

# Preference Tax Changes: The Sleeper in the 1976 Tax Reform Act

by *Gaylon E. Greer*

The number of taxpayers affected by the minimum tax on preference items is expected to be increased tenfold by the 1976 Tax Reform Act. This promises to be the major revenue generating feature of the new law. Yet the flurry of commentary on the Act has generally ignored changes in the preference tax. This is particularly curious since real estate investors will supply the bulk of the one billion dollars of additional tax revenue the changes are expected to generate. Judicious planning will be required to minimize the consequences of the new rules, which may drastically alter the way the real estate investment game is played.

## ORIGINS OF THE PROBLEM

The fortunate confluence of accelerated depreciation and long-term capital gain rules have traditionally made real estate a favored investment of high-bracket taxpayers. Rapid depreciation write-offs enabled "economic income" to escape immediate taxation, while the capital gain rules placed a premium on strategies enabling gains to be so characterized.

Stories abound of millionaires paying little or no income tax due to these and other special provisions generally available to the affluent. The Congress responded in 1969 by imposing a minimum tax on deductions popularly employed in "tax shelter" schemes. The initial preference tax rules were relatively innocuous. Liberal exemptions enabled most investors to avoid the tax without express planning to this end, and the rate itself was quite low. Consequently, the preference tax did little to alter the strategy of tax-oriented investment plans.

## New Teeth for the Preference Tax

All this is changed by a little-heralded aspect of the 1976 Tax Reform Act, which both reduces the exemptions and increases the rate of taxation on pref-

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erence items. To illustrate the importance of these changes, consider an investor who has tax preferences of \$125,000 and regular taxes of \$90,000. His minimum tax on preference items, under both the old and the revised rules, is shown in *Exhibit 1*.

**EXHIBIT 1**  
**THE EFFECT OF CHANGES IN PREFERENCE TAX RULES**

	<u>Old Rules</u>	<u>New Rules</u>
Tax preference items	\$125,000	\$125,000
Less exemptions	<u>120,000</u>	<u>45,000</u>
Amount subject to minimum tax	\$ 5,000	\$ 80,000
Tax rate	<u>10%</u>	<u>15%</u>
Minimum tax on preference items	<u>\$ 500</u>	<u>\$ 12,000</u>

This probably overstates the preference tax liability under the old rules, which permitted unused exemptions from prior years to be carried forward and offset against current preference items. This valuable provision has been eliminated by the 1976 amendment.

**Overview of Code Section 56**

All this suggests the wisdom of a fresh look at Section 56, which contains the rules for determining the minimum tax on preference items. In addition to the taxpayer's regular tax liability, there is a 15% tax on all preference items in excess of the greater of \$10,000 or one-half the regular tax.<sup>1</sup> Preference items of particular interest to real estate investors are:<sup>2</sup>

- 1) Long-term capital gains. The 50% of capital gains which is ordinarily excluded from income subject to taxation constitutes preference income. This provision remains invariant even if the investor uses the alternative method of computing his capital gain tax liability.
- 2) Accelerated depreciation. Preference income includes the excess of accelerated depreciation deductions over the amount which would have resulted from using the straight-line method.

The "regular tax liability" for purposes of determining the preference tax exemption includes the total tax for the year, before accounting for the preference tax, minus the following items: foreign tax credit, retirement income credit, the WIN credit, credit for political contributions, and personal credits.

*Exhibit 2* demonstrates how the preference tax is computed. The calculations assume an investor who has a regular tax liability of \$18,000, with long-term capital gains of \$30,000 and depreciation deductions of \$24,000. It assumes further that had he used the straight-line method his depreciation allowance would have been only \$15,000.

