INTRODUCTION

The Rural Housing Alliance publishes this study of tax subsidies for limited dividend housing in a spirit of outrage and trepidition. We are outraged that programs designed ostensibly to help moderate income people live in better housing should turn out to provide greater benefits for rich investors than poor tenants. We are fearful because this perversion of morality and sanity seems likely to spread from urban to rural programs. The Farmers Home Administration has recently issued regulations designed to encourage limited dividend corporations to build rural housing.

We are convinced, too, that we will not begin to solve either rural or urban housing problems until we identify the obstacles to better housing and the interests served by present programs. Thus, while this paper speaks largely in urban terms, we present it both as a warning and a call to action.

FEDERAL TAX RIP-OFFS: HOUSING SUBSIDIES FOR THE RICH

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FEDERAL TAX RIP-OFFS: HOUSING SUBSIDIES FOR THE RICH

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CHAPTER ONE

BACKGROUND: FEDERAL HOUSING SUBSIDY PROGRAMS

Housing subsidies have become big business. In less than five years since passage of the mammoth 1968 housing act, we have moved from a situation where the federal government was as likely as not to make a net profit on its housing operations[1] to one where housing subsidies consume a major portion of the budget of the Department of Housing and Urban Development (HUD) and the estimated total cost of units proposed in the administration's budget for fiscal 1973 ranged between $10 and $18 billion.[2]

Overt Subsidy Programs

From 1937, when Congress first adopted a program of overt housing subsidies for the poor by passing the Housing Act of 1937, through the middle 1960's, subsidized housing accounted for only 1 to 2 percent of all housing starts. Indeed, in any given year during the 1960's, total private housing starts exceeded all the subsidized housing ever built. The contrast with current program levels is indicated in the following excerpt from the 1971 Annual Report on National Housing Goals:

> "As the continuing inflation of housing cost has priced more and more American families out of the housing market, there has been increasing pressure for the Federal Government to move in to fill the cost/income gap by expanding subsidy programs at enormous cost of Federal budget funds. This was most dramatically evident in

1. Table B-59, Appendix B, Economic Report of the President, January 1967, shows the federal government with a net income from housing and community development programs in 9 of the 30 years between 1939 and 1968; since much of the expenditures following 1949 were for urban renewal and related programs, the figures for housing programs alone would be much higher. The reason for this is that income from federal mortgage and lending activities more than offset the relatively insignificant housing subsidies for low income families.

2. HUD-Space-Science-Veterans Appropriations for 1973, hearings before a subcommittee of the Committee on Appropriations, House of Representatives, p. 110.

the pressure in the Congress last year to extend the housing subsidies now available for low-and moderate-income families into a new program that would subsidize middle-income families as well.

In calendar year 1968, the Federal Government subsidized about 10% of all new housing units produced; last year, the figure was up to almost 25% and it is scheduled to remain in this range in this year and next. It is estimated that subsidized housing units started or projected for the 3 fiscal years 1970-72 have already obligated Federal Government to subsidy payments of perhaps $30 billion over the next 30 to 40 years. And assuming the completion of the 6 million subsidized units for low- and moderate-income families called for in the 10-year housing goals by 1978, present estimates suggest that the Federal Government will by that year be paying out at least $7.5 billion annually in subsidies. Over the life of the mortgages this could amount to the staggering total of more than $200 billion. Any increase in the number of units to be subsidized beyond those called for in the 10-year goal will only add further to the claims on future budgets.

Clearly, the public interest demands that the Federal Government not stand impassively at the cash register and continue to pay out whatever is necessary to feed runaway inflation or housing cost."[3]

The chief manner in which the government subsidizes housing is through below-market-interest-rate (BMIR) programs under which the Federal Government can pay to the lending institutions the difference between a 1% interest rate and the market rate at which the mortgage was negotiated. Almost all housing programs are referred to by number, not name, and these are no exception. "Section 502" refers to the rural ownership program administered by the Farmers Home Administration (FmHA) of the U.S. Department of Agriculture and "Section 235" is the similar urban program.[4] Rental housing in rural areas is known as "Section 515" and in urban areas as "Section 236."[5] Section 236 replaced two older programs,

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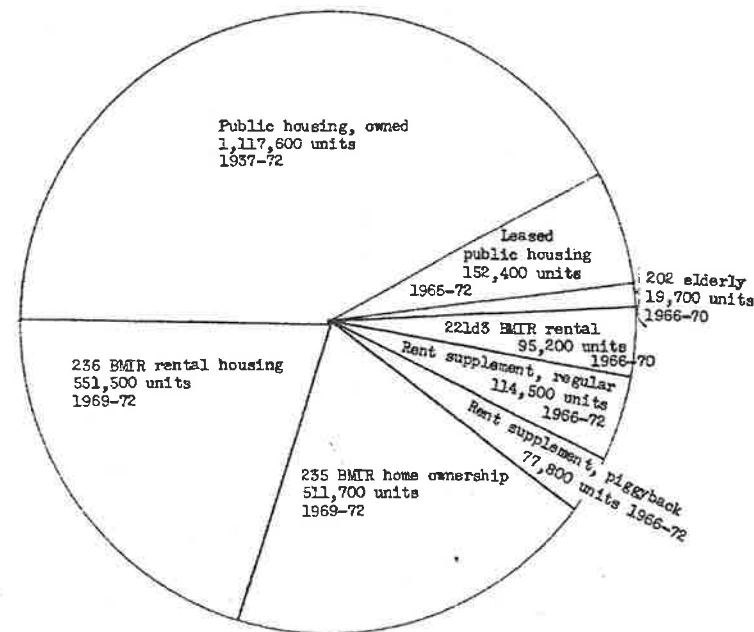
3. Third Annual Report on National Housing Goals, June 1971, House Document No. 92-136, pp. 21-22.

4. These are, in fact, Section 502 of the Housing Act of 1949 and Section 235, added to the National Housing Act in 1968.

5. Again, these sections are from the Housing Act of 1949 and the National Housing Act, as amended in 1968.

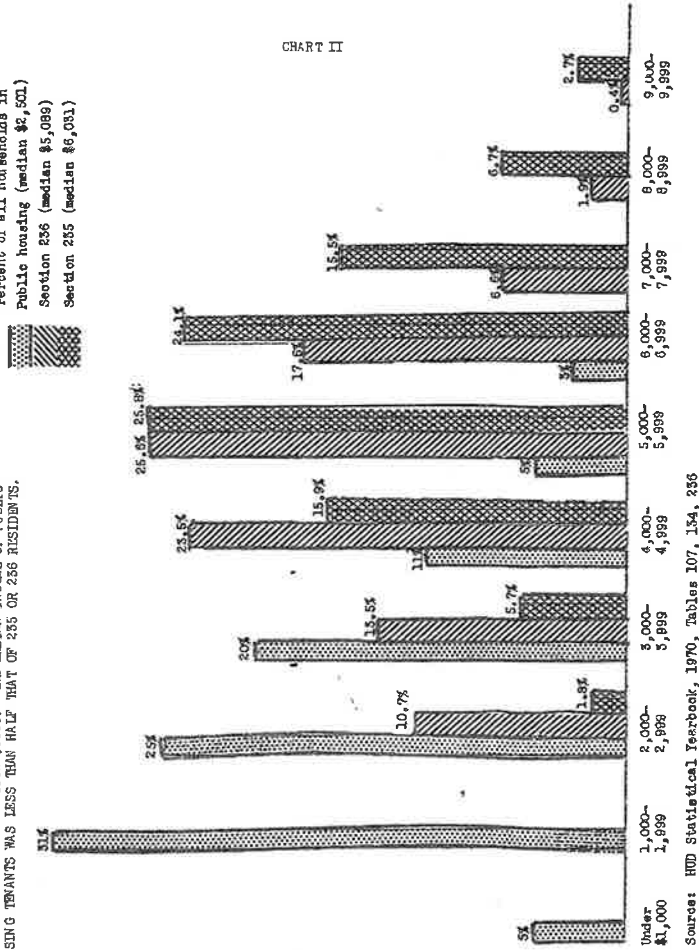
CHART I

ROUGHLY HALF OF ALL HOUSING SUBSIDIZED BY THE FEDERAL GOVERNMENT SINCE 1937 IS PUBLIC HOUSING FOR LOW INCOME FAMILIES. ALMOST ALL THE REST HAS INTEREST SUBSIDIES. FMHA HOUSING IS NOT SHOWN BECAUSE FIGURES ARE NOT AVAILABLE ON THE PROPORTION OF THE 480,000 UNITS WHICH ARE SUBSIDIZED.



Total units, 1937-1972: 2,640,400 units
Ownership: 511,700 units or 19.4%
Rental: 2,128,700 units or 80.6%

CHART II

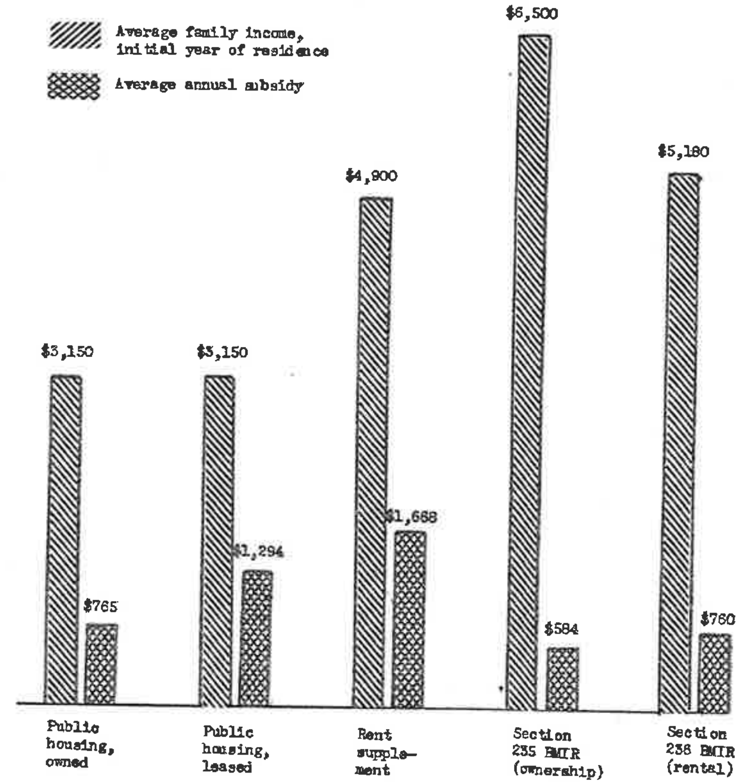


IN 1970, 61% OF THE FAMILIES IN PUBLIC HOUSING, BUT ONLY 11% OF FAMILIES IN 236 HOUSING AND LESS THAN 2% OF THE FAMILIES IN 235 OCCUPANTS HAD INCOMES BELOW $3000. THE MEDIAN INCOME OF PUBLIC HOUSING TENANTS WAS LESS THAN HALF THAT OF 235 OR 236 RESIDENTS.

