(i)(B).
4. Section 48(g)(2)(A).
5. Section 48(g)(2)(B) and Section 48 (g)(1)(D).
6. Section 48(g)(3).
7. Section 48(a)(3).
8. Section 46(e)(3). Also permitted are leases by corporations and leases of property manufactured by the lessor.
9. Section 48(a)(8).
10. Section 46(a)(3).
11. Section 48(a)(1)(A).
12. Section 48(a)(10)(A).
13. Section 48(a)(10)(B).
14. Section 48(l)(1).
15. Section 48(l)(2).
16. Section 48(l)(4).
17. Section 48(l)(3).
18. Section 48(l)(5).
19. Section 46(a)(2)(A). ESOP refers to corporations which have established special qualified employee stock ownership plans.
20. Section 46(a)(2)(D).
21. Section 46(a)(10)(A).
22. Section 46(a)(10)(B).
23. Section 46(a)(10)(C).
24. The earned income credit was the first refundable credit.
25. Section 167(k)(1).
26. Section 167(k)(3)(B).
27. Section 167(k)(3)(C).
28. Section 167(k)(3)(A).
29. Section 167(k)(2).
30. Section 191(a).
31. Section 167(n).
32. Section 167(o).
33. Section 1250(b)(4).
34. Section 167(p).
35. Section 167(q).
36. Section 57(a)(2).
37. Section 55.
38. Section 55(b)(1). Starting in 1979, sixty percent of net long term capital gains is a tax preference item. The amount of itemized deduction except medical and casualty losses in excess of sixty percent of adjusted gross income is also a tax preference item.
39. Section 55(a)(1).
40. Section 55(c)(2).