**EXHIBIT 2**  
**COMPUTATION OF PREFERENCE TAX LIABILITY**

<b>Preference Items:</b>	
One-half long-term capital gains	\$15,000
<b>Excess depreciation:</b>	
Total depreciation deductions	\$24,000
Straight-line depreciation	<u>15,000</u>
Excess over straight line	<u>9,000</u>
Total preference items	\$24,000
<b>Less Exemption:</b>	
(a) One-half regular tax	\$ 9,000
(b) Minimum exemption	10,000
Greater of (a) or (b)	<u>10,000</u>
Preference items subject to minimum tax	<u>\$14,000</u>
Preference tax (at 15%)	<u>\$ 2,100</u>

**THE LEAK IN THE TAX SHELTER**

The new rules have stripped real estate of much of its tax shelter allure.<sup>3</sup> Perhaps the greatest impact has been on the tax consequences of accelerated depreciation, which in some cases may actually reduce the after-tax rate of return on an investment. To see how this might be, we have analyzed the tax consequences of accelerated depreciation deductions under both the new and the old preference tax rules, using the following example:

Joe Dough purchases a new residential income property for \$300,000 financing the acquisition with a \$240,000, 8½%, 30-year first mortgage loan. Eighty percent of the value is attributable to the improvements, which have an estimated useful life of 40 years with no salvage value. The property generates net operating income of \$27,000 per year throughout a five-year holding period. Dough sells the property at the end of the fifth year for \$300,000. He uses the 200% declining balance depreciation method during the first four years of ownership, shifting to the straight-line method during the year of sale.

Dough, who is married and files a joint return, has \$10,000 of preference items each year, before accounting for the effect of this investment. He has taxable income, after all other deductions and exemptions but before including the results of this investment, of \$55,000 per year.

**Accelerated Depreciation under the Old Rules**

Joe Dough's taxable income after inclusion of the net operating income from the investment, but before deducting depreciation and interest expense, will be \$82,000. The first-year interest deduction will be approximately \$20,203, while that of the fifth and final year will be approximately \$19,459. Depreciation deductions range from a high of \$12,000 in the first year to a low of \$5,430 in the last year. Dough will therefore be in the 53% incremental income-tax bracket both before and after accounting for the effects of depreciation deductions in excess of straight line.<sup>4</sup>

Before 1976, Dough would have incurred no preference tax liability as a result of using accelerated depreciation. The additional tax savings from use of accelerated rather than straight-line depreciation would therefore have been equal to 53% of the excess depreciation. The annual savings under these assumptions are computed in *Exhibit 3*.

**EXHIBIT 3**  
**TAX SAVINGS FROM ACCELERATED DEPRECIATION**

	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>	<u>Year 4</u>	<u>Year 5</u>
Accelerated Depreciation	\$12,000	\$11,400	\$10,830	\$10,289	\$5,430 <sup>2</sup>
Straight-Line Depreciation <sup>1</sup>	<u>6,000</u>	<u>6,000</u>	<u>6,000</u>	<u>6,000</u>	<u>6,000</u>
Excess Depreciation	<u>\$ 6,000</u>	<u>\$ 5,600</u>	<u>\$ 4,830</u>	<u>\$ 4,289</u>	<u>\$ ( 570)</u>
Tax Savings (at 53%)	<u>\$ 3,180</u>	<u>\$ 2,968</u>	<u>\$ 2,560</u>	<u>\$ 2,273</u>	<u>\$ ( 302)</u>

<sup>1</sup>The straight-line depreciation rate is 1/40, or 2½% per annum. The original depreciable base is \$240,000.

<sup>2</sup>The undepreciated balance when Dough shifts to the straight-line method is \$195,481, and the remaining useful life is 36 years. The revised straight-line depreciation deduction will therefore be 1/36 x \$195,481, or \$5,430.

The cumulative tax savings in *Exhibit 3* are more than offset by the additional tax upon sale, due to the recapture of excess depreciation. *Exhibit 4* shows the computation of the tax consequences to Dough of recapture of excess depreciation upon sale of the property in our example, before consideration of the minimum tax on preference items.