Source: HUD Statistical Yearbook, 1970, Tables 107, 134, 236

CHART III

PUBLIC HOUSING, SERVING POOR FAMILIES, HAS LOWER SUBSIDIES THAN RENT SUPPLEMENT HOUSING. THE HOME OWNERSHIP PROGRAM, WITH HIGHEST AVERAGE INCOME, HAS LOWEST SUBSIDY, BUT THE RENTAL BMIR PROGRAM, WITH MUCH HIGHER INCOME TENANTS, GETS ALMOST AS MUCH SUBSIDY AS PUBLIC HOUSING. (Note: These figures do not include tax subsidies.)



Source: HUD memorandum contained in House Appropriations Committee hearings on HUD budget, April 1972, pp. 109-118. Average annual subsidy figure obtained by dividing estimated total payment by estimated years subsidized.

a program for direct housing loans for rental housing for the elderly and handicapped known as "202", and a second program of direct loans for rental housing, known as "221-(d)3". In addition to the below market interest rate programs, there is a relatively small rent supplement program, under which the difference between a minimum rent and an economic rent is subsidized. None of these programs by themselves can serve poor families successfully, because the subsidies do not lower housing costs enough. However, a combination of the interest subsidy and a rent supplement can reduce monthly costs enough so low income people can afford them.

The only housing program designed for low income people is public housing, in existence since 1937, under which the federal subsidy covers the interest and amortization of the bonds financing construction of the project or, in the case of rehabilitation or acquisition of as-is housing or leasing, an equivalent amount. More recently, Congress has authorized operating subsidies for public housing as well. But HUD, under pressure from budget-cutters, has urged local housing authorities to seek out higher income tenants instead of asking for more subsidies.

Charts I, II, and III briefly summarize the key characteristics of the major housing subsidy programs, and show income levels served by the programs, and rates of construction.

Hidden Subsidy Programs

The foregoing subsidy programs, however, tell only a minor part of the housing subsidy story. A recent study prepared for the Joint Economic Committee of the U.S. Congress totalled the gross cost of housing subsidies for 1970 and found that direct cash payments or credit subsidies accounted for $2.7 billion -- not quite one third of the total housing subsidies of $8.4 billion. Two thirds of all federal housing subsidies were in the form of tax subsidies or, as they are sometimes called, tax expenditures.

Tax expenditures are the cost to the government of various deductions on individual and corporate income taxes. They are not contained or even identified in the Federal budget. They are thus not subject to Congressional scrutiny on an annual basis, as are appropriations for housing program subsidies. They are, quite simply, the result of the interaction of tax laws and people's spending habits which often are heavily influenced by these laws. Tax subsidies almost never go to the poor, even though studies have shown that people with an annual income of $2,000 pay taxes at the same

rate as people with incomes of $50,000.

The deductibility of property taxes ($2.8 billion) and mortgage interest on owner-occupied homes ($2.6 billion) account for the vast bulk of tax subsidies in housing, and, indeed, 2/3 of all housing subsidies. (See chart IV)

The third major tax subsidy is depreciation on rental housing, totalling in 1970 an estimated $275 million.[6] Nevertheless, while the amount of this subsidy is dwarfed by those for property taxes and mortgage interest payments, it amounts to a substantial proportion of the subsidies for BMIR rental housing. More importantly, the subsidy goes almost exclusively to the rich. This is because a person needs to be in the 50% tax bracket before it pays to try to take advantage of this tax subsidy or "shelter", since many projects generate very little income.

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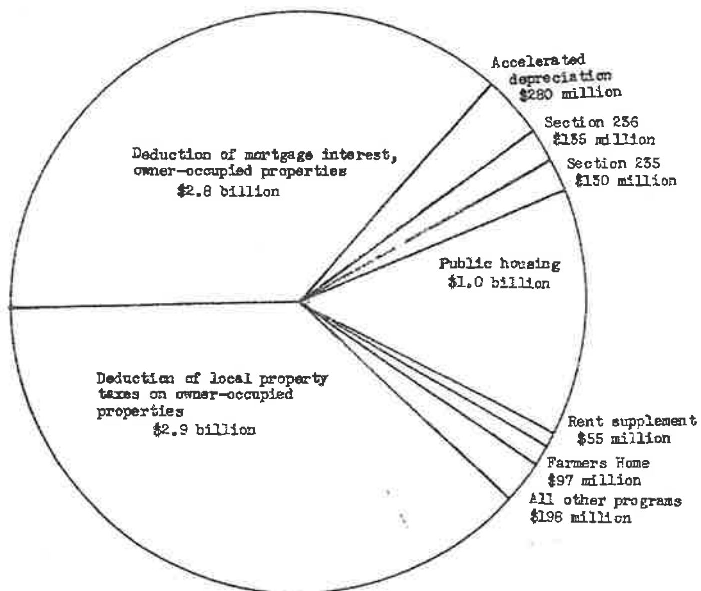
6. The Economics of Federal Subsidy Programs, Joint Economic Committee, January 1972, p. 152.

CHART IV

THREE QUARTERS OF ALL HOUSING SUBSIDIES IN 1970 WERE HIDDEN, OR TAX, SUBSIDIES. LESS THAN ONE QUARTER OF ALL SUBSIDIES WERE PAYMENTS TO ASSIST LOW OR MODERATE INCOME FAMILIES



Tax subsidies	$5.7 billion or 77%
Other subsidies	$1.6 billion or 22%
Total	$7.3 billion

Source: Economics of Federal Subsidy Programs, Joint Economic Committee, pp. 152-165 and Budget of the United States Government, Fiscal Year 1973, Appendix. (Figures for 235-236 and rent supplements are contract authority).

TABLE I. COMPARISON OF NUMBER OF UNITS, SUBSIDY, AND INCOME OF OCCUPANTS IN HUD PROGRAMS IN 1972

	Public Housing		202	221(d)3	Rent Supplement		235	236
	Owned	Leased	202	221(d)3	Market	BMIR	235	236
Period covered	1937-72	1966-72	1966-70	1966-70	1966-72	1966-72	1969-72	1969-72
Number of units	1,117,600	152,400	19,700	95,200	114,500	77,800	511,700	551,500
Percent of all subsidized housing	42.3%	5.7%	0.7%	3.6%	4.3%	2.9%	19.3%	20.8%
Maximum commitment	40 years	12.6 yrs	50 yrs	40 yrs	40 yrs	40 yrs	30 yrs	40 yrs
Estimated length of subsidy	40 yrs	12.6 yrs	50 yrs	40 yrs	40 yrs	9-11 yrs	12-14 yrs	19-25 yrs
Contract authority in millions	$845	$197	$277	$1,607	— $ 232 —		$495	$525
Cost per unit over life of program								
Maximum possible	$30,600	$16,300	$4,600	$4,500	— not available		$26,600	$35,100
Estimated probable	$30,600	$16,300	$4,600	$4,500	$66,700	$3,400[a]	$7,600	$15,200
Operating costs, 1972	$725	$725	—	—	$775	$775	—	$775
Average gross family income of residents moving in during 1972	$3,150	#3,150	—	—	$4,900	$3,250	$6,500	$5,180
Average annual rate of resident income growth	3.6%	3.6%	—	—	4.3%	5.0%	5.7%	5.7%

a Supplemental subsidy, added to 236 subsidy

Source: 1972 House Appropriation Hearings on HUD, p. 109. Maximum possible payments are $81,987,905,000; total estimated probable payments are $56,987,635,000.

CHAPTER TWO

THE REAL ESTATE TAX SUBSIDY: A NECESSARILY COMPLICATED PRIMER

The bulk of housing subsidies will almost certainly remain hidden in our tax laws until there is general understanding of how these tax laws work. The refuge of the expert in any field is to surround his or her subject with a cloak of mystery that others cannot possibly unravel. Tax experts are past masters of this art. Indeed, federal tax nomenclature makes the arcane jargon of the housing practitioner appear to be lucidity itself. This is perhaps the basic reason why people concerned about housing have paid so little attention to the impact of federal tax subsidies. To understand housing programs, one has to memorize a series of programs by number. To understand tax subsidies, there are a few technical terms which sound forbidding but are not nearly as difficult as tax experts like to make them appear.

Everyone who has ever filed an income tax return knows that the "taxible income" on which the tax is calculated is not the same as actual income. For example, there are deductions for children and other dependents and either a "standard deduction" or the possibility of itemizing and subtracting a variety of other expenses. For investors in housing partnerships, the tax law in practice makes it possible for the investor to be receiving a cash income from the investment while, at the same time, legitimately reporting a "tax loss" to the Federal Government. This means that income from the housing investment is tax free and, assuming that there is also income from other sources, total taxable income is reduced by the amount of the tax loss.

The magic of making money and reporting losses is accomplished through the manipulation of "depreciation allowances." The assumption behind depreciation allowances is a simple one: as property, in this case housing, is used it wears out and eventually must be replaced. The depreciation allowance is an attempt to allow for this on the basis of the fiction[7] that the owner or investor is setting aside that amount for eventual replacement.

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7. Fiction is a term used by lawyers. It is defined as "an assumption of a possible thing as a fact irrespective of the question of its truth." (Webster's New Collegiate Dictionary, second edition). Put even more bluntly, a fiction is "a supposition known to be at variance with fact, but conventionally accepted." (Shorer Oxford English Dictionary, third edition.)

There are basically two approaches to figuring depreciation. The first is to assume that property wears out, loses value, or depreciates at an even rate. This is known as "straight-line" depreciation.[8] The other is to assume that the decline in value is much faster when the property is new than when it is older. This approach is known as "accelerated depreciation." Accelerated depreciation is figured through either "declining balance"[9] or "sum of the year's digits" approach.[10]

The present law with respect to depreciation on rental property is embodied in the Tax Reform Act of 1969. This act permits the use of the 200% declining balance or the sum-of-the-years digit method on all new residential rental property. Before 1969, these depreciation rates could be used on all new buildings including industrial or commercial buildings.[11] Table II shows the advantages of accelerated depreciation, assuming a new $10 million rental project with a 40 year life.

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8. Under straight line depreciation, the value of the property is divided by its estimated life. This is 40 years for new housing, generally 25 years or less for older housing. The same amount of depreciation is taken each year.

9. The rate of depreciation is higher than straight line, but the amount of depreciation taken each year is deducted from the value of the project. The formula is usually expressed as a percentage of the straight line depreciation: e.g. $200%" -- the rate permitted for new rental housing or "125%", the rate for used rental housing with a remaining useful life of 20 years or more.

10. The most complicated way of figuring depreciation, but perhaps the best from the viewpoint of the person looking for a big tax subsidy, the "sum of the years" is obtained by adding together the number of years of useful life of the building each year the depreciation is expected to be taken. For a 40-year life, the sum of the years would be 820 or 1 plus 2 plus 3 plus 4 plus 5 and so on up to 40. This is the denominator of the fraction used for depreciation. The numerator is the number of years of remaining useful life. Thus, in the first year, the depreciation would be 40/820 of the value. The second year, it would be 39/820, and so on.

11. Used residential rental property having a useful life of 20 years or more may be depreciated under a 125 percent declining balance method. New non-residential real property, including office buildings, shopping centers, hotels, etc. is limited to 150 percent declining balance and used real property to straightline depreciation.

TABLE II. THE ADVANTAGES OF ACCELERATED DEPRECIATION, ASSUMING A $10 MILLION NEW RENTAL PROJECT WITH A 40-YEAR LIFE, FIRST TEN YEARS

Year	Amount of Depreciation Allowance			
	Straight-line	200% Declining Balance		Sum of year's digits
		Depreciation	Balance	
First	$250,000	$500,000	$10,000,000	$487,805
Second	250,000	475,000	9,500,000	475,610
Third	250,000	451,250	9,025,000	463,415
Fourth	250,000	428,688	8,573,750	451,220
Fifth	250,000	407,253	8,145,062	439,024
Sixth	250,000	386,890	7,737,809	426,829
Seventh	250,000	367,546	7,350,919	414,634
Eighth	250,000	349,169	6,983,373	402,439
Ninth	250,000	331,710	6,634,204	390,244
Tenth	250,000	315,125	6,302,434	378,049
TOTAL	2,500,000 or 25% of original value	4,012,631 or 40% of original value		4,329,269 or 43% of original value

Residential rental property is defined in terms of income received. At least four-fifths of the gross rental income must come from dwelling units. This permits a small amount of commercial or office use in large residential developments.

There is also a five-year straightline depreciation deduction which can be taken for expenditures to rehabilitate low-income rental housing. This is really a special form of accelerated depreciation.

No matter how they are figured, depreciation allowances are a tax subsidy. A recent study concludes: "In the first year, true depreciation is less than one-fourth of that allowed under the straightline method and true depreciation does not exceed the tax allowance until after the passage of 40 years. The straightline tax depreciation method confers a subsidy of 14% while accelerated methods can double this.[12]

"Excess depreciation" is the term used for the amount of accelerated depreciation that exceeds straightline. Table III is really another way of looking at the information presented in Table II, showing the cummulative amount of depreciation and the amount of excess depreciation for the same hypothetical project.

Capital Gains and "Recapture Rules"

One of the largest loopholes in present income tax laws is the so-called "capital gains" tax. Long term capital gains, or the increase in value of assets held over 6 months, are taxed at roughly 1/2 the rate of earned income.[13]

The total capital gains tax subsidies to individuals in

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12. "Subsidies, Tax Law, and Real Estate Investment" by Paul Taubman and Robert Rasche, in The Economics of Federally Subsidy Programs: A compendium of papers submitted the Joint Economic Committee, Congress of the U.S. Part III, Tax Subsidies, p. 343.

13. The minimum tax rate on capital gains is 25% of the first $50,000 gain and 35% of any gain over $50,000. IRS, Your Federal Income Tax, 1972 edition, p. 113. In addition, there is also a minimum tax of 10 percent on certain kinds of otherwise tax exempt income. This includes the benefits of accelerated depreciation. The tax applies to the amount by which tax exemptions covered by this minimum tax exceed $30,000 plus the amount of income tax due.

TABLE III. CUMULATIVE VALUE AND EXCESS DEPRECIATION, ASSUMING A NEW $10 MILLION RENTAL PROJECT WITH A 40-YEAR LIFE

Year	Straight Line	Sum of year's digits		200% Declining balance	
		Cumulative Total	Cumulative Excess	Cumulative Total	Cumulative Excess
1	250,000	487,805	237,805	500,000	250,000
2	500,000	963,415	463,415	975,000	475,000
3	750,000	1,426,830	676,830	1,426,250	676,250
4	1,000,000	1,878,050	878,050	1,854,938	854,938
5	1,250,000	2,317,074	1,067,074	2,262,191	1,012,191
6	1,500,000	2,743,903	1,243,903	2,649,081	1,149,081
7	1,750,000	3,158,537	1,408,537	3,016,627	1,266,627
8	2,000,000	3,560,976	1,560,976	3,365,796	1,365,796
9	2,250,000	3,951,220	1,700,220	3,697,506	1,447,506
10	2,500,000	4,329,269	1,829,269	4,012,631	1,512,631

1972 have been estimated at $13.7 billion. Over 1/2 of these subsidies went to people with incomes above $100,000 and almost 90% went to those with incomes over $25,000.[14]

The result of accelerated depreciation is that the "book" or depreciated value of the property falls more rapidly than its real value. Therefore, if and when the property is sold, there will almost certainly be a taxable profit. This profit is the difference between the actual sale price and the depreciated value. When a property, or an interest in a property, is sold, this profit is taxable, either as a capital gain or as ordinary income.

The idea behind the so-called "recapture rules" is a simple one: to recover all or part of the tax subsidy given through accelerated depreciation. This is done by taxing excess depreciation as ordinary income until the property has been held for a fixed period. The recapture rules do not apply after 10 years for subsidized rental housing and after 17 years for all other rental housing.[15]

What this really means is that, although under tax law a luxury apartment building can be depreciated as rapidly as a subsidized project, the tax on the sale of a subsidized project at the end of a ten year period is only a little more than half of the tax on a luxury project. In the example used for Tables II and III, if the project were sold at its initial value, the tax on excess depreciation would be $640,244 for subsidized housing, compared to $1,152,439 for unsubsidized housing under the sum of the years digit method and $529,421 for a subsidized project compared with $952,958 for an unsubsidized project under the 200% declining balance method.[16] Clearly, the recapture rules provide a powerful incentive for investors to seek investment in limited dividend subsidized housing and to hold their investments for about ten years. At that point, their tax shelter has almost disappeared and it is likely to be profitable to sell the investment, pay the capital gains tax, and reinvest in another property which can then be rapidly depreciated. Since none of the programs affected is ten years old, there is no way of telling what will happen when present investors decide to unload their properties for tax reasons.

Leverage

One important point, particularly for tax purposes, is that the depreciation and other tax deductions are based on the total cost or value of the project. However, the project is paid for in large part through a mortgage so that the investor benefiting from the tax shelter has in fact only invested in a small fraction -- generally less than 10% -- of the total cost. The capacity to take advantage of the tax shelter through depreciation of the total basis of the project even though the investor has financed only a small portion of it is known as "leverage."

The simplest way to understand leverage is to see it as multiplying the value of the tax shelter to the investor by at least 10 times.

14. "Individual income tax erosion by income classes" by Joseph Pechman and Benjamin A. Okner, in Joint Economic Committee, op. cit., Part 1, p. 34, Table A-2.

15. Specifically, after a fixed holding period, during which all excess depreciation is taxable as ordinary income, the amount of excess depreciation recaptured falls by 1% per month, until at the end of the holding period all profits are taxable as capital gains. In the case of subsidized housing, including 221(D)3 and 236 as well as similar state and Farmer's Home programs, the phase-out begins after the property is held 20 months. Thus, after 10 years nothing is recaptured and all profits are taxed at the lower capital gain rates. In the case of unsubsidized rental housing, the phase-out begins after 100 months (8 years and 4 months). Therefore, it takes 16 years and 8 months to reach the point of no recapture.

16. This assumes the tax payer had other capital gain amounting to $50,000. Otherwise the tax figures would be slightly lower (less than 1%).

CHAPTER THREE

THE LIMITED PARTNERSHIP ARRANGEMENT

The form of organization necessary to take advantage of the tax subsidy, or shelter, is the so-called limited partnership.[17] Under the terms of a limited partnership, the investor who becomes such a partner puts up the money but is absolved from most of the risk and liability, as well as the responsibilities are undertaken by the "general partner."

A whole new sector of the investment business has grown up around the marketing of investments in limited dividend 236 projects. There has been a growing trend toward the formation of investment syndicates, which are registered with the Securities and Exchange Commission. But while some of the larger efforts have been so registered, a frequent practice is to apply to the SEC for an exemption from the registration requirement. To obtain such an exemption, the investment cannot be publicly offered and is usually sold in a limited, behind-the-scenes way to business associates.[18]

The Section 236 program is limited to nonprofit, cooperative, or "limited dividend" (Not more than 6% return) sponsors.

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17. Partnerships are not taxed under income tax law. Instead, each partner must report income or losses on his or her own income tax return.