**EXHIBIT 4**  
**TAX CONSEQUENCE OF RECAPTURED EXCESS  
DEPRECIATION BEFORE CONSIDERATION OF PREFERENCE TAX**

Joe Dough's taxable income before accounting for sale of property <sup>1</sup>	\$57,111
Add recapture of excess depreciation:	
Cumulative depreciation	\$49,949
Less straight-line depreciation	<u>30,000</u>
Excess (100% recaptured)	<u>19,949</u>
Total ordinary income subject to tax	<u>\$77,060</u>
Income-tax liability	\$31,635
Less tax on \$57,111	<u>20,769</u>
Tax consequences of recapture of excess depreciation	<u>\$10,866</u>
<sup>1</sup> Taxable income before accounting for sale of property:	
Taxable income from other sources	\$55,000
Add income from operations:	
Net operating income	\$27,000
Less:	
Fifth-year interest expense	\$19,459
Fifth-year depreciation	<u>5,430</u>
Net income from investment	<u>\$ 2,111</u>
Total taxable income before results of sale	<u>\$57,111</u>

The \$10,866 increase in Dough's tax liability due to the recapture of excess depreciation exceeds the cumulative tax savings from excess depreciation over the holding period, because lumping the recapture in the year of sale moves him from the 53% to the 58% incremental tax bracket. The "rate of interest" on the funds made available through accelerated depreciation deductions is that discount rate which equates the present value of the annual tax savings from claiming excess depreciation over the straight-line amount with the present value of the tax consequences of recapture of the excess depreciation upon sale of the property. This can be expressed as:

$$\sum_{t=1}^n \frac{S_t}{(1+d)^t} = \frac{P_n}{(1+d)^n}$$

where  $t$  ranges from one through five,  $S_t$  is the differential tax effect of using accelerated depreciation rather than straight line in year  $t$ , and  $P_n$  is the tax consequence of recapture of excess depreciation upon sale. The common discount rate,  $d$ , is the "rate of interest" on these funds. Solving for  $d$  results in a rate of discount only slightly above zero. Using income averaging in the year of sale would reduce the incremental tax rate to 53% and result in a discount rate of exactly zero. The funds provided by the tax savings from the excess of accelerated over straight-line depreciation deductions are essentially costless.

### Preference Tax Introduces a Cost

So far we have reckoned without the impact of the minimum tax on preference items. This was a perfectly legitimate approach before 1976, because the preference tax generally was of no consequence. In our example, Joe Dough would not have incurred a minimum tax on preference items at any time during the projection period, under the old rules.

The preference tax rules now in effect introduce an additional tax liability in each year accelerated depreciation is claimed, reducing the amount of funds provided by the depreciation deductions. This reduction in funds provided, with no corresponding decrease in tax liability from recapture of excess depreciation upon sale, constitutes an added cost.

Our example stipulated that Dough has preference items of \$10,000 other than those resulting from the investment under analysis. Since there is a \$10,000 exemption always available to the taxpayer, no preference tax liability would exist were it not for inclusion in preference income of accelerated depreciation in excess of straight line. But the entire amount of Dough's excess depreciation each year will be subject to the 15% tax on preference items. *Exhibit 5* shows his preference tax liability from excess depreciation for each year of the holding period.

**EXHIBIT 5**  
**PREFERENCE TAX ON EXCESS DEPRECIATION**

	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>	<u>Year 4</u>	<u>Year 5</u>
Excess Depreciation (from <i>Exhibit 3</i> )	<u>\$6,000</u>	<u>\$5,600</u>	<u>\$4,830</u>	<u>\$4,289</u>	<u>\$ (570)</u>
Preference tax liability (at 15%)	<u>\$ 900</u>	<u>\$ 840</u>	<u>\$ 725</u>	<u>\$ 643</u>	<u>\$ 000</u>

In the year of sale Dough's preference tax liability (on the capital gain) will be *reduced* as a consequence of the recapture of excess depreciation, which increases the preference tax exemption by one-half the resultant increase in his regular tax liability. The tax on the recapture of excess depreciation must be offset by this reduction in preference taxes on the capital gain to determine the tax consequence in the year of sale, of having used accelerated depreciation. These calculations are presented in *Exhibit 6*.