18. William J. Casey, chairman of the SEC has noted that there were 210 tax shelter real estate offerings, in the amount of $3.1 billion, during 1971. Ninety of these were offered within states and were not subject to SEC regulations; these, however, were relatively small, amounting in total to $155 million. By August 15 offerings for 1972 had reached a level of 165, accounting for $1.6 billion. Eighty of these were intrastate, representing a total of $195 million. These figures are only for offerings filed with the National Association of Securities Dealers; they do not include "private" offerings. Nor were all of these offerings for subsidized housing at the tax shelter for other real estate partnerships, while not as dramatic, is still substantial. "Requirements of a National Market in Real Estate Securities," speech by William J. Casey, September 28, 1972, available from SEC.

Under the provisions of the law a limited dividend sponsor must put up 10% of the total cost and can obtain a 90% mortgage[19], which may not exceed the FHA-approved replacement cost. However, this cost may include the "Builders and Sponsors Profit and Risk Allowance" (BSPRA). This amount is 10% of the development cost of the project.[20]

For example, if the project had a total replacement cost of $10 million, the mortgage would be $9 million. Theoretically, the investor or investors would have to put up $1 million in equity. If, however, the development cost excluding land were $9 million, the BSPRA would amount to $900,000 and therefore the actual cash equity which would have to be involved would be only $100,000. In other words, the entire advantages of tax shelters afforded under the 236 program for a $10 million project could be obtained by an investment of only $100,000--less than 1% of the amount on which the tax shelter is based.[21] Charts V and VI shows the impact of these provisions and the resulting tax benefits and profits.

There are not very many builder-sponsors with incomes large enough to need the amount of tax shelter which a 236 project can generate. Moreover, the tax shelter is so generous that it can be sold at a profit. That is, the builder can obtain much more than is needed for equity by setting up a limited partnership arrangement and selling limited partnerships. The sale of such tax shelters is called "equity syndication." Equity syndication can be a major source of profit for the builder-sponsor of a 236 project.

What happens in a typical arrangement is that the builder

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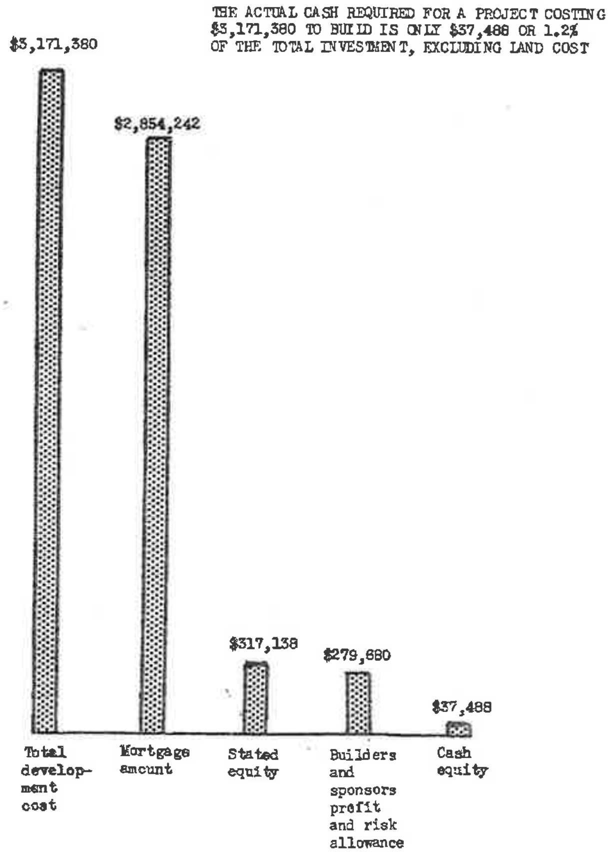
19. In contrast, nonprofit sponsors, although a certain amount of "seed money" can be required, may obtain 100% mortgages.

20. Development cost is the replacement cost minus the land.

21. This example, using a different base, follows that presented in "Syndication of Equity in Section 236 Projects", staff memorandum prepared by G. Richard Dunnells, Deputy Asst. Sec., for Housing Management, Dept. of Housing and Urban Development, January 1972. The reader is cautioned that the materials in this memorandum do not necessarily reflect the views or positions of HUD.

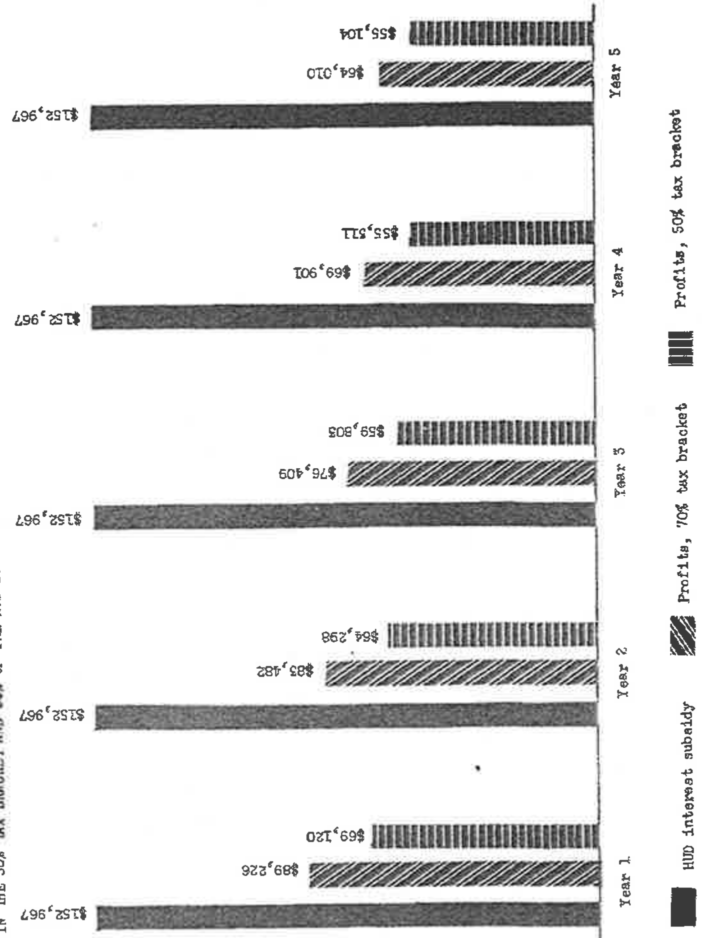
CHART V



Note: The actual cash equity required is calculated by subtracting the builders and sponsors profit and risk allowance (BSPRA) from the "stated" or theoretical equity requirement.

Source: Private Capital and Low-Income Housing: A Case Study National Urban Coalition

CHART VI



developer sells 95% of the interest in the project to limited partners, in return for 100% of the equity requirements plus a premium for buying in. He thus obtains his profit and risk allowance in cash, plus the extra cash of the premium which the limited partners have paid to obtain profits and tax shelters.[22] Nonetheless, the builder-developer, as general partner, retains complete control over construction and management and, under the partnership agreement, also receives a share of the cash profits and tax losses.

The limited partner in the 70% tax bracket can expect an after-tax return on investment of at least 15-20%. Often it is much higher and the original investment can be recovered in two to three years. As an example, one recent prospectus for a limited partnership cites the record of 9 tax shelter partnerships formed by the same sponsors. Deductions for three partnerships set up in 1970 averaged $573.77 per $1,000 invested, or 57%. Deductions for six partnerships set up in 1961 averaged $811.48 per $1,000, or 81% of the investment.[23]

Since the limited partner is not responsible for the construction or management of the project, there is only one major risk. This is possible foreclosure on the property, since foreclosure triggers the recapture rules and means that the tax shelter is valueless. Indeed, in some cases the limited partner instead of having the best of two worlds (cash income plus tax loss) has the worst (cash loss plus taxable income).

Nevertheless, the limited partnership interests are so attractive to high income initial investors that their sales prices are reported to range between 12 and 18 "points" or percentages of the mortgage. Thus, if the mortgage on a project is 10 million, 95% of project profits and losses -- basically, the tax shelter -- would sell for between $1,200,000 and $1,800,000.[24]

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22. HUD, op. cit., p. 19, SEC chairman Casey cites one instance where 67% of the money raised was to go to the people setting up the partnership. SEC, op. cit., p. 14.

23. Preliminary prespectus, dated October 19, 1972, Capital Resources Real Estate Partnerships, First Nation Security, Inc., p. 9.

24. HUD, op. cit., p. 26.

There is also a considerable profit to be made in acting as broker for limited partnership arrangements. For example, a builder-developer of a 236 project may be approached by a syndicator and offered 12 points of the mortgage as a limited partnership arrangement. The syndicator may then sell these interests to high income investors for as much as 18 points, keeping the difference. There is even one instance on record where 95% of the equity in a 236 rehabilitation project with a $2,440,000 mortgage was purchased by an investment banker for $280,000 and then sold for $560,000. The investment banker therefore made a gross profit of $280,000 on the transaction.[25]

While accelerated depreciation is the major tax subsidy for limited partnerships, it is by no means the only one. Some special, one-time starting costs can be deducted, as can operating expenses.

Another major tax subsidy is provided by deduction of interest on the mortgage to finance the property. This is true even though in fact, the HUD subsidy may comprise the bulk of the interest payment.[26] At current interest rates, deductions during the early years of a mortgage may be even more important than depreciation as a tax subsidy. The minimum $100,000 cash investment required for the hypothetical $10 million project with a $9 million mortgage which we have been using as an example would, in the first 10 years at an interest rate of 8%, generate $7 million in interest deductions as well as $4.2 million in depreciation, for total reportable tax losses from these 2 sources alone of $11.2 million.[27]

Although most of the tax advantages of Section 236 developments have apparently gone to individuals, they are also available to corporations. Thus, corporations

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25. Ibid. The gross profit does not allow for legal, accounting or other expenses.

26. "Under an IRS ruling, the owner of a 236 project can deduct the full market rate interest expense on the mortgage irrespective of the fact that HUD is actually paying the difference between the market rate and 1% to the mortgagee."

27. The monthly payment for a $9 million 40 year mortgage at 8% would be $62,640. At 1% interest, the payment would be $22,770 or a reduction of $39,870 -- the maximum possible HUD subsidy.

investing in limited partnerships may take the tax losses to offset against other income.

A calculated effort to stimulate corporate investment in low and moderate income housing was embodied in the 1968 Housing and Urban Development Act, which authorized the establishment of what is now the National Corporation for Housing Partnerships, in which many of the largest corporations and banks in the country are committed to invest a total of $42,000,000.[28]

By March 1972, the Partnership had approved 78 projects, comprising roughly 14,500 housing units in about 30 states. Almost half of these were under construction.[29] $10.5 million of the $42 million subscribed by investors in the Partnership had been paid in. The partnership reported a tax loss for income tax purposes of $447,567 for 1970 plus a carry-over of $800,000 available to reduce future taxable income, for 1971. Tax losses amounted to 7.6% of cash actually invested in 1970 and 24.9% in 1971.

Fortunately for those whose major concern with housing is shelter, not tax advantages, investment in limited dividend housing is not without its hazards. The foreclosure rate on Section 236 housing is considerably higher than that for other rental housing, and early foreclosure, as already noted, can wipe out tax advantages. Among the other pitfalls which await unwary or unwise investors are the disallowance by IRS of deductions claimed. It is widely alleged that regional and local IRS officials do not understand the national policy of encouraging private participation in housing investment, and therefore have been aggressively challenging some claimed tax deductions.[30] There is also the possibility of challenge to the allocation of deductions among the general and limited partners. More important, the project may not turn out to be viable, and investors are warned against accepting FHA's analysis as adequate. The location of the project -- especially if it is in the inner city or in a rural area -- may prove risky. There may be construction cost overruns which limited partners, although legally not liable, may have to cover to avoid loss of their investment. Operating expenses, which have been rising rapidly, may prove greater than originally budgeted and the FHA may not approve rent increases or, if it does, tenants may engage in rent strikes, thus reducing the tax flow and conceivably throwing the project into default.[31]

The net results of these considerations mitigate against locating 236 projects either in core city or rural areas. They provide, instead, incentives to locate in relatively homogeneous suburban communities needing housing for teachers, public officials, and other white collar occupations for people employed in the community but unable to afford new single family housing at today's construction costs as aggravated by suburban zoning.

Despite the element of risk, the following quote from a recent prospectus sums up the situation: "The Partnership will compete with other investors, including under other limited partnerships, for projects. These projects are offered to high tax bracket investors through public and private offerings by real estate brokers, investment institutions and developers. Some projects are retained by their developers and are consequently not available for investment by the Partnership. For the 1972 fiscal year

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28. The 270 Investors in NHP include 23 of the largest insurance companies, 73 leading banks, and dozens of corporations on the list of the Fortune 500. The roster includes the Metropolitan, Equitable, Aetna, John Hancock, New York Life, and Travelers Insurance Companies; Bank of America and Bowery, Banker's Trust, Chase Manhattan, Chemical, First National City, First Pennsylvania, Morgan Guaranty, Mellon, and Wells Fargo Banks; the AFL-CIO, International Brotherhood of Electrical Workers, and Alliance for Labor Action; and ALCOA, Allied Chemical, American Express, Boise-Cascade, Dupont, Ford, General Electric, General Motors, U.S. Steel, IBM, ITT, Kaiser, Minnesota Mining and Manufacturing, Polaroid, and Xerox. "The NHP-An Invitation to Housing Partnership" by Sidney Freidberg, Executive Vice President and General Counsel, National Corporation for Housing Partnerships, in New York Law Journal, November 11 1971.

29. National Corporation for Housing Partnerships and National Housing Partnership, Annual Report, 1971, pp. 16-17.

30. Discussion at New York Law Journal's Seminar on Subsidized Housing, May 18-19, 1972.

31. Ibid.

ending June 30, the FHA has authority to enter into new contracts to provide annual interest subsidies of $200,000,000 in connection with projects generally of the type in which the Partnership will invest. The President's budget request for the 1973 fiscal year seeks Congressional approval for an additional $150,000,000 or contract authority. If such request is not granted or is severely curtailed, competition for available projects will intensify."32

32. Prospectus dated June 29, 1972, American Housing Partners-II, p. 5.

CHAPTER FOUR

CONSEQUENCES OF THE TAX SHELTER ON PROJECT QUALITY AND MANAGEMENT

Traditionally, federal housing policy has been oriented toward production. Little attention has been paid to the maintenance of our existing stock of housing, although this has been identified as the largest single component of our national wealth. Indeed, it was 20 years after the passage of the first major federal housing legislation -- the National Housing Act, enacted in 1934 -- before federal housing laws recognized the possibility of rehabilitation or renewal.

Not only has housing maintenance been the stepchild of housing policy, but housing production programs have typically skimped on quality. This may be due, as it seems to be in public housing, to the social philosophy of legislators and administrators who, wary of providing anything too good for the poor, require public housing without such elementary anemities as doors on the closets. Or, it may be the result of the operation of the tax policies with which this paper is concerned.

The interest and depreciation deductions are concentrated in the early years of a mortgage. With a 40 year, 8% mortgage, 1/3 of the interest payments are in the first 10 years. So is more than 40% of the possible depreciation. Therefore, the heavy tax advantages of the early years disappear. While in the early years of a mortgage there is usually cash income generated by the property which nevertheless shows a tax loss, later on the situation may reverse itself so that there is a cash loss while the accounting rules show a tax profit. Clearly, this is the worst of all possible worlds for an investor since in theory he or she is making money and therefore paying taxes, while in practice expenses are greater than income.

The profit-motivated investor therefore has a strong incentive to sell as soon as possible without incurring excessive recapture. This means that the initial investor in a limited dividend partnership often plans to be out of the project within 10 years. More likely than not, the amount of the tax shelter is more important than the ultimate sales price. Thus, while it may be in the interest of the mortgage and even of the federal government to

provide reasonably adequate quality, it is not to the advantage of the investor.

Complicating this picture even further is the fact that the arithmetic of the 236 program tends to be fairly tight. There is a tendency to overestimate construction budgets to get larger mortgages and then to underestimate operating expenses so as to prove to FHA that the project is financially feasible. Otherwise, it cannot be undertaken. A recent HUD study found that operating expenses for 236 projects were being consistently underestimated by anywhere from 30-40%.[33]

In addition to the tax shelter problem, the mechanism of the subsidy system also operated to make adequate management difficult. In a time when management costs are rising at an average of 6% per year, the subsidy is limited to interest payments. Clearly, either projects will not be able to break even, or rents will have to rise. These factors are already responsible for the fact that a great many residents of 236 housing are paying more than 35% of their income for rent.[34] Indeed, HUD has recently promulgated a series of regulations raising the minimum income required for occupancy, except for the elderly, of all 236 projects to people with enough money to keep the rent-income ratio below 35%. This step was motivated, quite clearly, not by concern for tenants so much as by the mounting rate of foreclosures and the even more rapidly mounting rate of criticism of HUD programs.

The obvious step of deepening housing subsidies has been proposed both by HUD and by members of the Congress. However, these deeper subsidies proposed are to be available for only a small fraction of the total number of subsidized units. There appears to be no prospect, even if housing legislation is substantially revised, that 236 and comparable BMIR programs will in any sense be housing for the poor.

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33. "HUD view of housing management," remarks by G. Richard Dunnells, Deputy Asst. Secretary for Housing Management before New York Law Journal's Subsidized Housing Seminar, May 18, 1972.

34. Although the law sets a standard rent-income ratio at 25%, the subsidy does not in fact allow rents to be reduced to this level for many tenants.

Defenders of the present system of financing nonprofit housing can point out that the whole 236 program is so new -- enacted in 1968, with the first real flow of units coming on to the market in 1970 -- that we cannot yet judge the long term viability of the projects. This is true enough. But the fact that there is no financial incentive to the limited partner to take an interest in longterm project management or ownership is incontrovertible. And in the substantial segment of 236 which is operated largely as a profit mechanism, to expect results for which there is no financial incentive is, to say the least, unrealistic.

CHAPTER FIVE

CONCLUSION

This country's housing policies have been built on a series of myths.

The first myth was that an urgent national problem could be solved at little or no cost to the federal treasury. This led to two decades of housing programs, from 1949-1969, when the federal government more often than not made a net profit on its housing operations.

It led also to the cutting back of such basic subsidized programs as public housing in favor of encouragement of demonstration efforts. The demonstrations had the common theme of seeking to provide costless or very inexpensive solutions to our housing needs and the common fate that all of them failed to do so.

The second great myth of housing policy has been that it should be the responsibility of private enterprise. Thus, decades after it has become clear to even the most casual observer that operation of decent slum housing is unprofitable for the private operator and construction of low cost new housing impossible for the private builder, we have sought to channel our housing programs through the private market.

This approach has been true from the inception of our housing programs. Even public housing, ultimately owned and managed by public agencies, has been financed by bonds sold to private investors and built by private builders. Alternatives, which may or may not be better, have never been seriously considered.

The link between private enterprise and meeting housing needs is evident in statements of housing policy contained in national legislation from the Housing Act of 1937, which established public housing, through the Housing Act of 1949, which set the national goal of "a decent home and a suitable living environment for every American family", to the Housing and Urban Development Act of 1968, which first set a numerical goal for housing production of 26 million new or rehabilitated units in a ten year period, six million of which would be subsidized. One section of the new act states: "The Congress finds that the volume of housing being produced for families and individuals of

low or moderate income must be increased to meet the national goal of a decent home and a suitable living environment for every American family, and declares that it is the policy of the United States to encourage the widest possible participation by private enterprise in the provision of housing for low or moderate income families."[35]

The influence of these make-believe assumptions accounted for two decades of continuing failure in housing. While this failure generated greater demand for solutions to the housing problem, the continuing existence of the mythology meant that programs, instead of being revised, were expanded and the bonanza of the tax shelter was unwittingly harnessed, by public officials and reformers alike, to advocacy of increased spending for housing.