**EXHIBIT 6**  
**TAX CONSEQUENCE OF RECAPTURED EXCESS DEPRECIATION  
WITH PREFERENCE TAX CONSIDERED**

Tax due to recapture of excess depreciation (from <i>Exhibit 4</i> )	\$10,866
Less consequent reduction in preference tax on capital gain:	
Increase in preference tax exemption (one-half the tax on recapture)	\$5,433
Preference tax rate	<u>15%</u>
	<u>\$ 815</u>
Net tax increase due to having claimed excess depreciation	<u>\$10,051</u>

The annual tax savings and the additional tax liability from the use of accelerated depreciation in our continuing example can now be summarized. The starting point is the annual savings from the use of accelerated depreciation instead of straight line, before the effect of the new preference tax rules, as presented in *Exhibit 3*. From these savings must be subtracted the resultant preference tax liability, as illustrated in *Exhibit 5*. Finally, additional taxes in the year of sale due to the recapture of excess depreciation, adjusted for the consequent reduction in the preference tax on the capital gain, must be considered.

These calculations are all brought together in *Exhibit 7*:

**EXHIBIT 7**  
**ANNUAL TAX CONSEQUENCE OF ACCELERATED  
DEPRECIATION AND THE PREFERENCE TAX**

	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>	<u>Year 4</u>	<u>Year 5</u>
Reduction (increase) in regular tax liability <sup>1</sup>	\$3,180	\$2,968	\$2,560	\$2,273	\$ (302)
Less:					
Increase in preference tax <sup>2</sup>	900	840	725	643	-
Tax on recapture of excess depreciation, net of preference tax savings <sup>3</sup>	-	-	-	-	\$10,051
Net tax saving (additional tax liability)	<u>\$2,280</u>	<u>\$2,128</u>	<u>\$1,835</u>	<u>\$1,630</u>	<u>(\$10,352)</u>

<sup>1</sup>From Exhibit 3.

<sup>2</sup>From Exhibit 5.

<sup>3</sup>From Exhibit 6.

Calculating as before the rate of discount which equates the present value of the annual tax savings from the use of accelerated rather than straight-line depreciation with the differential tax consequences on sale due to the recapture of excess depreciation, the "rate of interest" on the funds made available is approximately 10.7%. It is important to note that this is an "after-tax" cost of making the funds available. Borrowed funds have an after-tax cost of:

$$(1 - t) i$$

where  $t$  is the borrower's incremental tax rate and  $i$  is the rate of interest charged by the lender. Thus, the after-tax rate on funds made available through the use of accelerated depreciation, to be made comparable with before-tax rates on borrowed funds, must be divided by  $(1 - t)$ . In our example, Joe Dough's incremental tax rate ( $t$ ) is 53%, so  $(1 - t)$  is 47%. Dividing the discount rate of 10.7% by .47 results in a before-tax equivalent rate of interest of 22.8%.

The example used here is, of course, deliberately structured to generate the results achieved. The cost of taking accelerated depreciation was demonstrated, among other ways, by assuming a relatively short projection period. The longer the property is held the less will be the cost, as a per-annum rate, of generating funds by claiming accelerated depreciation deductions. The cost will also vary with the amount of other tax preference items, and with the level of the taxpayer's ordinary income. But whatever the assumptions employed, it is clear that the new preference tax rules have the potential to transmute accelerated depreciation benefits into an expensive proposition.

### LIVING WITH THE NEW RULES

This analysis of the implications of the revised rules governing the minimum tax on preference items is by no means exhaustive. An important dimension which has been excluded is the effect on capital gains. Also ignored is the increased interdependence of various tax provisions.

Whatever their influence on resource allocation, the new rules will most assuredly effect changes in the relative emphasis placed on various aspects of investment analysis. When coupled with the more stringent tax provisions in other investment-related areas, they may render many traditional investment strategies obsolete.