The expansion in the scale of our housing programs initiated in 1968, with continued reliance on private investment, has generated the tax shelters discussed in this report. It seems clear that the Tax Reform Act of 1969 ould not have continued the shelters if alternative means f financing subsidized housing had been contained in housing legislation.

We could hardly find a more expensive way of producing an inferior product. One estimate of the total cost of a 236 apartment put the subsidy at $116,104 per unit.[36] While

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35. Housing and Urban Development Act of 1968, Section 901.

36. "Housing subsidies are a grand delusion" by Gurney Breckenfeld, Fortune, February 1972. Breckenfeld states "One developer who recently put together a Section 236 project in Connecticut figures that the final cost of each modest apartment (average rent: $151 a month) may run to $116,104 per unit. The land, almost entirely subsidized by urban renewal, costs $23,196 per unit, and construction $29,219. Interest subsidy and FHA mortgage insurance over the forty-year life of the loan will add $25,162. The government will throw in another $2,086 per unit by buying the mortgage for more than its market value through the Government National Mortgage Association, and the Treasury will contribute a subsidy of $8,441 per unit through tax deductions granted to the nominal private owners of the project. By making the project exempt from local property taxes, the state and locality will provide a subsidy of at least $28,000." This example has been challenged as extreme by the National Association of Home Builders, which estimates average direct subsidy cost per unit at $37,645 under 236. Journal of Home Building, June 1972 p. 29.

in his own home escapes the income tax system and, together with the deductibility from Federal taxes of mortgage interest and property taxes, provide taxpayers with an incentive to acquire a home rather than rent. In addition, rental housing depreciation provisions are supported on the grounds that they encourage the production and use of housing.

Also of great importance are the credit subsidies that are used to encourage homeownership, repair, or rental for a specifically targeted group. A relatively small number of these are loans made directly by the Government, such as housing for the elderly and for the rehabilitation of homes in urban renewal areas. More important are the loan guarantees either granted alone, in which case they confer substantial benefits on recipients but usually small or no budgetary costs to Government, or granted in combination with long-term partial debt service payments, in which case their benefits also bring about large Government budgetary costs. As was the case with rent supplements, such partial debt service payments are long-term contracts and their budgetary costs are most appropriately measured as those costs that Government pays over the lifetime of the commitment, again, on a capitalized basis. The Interest Subsidy for Rental Assistance (236), and Interest Subsidy for Homeownership Assistance (235), are the two most important examples.

A large part of the new low-priced housing is supplied by government itself and may therefore be appropriately thought of as a benefit-in-kind subsidy, to the extent that it is offered below market price or cost. It may also be considered a credit subsidy because, while local housing authorities actually own and operate the public housing facilities, the Federal Government funds the subsidy through annual contributions to the housing authorities to meet a large part of their debt service requirements. Again, the long-term contracts associated with these subsidies make it appropriate to measure their costs on a capitalized basis.

Table 5–7 contains a list of housing subsidies in the forms discussed above. The estimated gross budgetary costs of these programs in fiscal year 1970 was $8.4 billion. That total includes $2.6 billion as the value of annual mortgage interest deductions, $2.8 billion as the value of property tax deductions by owners of owner-occupied housing, and $275 million as the annual value of depreciation deductions on rental housing. Thus, $5.675 million is accounted for by tax subsidies which go to the owners of housing properties.

Most of the other approximately $3 billion represent credit or cash subsidies explicitly designed to assist specially targeted groups in the purchase or rental of housing. Moreover, the cost figures of $3 billion are the budgetary cost of the commitments of the Federal Government in fiscal 1970 to make future year annual subsidy payments over the lifetime of the contract commitment, that stream of costs measured in terms of its worth in fiscal 1970; that is, on a capitalized basis. The budgetary cost of the commitment is thus capitalized into a present value for the year of commitment, no part of the commitment's cost being recorded in any future year. This puts the full cost of the Government's commitment into the year in which the decision and the commitment about the subsidy is made. As we have previously argued, this is superior to representing the cost of such long-term subsidies in terms of their first-year payments.[14]

As one can see, both the objectives, forms, and costs of housing subsidies make this a very complex subsidy area. Our brief introduction to the area should be followed by a careful reading of the appropriate papers in the forthcoming study series.[15]

TABLE 5-7.—GROSS BUDGETARY COST OF FEDERAL HOUSING SUBSIDIES, FISCAL YEAR 1970

[In millions of dollars]

Program	1970 actual
Direct cash payments:	
Housing rehabilitation grants	22
Farm labor housing grants	2
Rent supplement payments[1]	163
Specially adapted housing for disabled veterans	8
Tax subsidies:	
Deductability of interest on owner-occupied homes	2,600
Deductability of property taxes on owner-occupied homes	2,800
Depreciation on rental housing	275
Rehabilitation of low-income housing	5
Exclusion of imputed net rent[2]	-----
Credit subsidies:[3]	
Interest subsidy for home-ownership assistance (235)	426
Interest subsidy for rental assistance (236)	790
Housing opportunity allowance program	0
Below market interest rate loans on multifamily dwellings (221(d)(3))	69
Rural housing insurance	118
Housing for elderly and handicapped	53
Rehabilitation loan fund	12
Rural housing direct loans	18
Low-rent public housing	1,064
Order of magnitude total	8,425

[1] The rent supplement program is estimated on a capitalized basis.

[2] The revenue loss associated with imputed net rent has not been included in the totals because the exclusion of imputed income has not been accounted for in other areas of the study. In a 1970 article entitled "Income Taxes and Housing," the American Economic Review, Henry Aaron estimated the 1966 cost of this subsidy provision to be $4 billion.

[3] All the credit subsidies are estimated on a capitalized basis. As in other areas, the direct loan program costs were estimated by the Department of the Treasury and are contained in app. B. The subsidy costs estimates for 235, 236, rent supplements and public housing are made from HUD data contained in Senate Appropriations Committee hearings for fiscal 1970 (p. 784) and "The Budget of the U.S. Government, Fiscal 1972." HUD's estimate of total payments to be made for the minimum commitment was adjusted, according to actual units committed as reported on p. 130 of the budget, this aggregate number was then divided by the minimum years of commitment, and this stream of payments expressed as a capitalized value. See the individual data sheets for additional details.

Source: "1971 Catalog of Federal Domestic Assistance"; "The Budget of the U.S. Government, Fiscal Year 1972"; "The Budget of the U.S. Government—Appendix, Fiscal Year 1972"; "Special Analyses, Budget of the U.S. Government, Fiscal Year 1972"; Department of Treasury estimates, apps. A and B.

HOUSING REHABILITATION GRANTS

Administering agency	Community Development, Department of Housing and Urban Development.
Identification	Authorization: 42 U.S.C. 1406, Housing Act of 1949, sec. 115 as added by the Housing and Urban Development Act of 1965, sec. 106(a); Public Law 89–117; 42 U.S.C. 1452G Housing Act of 1964, as amended, sec. 312; Public Law 85–580. Budget account: 25-06-4035-0-3-555. CFDA: 14.805.
Objectives	To provide fonds to individuals and families who own residences and to owners and tenants of nonresidential properties in neighborhood development programs, urban renewal, code enforcement or to owner-occupants of residential property in certified areas.
Financial form	Direct cash payments.
Direct recipient	Individuals and families who own residences and owners and tenants of nonresidential properties in neighborhood development programs. When grantee's income exceeds $3,000 per year, the grant may be reduced if the housing expense is less than 25 percent of his income. To be eligible the borrower must have an income within the limitations prescribed by the HUD Secretary for projects financed with BMIR mortgages.
Subsidy costs	Fiscal year 1970, $22,300,000; fiscal year 1971, estimate $37,800,000.

FARM LABOR HOUSING GRANTS

Administering agency: Farmers Home Administration, Department of Agriculture.

Identification: Authorization: Housing Act of 1949, as amended, secs. 514 and 516; Public Law 89-117 and 89-754; 42 U.S.C. 1484 and 1486. Budget account: 05-60-2004-0-1-352. CFDA: 10.405.

Objectives: To provide decent, safe, and sanitary low-rent housing and related facilities for domestic farm laborers.

Financial form: Direct cash payments.

Direct recipient: States, political subdivisions of States, and certain nonprofit organizations and other public organizations may qualify for grants. Grants are available when there is a pressing need and when there is a reasonable doubt that such facilities could be provided without grant assistance. Facilities are then provided to those who are classified as farm laborers.

Subsidy cost: Fiscal year 1970, $2,134,000; fiscal year 1971, $3,700,000.

RENT SUPPLEMENT PAYMENTS

Administering agency: Housing Production and Mortgage Credit/FHA, Department of Housing and Urban Development.

Identification: Authorization: Housing and Urban Development Act of 1965; Public Law 89-117; 12 U.S.C. 1701(s). Budget account: 25-02-0139-0-1-655. CFDA: 14.149.

Objectives: To make good quality rental housing available to low-income families at a cost they can afford. HUD/FHA makes payments to owners of approved multifamily housing rental projects to supplement the partial rental payments of eligible tenants. Assistance covers the difference between the tenant's payment and the market rental. Rent supplements may be provided in conjunction with interest reduction programs such as sec. 221(d)(3), sec. 236, and sec. 202.

Financial form: Direct cash payments.

Direct recipient: Eligible sponsors include nonprofit, cooperative, builder-seller, investor-sponsor, and limited-distribution mortgagors. Families must be within the income limits prescribed for admission to public housing in order to qualify for benefits under this program.

Subsidy cost: Fiscal year 1970, $163,000,000. HUD data contained in Senate Appropriation Committee hearings for fiscal year 1970 (p. 784) estimated that the total number of units to be supported in 1970 would be 84,600, the total estimated payments to be made would be $2,517,000,000, and the average number of years the payments would be made to be 39. Using the actual number of units supported as listed in "The Budget of the U.S. Government, Fiscal Year 1972" (p. 130), 17,000, a proportional estimate was made of the total payments. This aggregate figure was then expressed in terms of annual payments and the cost of this stream of payments was capitalized at 7½ percent over 39 years.

DEDUCTIBILITY OF INTEREST ON OWNER-OCCUPIED HOMES

Authorization: Sec. 163 of Internal Revenue Code.

Financial form: Tax subsidies.

Description: Owner occupants of homes may deduct mortgage interest as itemized nonbusiness deductions. This provision dates back to the Revenue Act of 1918, when the deductibility of interest payments for conventional business expenses was expanded.

It is now also widely held that this tax provision provides encouragement to homeownership, which it is argued is beneficial to both the community and the individual.

The present law allows the deduction of interest paid, except on indebtedness incurred for the purchase of tax-free obligations or securities. This is difficult of administration, for in many cases it is impossible to tell for what purpose indebtedness is incurred. A man, for example, may have a mortgage on his house and have $1,000 in the bank. He borrows $1,000 and buys a Liberty bond and makes a payment on his mortgage. For what purpose was the $1,000 borrowed? The proposed bill allows the deduction of all interest paid in excess of the amount of interest received free from income tax. This is easy of administration and carries out the general purpose of the existing law. (Quote from House report on the Revenue Act of 1918.)

Subsidy costs: Fiscal year 1970, $2,600,000,000; fiscal year 1971, $2,800,000,000.

DEDUCTIBILITY OF PROPERTY TAXES ON OWNER OCCUPIED HOMES

Authorization: Section 164 of Internal Revenue Code.

Financial form: Tax subsidies.

Description: This provision of the tax code was a part of the original 1913 Revenue Act. The act stated that: "Third, all National, State, county, school, and municipal taxes paid within the year, not including those assessed against local benefits." It appears that taxes were excluded as the result of legislators attempting to find an appropriate definition of net income.

It is now also widely held that this tax provision provides encouragement to homeownership, which it is argued is beneficial to both the community and the individual.

Subsidy costs: Fiscal year 1970, $2,800,000,000; fiscal year 1971, $2,900,000,000.

DEPRECIATION ON RENTAL HOUSING

Authorization: Sec. 167(f)—Depreciation.

Financial form: Tax subsidies.

Description: The owners of rental housing may claim in early years depreciation in excess of straight-line depreciation.

The 1969 Tax Reform Act limited the depreciation allowance to 125 percent declining balance depreciation for used residential property. Five-year amortization for the rehabilitation of low-income rental housing was also provided for.

Subsidy costs: Fiscal year 1970, $275,000,000; fiscal year 1971, $255,000,000.

INTEREST SUBSIDY—FOR HOMEOWNERSHIP ASSISTANCE (235)

Administering agency	Housing Production and Mortgage Credit/FHA, Department of Housing and Urban Development.
Identification	Authorization: National Housing Act as amended, sec. 235. Budget account: 25–24–0139–1–1–555. CFDA: 14.105.
Objectives	To make homeownership more readily available to lower income families by providing monthly payments to lenders of FHA insured mortgage loans on behalf of the lower income families or by making it possible for a nonprofit organization or public body to finance the acquisition and the rehabilitation of housing that will be sold to lower income families.
Financial form	Credit aids (insured loans and direct cash payments).
Direct recipient	The subsidy is paid to the lender. Eligible sponsors are private nonprofit organizations and public bodies that have been approved by HUD. Families eligible to apply for mortgage insurance and receive the benefits of the subsidies must fall within certain income limits and other criteria as determined by locality on a case-by-case basis.
Interest rate and maturity	6 percent. 30-year maturity.
Subsidy costs	Fiscal year 1970, $426,000,000. HUD data contained in Senate Appropriation Committee hearings for fiscal year 1970, (p. 784) estimated that the total number of units to be supported in 1970 would be 126,000, the total estimated payments to be made would be $676,000,000, and the average number of years the payments would be made to be 17. Using the actual number of units supported as listed in "The Budget of the U.S. Government, Fiscal Year 1972" (p. 130), 143,000, a proportional estimate was made of the total payments. This aggregate figure was then expressed in terms of annual payments and the cost of this stream of payments was capitalized at 7½ percent over 17 years.

INTEREST SUBSIDY FOR RENTAL ASSISTANCE (236)

Administering agency	Housing Production and Mortgage Credit/FHA, Department of Housing and Urban Development.
Identification	Authorization: National Housing Act, as amended, sec. 236. Budget account: 25–02–0139–0–1–555. CFDA: 14.103.
Objectives	To provide good quality rental and cooperative housing for persons of low and moderate income by providing interest reduction payments in order to lower their housing costs.
Financial form	Credit aids (insured loans and direct cash payments).
Direct recipient	Subsidy is paid to the lender. These include nonprofit, cooperative, builder-seller, investor-sponsor, and limited-distribution sponsors. Public bodies do not qualify as mortgagors under this program. Families and individuals, including the elderly and handicapped, eligible to receive the benefits of the subsidies must fall within certain income limits as determined locally. The assistance payments are passed on to the tentant in the form of reduced rental.
Interest rate and maturity	2 percent. 35-year maturity.
Subsidy costs	Fiscal year 1970, $790,000,000. HUD data contained in Senate Appropriation Committee hearings for fiscal year 1970 (p. 784) estimated that the total number of units to be supported in 1970 would be 118, the total estimated payments would be $1,424,000,000, and the average number of years the payments would be made to be 21. Using the actual number of units supported and listed in "The Budget of the U.S. Government, Fiscal Year 1972" (p. 130), 132,000, a proportional estimate was made of the total payments. This aggregate figure was then expressed in terms of annual payments and the cost of this stream of payments was capitalized at 7½ percent over 21 years.

HOUSING OPPORTUNITY ALLOWANCE PROGRAM

Administering agency	Federal Home Loan Bank Board.
Identification	Authorization: Emergency Home Finance Act of 1970, title I; Public Law 91–351; 12 U.S.C. 1437. Budget account: None. CFDA: 71.001.
Objectives	To assist upwardly mobile, moderate-income families, where annual incomes are too great to allow them to participate in HUD's subsidized housing programs, but whose annual incomes are also insufficient to allow them to obtain conventional mortgage loans, to obtain such loans. The assistance, which is in the form of a $20 allowance for a period of not more than 60 months, can be applied only to the contractually required monthly payment on a 25- to 30-year first mortgage for the purchase of a single family home or condominium unit.
Financial form	Direct cash payments.
Direct recipient	Any family consisting either of two married persons living together or a head of household with at least one dependent person may apply for a HOAP allowance. Eligible families may not have incomes in excess of the HOAP regular family income limits. Borrowers may not use HOAP to refinance their present homes. Rental properties are not eligible.
Subsidy costs	Not available at this time.

BELOW MARKET INTEREST RATE LOANS ON MULTIFAMILY DWELLINGS 221(d)(3)

Administering agency	Housing Production and Mortgage Credit/FHA, Department of Housing and Urban Development.
Identification	Authorization: National Housing Act, as amended in 1954, sec. 21; Public Law 560; 12 U.S.C. 1715(1). Budget account: 25–02–4070–0–3–556. CFDA: Not listed. This is not the program described in 14.137.
Objectives	To provide good quality rental or cooperative housing within the price range of low- and moderate-income families.
Financial form	Credit aids (guaranteed and insured loans). Private bankers would make loans to qualified builders at 3 percent because the Government National Mortgage Association (GNMA) would purchase the mortgage at par.
Direct recipient	Credit assistant would go to nonprofit, cooperatives, builder/sellers who in turn would provide dwellings at rents below market value.
Interest rate and maturity	2–3 percent. 35–40-year maturity.
Subsidy costs	Fiscal year 1970, $69,000,000. HUD data contained in Senate Appropriation Committee hearings for fiscal year 1970 (p. 784) estimated that the total number of units to be supported in 1970 would be 19,300, the total estimated payments would be $135,000,000, and the average number of years the payments would be made to be 20. This aggregate figure was then expressed in terms of annual payments and the cost of this stream of payments was capitalized at 7½ percent over 20 years.

HOUSING FOR ELDERLY AND HANDICAPPED

Administering agency	Housing Production and Mortgage Credit/FHA, Department of Housing and Urban Development.
Identification	Authorization: Housing Act of 1959, sec. 202, Public Law 86–372; 73 Stat. 654; sec. 24 CFR, sec. 236.40(b) for conversion to a 236 project. Budget account: 25–24–4115–0–3–555. CFDA: 14.102 (1970 CFDA).
Objectives	To assist the development of housing for the elderly or the handicapped. Loans cover the development costs of new or rehabilitated rental housing and related facilities for the elderly or handicapped.
Financial form	Credit aids (direct loans).
Direct recipient	Private nonprofit corporations, limited profit sponsors, consumer cooperatives, certain public bodies or agencies that are not receiving financial assistance from the U.S. Government exclusively under the 1937 Housing Act.
Interest rate and maturity	3 percent. Interest shall be the lesser of 3 percent per annum or the average annual interest rate on all interest-bearing obligations of the United States plus one-fourth of 1 percent. 50-year maturity.
Subsidy costs	Gross outlays, 1970: $105,000,000. Capitalized value at 7½ percent: $53,000,000.

LOW-RENT PUBLIC HOUSING

Administering agency	Housing Production and Mortgage Credit/FHA, Department of Housing and Urban Development.
Identification	Authorization: U.S. Housing Act of 1937, as amended; Public Law 75–412; 42 U.S.C. 1401–1435. Budget account: 25–02–0139–01–555. CFDA: 14.146.
Objectives	To provide decent, safe, and sanitary low-rent housing and related facilities for families of low income through authorized public agency ownership. To assist local housing authorities in providing low-rent housing by (1) acquiring existing housing from the private market (acquisition); (2) procuring construction by competitive bidding where the housing authority acts as the developer (conventional); or (3) letting contracts to private developers (turnkey).
Financial form	Credit aids (debt services payments). Annual contributions are made to housing authorities to meet debt service requirements. Additional contributions are available for certain operating and maintenance expense in order to maintain income at or below 25 percent of tenant income.
Direct recipient	Local housing authorities acting in behalf of individuals and families who reside in, work in, or otherwise use the affected areas.
Interest rate and maturity	The interest rate is variable with the market based on a formula rate determined by the Secretary of the Treasury, taking into consideration the current average rate on outstanding marketable obligations of the United States. Average maturities: 8 months for temporary loans, 40 years for permanent financing.
Subsidy costs	Fiscal year 1970, $1,064,000,000.