### **New Emphasis on Basic Economics**

Tax shelter alone was, of course, never sufficient reason to ignore the economics of an investment proposal. Implementation of the revised revenue code makes it less likely that this truism will be ignored. In addition to the increased minimum tax on preference items the amendment tightened the rules governing investment interest deductions, discontinued the more favorable recapture rules applicable to excess depreciation on residential income property, and eliminated the current deduction for construction-period interest and taxes. While these changes are relatively mild compared to the treatment afforded investment outlets other than real estate, we can expect to see greater emphasis placed on basic economic analysis of real estate investment proposals.

### **Added Value in Tax Planning**

Paradoxically, individual tax planning has been given added importance. Increased complexity of tax rules combined with greater potential tax liability places a premium on careful advance planning to minimize the tax consequence of investment portfolio decisions. Changes in carryover rules and exemption provisions give added importance to timing of recognition of revenue and expense items.

Moreover, the analysis now more than ever must be based on a total portfolio approach. Analyzing a single investment opportunity out of the context of a particular investor's composite portfolio will inevitably misstate the true tax consequences of the proposal. The interdependency of tax factors in the asset portfolio, both realty and personalty, gives added impetus to integrated investment analysis.

### **Analysis of Incremental Rather Than Average Consequences**

The reform bill lowered the threshold for incurring a tax liability on preference items and for disallowance of investment interest deductions. It is more than ever the case that the incremental tax effect may greatly exceed the investor's average tax liability, due to crossing these thresholds. Rather than simply applying average tax rates, accurate analysis requires a comparison of the total tax bill both with and without the proposed investment, to determine the incremental income tax consequences of the decision being rendered.

### **New Lustre for Old Tax Management Tools**

The seasoned tax strategies of controlling the timing of recognition of gains by using like-kind exchanges and installment sales reporting become increasingly valuable under the new tax rules. They increase the investor's flexibility in managing his affairs to avoid "bunching" deductions or gains in a manner that will trigger the preference tax liability or investment interest deduction



limitations. Recognition of their increased potential in light of the new tax rules should give these strategies greater prominence in tax-wise investment plans.

## SUMMARY

Changes in the minimum tax on preference items is a little-noticed aspect of the 1976 Tax Reform Act which promises to have a big impact on investment strategy. It will decrease the value of both capital gains and accelerated depreciation provisions. Accelerated depreciation will no longer be an unmixed blessing, because the tax deduction attributable to excess depreciation may prove to be a costly source of funds.

Anticipation of tax preference items in excess of preference tax exemptions calls for advance planning to enable rescheduling recognition of the items. This places a premium on judicious use of like-kind exchanges and installment sales. It also increases the importance of an incremental approach to analysis of the tax implications of all investment proposals.

### SCHEDULE A FIVE-YEAR AMORTIZATION SCHEDULE

	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>	<u>Year 4</u>	<u>Year 5</u>
Annual Principal Payments	\$ 1,944	\$ 2,088	\$ 2,280	\$ 2,448	\$ 2,688
Annual Interest Payments	\$20,203	\$20,059	\$19,867	\$19,699	\$19,459
Annual Debt Service <sup>1</sup>	\$22,147	\$22,147	\$22,147	\$22,147	\$22,147

<sup>1</sup>Assumes \$240,000, 8½%, 30-year loan with level monthly payments.

### REFERENCES

1. The preference tax rules for corporations are similar to those for individuals, except that the exemption is equal to the greater of \$10,000 or the total corporate tax liability.
2. Other tax-preference items of less immediate concern to real estate investors are the excess of market value over the option price of stock received under a qualified stock option plan, depreciation in excess of straight line on personalty under a lease, the excess of rapid amortization of certain items over the amortization otherwise permitted, depletion in excess of cost of the depletable item, and bad-debt deductions allowed financial institutions in excess of actual bad-debt experience.
3. Other changes wrought by the 1976 Tax Reform Act which reduce the tax benefits of real estate investments include additional limitations on investment interest deductions, elimination of the current deduction for construction-period interest and taxes, and elimination of the more permissive recapture provisions formerly applicable to excess depreciation on residential income property.
4. Interest expense calculations are presented in *Schedule A*, at the end of the article. All tax calculations are based on the tax rate tables in effect in 1976.