RURAL HOUSING INSURANCE

Administering agency	Farmers Home Administration, Department of Agriculture.
Identification	Authorization: Housing Act of 1949, as amended, section 502; Public Law 89-117 and 42 U.S.C. 1484 and 1486; 7 CRF 1822.1-1822.17. Budget Account: 05-60-4141-0-3-352 CFDA: 10.410
Objectives	To assist rural families to obtain decent, safe, and sanitary dwellings and related facilities. The loans may be used for: Construction, repair or purchase of housing; provide necessary and adequate sewage disposal facilities for the applicant and his family; purchase or install essential equipment which upon installation becomes part of the real estate; buy a minimum adequate site on which to place a dwelling for applicant's own use.

RURAL HOUSING INSURANCE—Continued

Financial form	Credit aids (guaranteed and insured loans)
Direct recipient	Owners of a farm or nonfarm tract or a rural resident or a nonrural resident of low or moderate income who works in the rural area and will, when the loan is closed, become the owner of a nonfarm tract of minimum adequate size. Must also be a citizen of the United States or reside in the United States after being legally admitted for permanent residence and have adequate and dependably available income to meet his operating and family living expenses, including taxes, insurance, and maintenance, and repayments of debts including the proposed loan. The recipient must be without sufficient resources to provide on his own account the necessary housing, buildings, or related facilities, and be unable to secure the necessary credit from other sources upon terms and conditions which he reasonably could be expected to fulfill.
Interest rate and maturity	6¼ percent—interest credits may be granted to lower income families which will reduce the effective interest rate paid to a low of 1 percent, depending on the size and income of the applicant family. 33-year maturity.
Subsidy costs	Gross outlays, fiscal year 1970 $978,000,000. Capitalized value at 7½ percent: $118,000,000. The subsidy is brought about by the sale of guaranteed loans to private lenders. Since these loans have or will earn less than the market rate of interest, they must be sold at a discount, or the sale must be accompanied by an interest subsidy sufficient to induce purchasers to pay the face value. See Henry Aaron, "Federal Housing Subsidies," in the forthcoming JEC study papers for a more detailed explanation of this program.

APPENDIX B

TAX STATEMENT FROM A TYPICAL PROSPECTUS

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TAX ASPECTS

The Internal Revenue Service issued a tax ruling on June 21, 1972 to the effect that for Federal Income Tax purposes, the Partnership will be classified as a partnership rather than as an association taxable as a corporation.

The following is a discussion of tax factors that may affect investment in the Interests. The statements hereunder have been reviewed by and General Counsel and Tax Counsel, respectively, for the Partnership and have been included herein in reliance upon their authority as experts thereon.

Partnership Taxation. The Internal Revenue Code provides that no federal income tax is paid by a partnership. Each Partner reports on his federal income tax return his distributive share of the income, gains, losses, deductions, and credits of the Partnership, whether or not any actual distribution is made to such partner during his taxable year. It is therefore possible for a Partner to have a loss reported on his Federal income tax return although cash is distributed to him, which will be treated as a reduction of his tax basis; similarly, it is possible for a Partner to have income reported on his Federal income tax return although cash in an amount less than his reported income is distributed to him. A Partner may offset his distributive share of Partnership losses in any taxable year against his income from other sources to the extent of his tax basis for his interest in the Partnership.

Tax Basis. A Partner's tax basis for his interest includes not only the amount of money he contributes to the Partnership, but also his pro rata share of Partnership liabilities (including, in the case f Limited Partners, liabilities as to which no Partner is personally liable). Consequently, it is anticipated that each Partner's tax basis for his interest in the Partnership will include his pro rata share of the mortgages on the Partnership's property described under DESCRIPTION OF PROPERTY (as to which no Partner is personally liable) and will, therefore, be sufficient to permit deduction of his share of the anticipated tax losses of the Partnership. Correspondingly, any decrease in his share of Partnership liabilities (including the reduction in his share of liabilities resulting from any repayments of mortgage or other indebtedness) is considered as a distribution of money to him and accordingly decreases his tax basis (or is taxable as capital gain once his basis is reduced to zero). (See THE PARTNERSHIP AGREEMENT—Transferability of Interest for a summary of the allocation of profits and losses when Interests are transferred.) Any adjustment of revenues, deductions, or credits by Internal Revenue Service audit, or treatment of the Partnership as a corporation, would result in adjustments on the tax returns of the Partners, as well as on the return of the Partnership.

The Partnership's basis for each of the properties will be approximately as follows:

Property	Basis
K	$5,000,000
B	3,520,000
P	1,960,000
T	3,250,000

These amounts do not reflect certain adjustments which are not determinable at this time such as prorations at closing and formula reductions based on Operating Deficits as defined (see DESCRIPTION OF PROPERTY—Terms of Purchase for each of the properties).

Depreciation. Current federal income tax law will permit the Partnership, as an owner of improved real property, to take depreciation deductions based on the entire cost of the depreciable improvements, even though such improvements are financed largely with borrowed money.

Accelerated depreciation methods will probably be used by the Partnership. Sum-of-the years digits and double-declining balance depreciation are permissible methods of computing depreciation for new rental residential real property wherein dwelling units account for 80% of the gross annual rental income. Declining balance depreciation is limited to 150% of straight-line for other new buildings. Used residential rental property with a useful life of twenty years or more at acquisition is allowed

125% of straight-line declining balance depreciation while other used buildings are limited to straight-line depreciation.

Personal Property Bonus Depreciation is permitted by the Internal Revenue Code on depreciable tangible personal property under certain circumstances. A taxpayer filing a joint return can deduct up to $4,000 of Bonus Depreciation in any one year (single taxpayer $2,000) from all of his investments. The Partnership intends to elect to take Personal Property Bonus Depreciation for each property. (See DESCRIPTION OF PROPERTY.)

The Partnership intends to depreciate the improvements on each of the properties as follows:

(a) *K* —200% declining balance on a first user basis, with certain personal property on a straight-line basis, depreciating the shell over 40 years and the other components from 3 to 20 years.

(b) *B* —125% declining balance on a second user basis, with certain personal property on a straight-line basis, depreciating the shell over 40 years and the other components from 5 to 20 years.

(c) *P* —200% declining balance on a first user basis, with certain personal property on a straight-line basis, depreciating the shell over 40 years and the other components from 6 to 20 years.

(d) *T* —200% declining balance on a first user basis, with certain personal property on a straight-line basis, depreciating the shell over 40 years and the other components from 6 to 20 years.

Although the Partnership intends to depreciate T on a first user basis, it is possible that the Internal Revenue Service may take the position that the Partnership is a second user and, therefore, not entitled to the more favorable depreciation basis. Since under the terms of the T Purchase Agreement the Partnership was in possession of T as of March 15, 1972 and an executed memorandum of lease was recorded on March 30, 1972, prior to the time that any tenants moved in, the General Partners believe that the Partnership will be deemed the first user of T However, since the installment purchase agreement was not executed until after the first tenant moved in, the Internal Revenue Service may assert that the Partnership is not a first user. If the Internal Revenue Service is successful in that assertion, the depreciation of T , subject to Internal Revenue Service approval, will be on the basis of 125% instead of 200% declining balance method.

Component Depreciation. The Partnership intends to use component depreciation separating from the land and building shell certain parts of the building to be depreciated separately. The value to be attributed to each component will be obtained from the builder of the property if the information is available and if not available, then an appraisal will be made. The useful life of each component will be determined by the General Partners who will rely on their employees, one of whom is a certified public accountant, and outside advisers, if necessary, who are familiar with the depreciation guidelines established by the Internal Revenue Service as interpreted by the courts.

Personal property as to which component depreciation applies is subject to recapture (ordinary income when sold) for all the depreciation claimed, and not merely the excess over straight-line as is the case with the building shell. At the time of sale or other disposition, the property being depreciated as a component may have a value not greatly in excess of its depreciated tax basis. Depreciation recapture on components or on the building shell is limited to the amount of the gain realized upon the disposition or sale. It is projected that this gain on sale of components, if any, will be nominal.

It is clear under case law that components of an entire new building may be segregated for purposes of computing separate deduction lives. However, the Internal Revenue Service, in a 1966 ruling, has taken the position that separate component accounts may not be used to determine useful lives

for used buildings. Many tax lawyers have questioned this position in legal periodicals and, recently, a Federal Judge in the case of *Harsh Investment Corp.* v. *United States*, 71-1 USTC 85,798 (D. Ore. 1970), allowed component depreciation for purchased rental investment property. This case may be reversed on appeal, or other cases may hold to the contrary. The Partnership may use component depreciation for used, as well as new, properties, and if the Internal Revenue Service successfully challenges this position, then the deduction for depreciation will be more spread out and the depreciation deduction in the earlier years of the Partnership will be adjusted.

Investment Interest Expense. The deduction for investment interest paid or accrued on indebtedness incurred or continued to purchase or carry property held for investment is limited for taxable years beginning in 1972 and thereafter. The limitation is used in the following order: (1) $25,000 ($12,500 for a married person filing a separate return) (not applicable to a trust); (2) net investment income; (3) excess of net long-term capital gain over net short-term capital loss; (4) 50% of the excess of investment interest over the total of the three preceding items. Disallowed investment interest may be carried over to subsequent years within certain limitations. Interest incurred in real estate ventures, if the property involved is rented under a net lease, is regarded as "investment interest" subject to possible disallowance, rather than business interest which remains fully deductible. Investment interest expense from all subject transactions will be accumulated for purposes of the deduction limitations in each Partner's individual income tax return. It is not currently the intention of the General Partners to enter into net leases.

Prepaid Interest Expense. The Partnership plans to prepay interest during 1972 on certain promissory notes for the balance of the purchase price of particular properties and intends to prepay interest for part of future interest on first mortgage financing. The amount of interest to be prepaid with respect to Kempwood, if any, has not been determined as of the date of this Prospectus. The amount of terest to be prepaid for 1973 in 1972 on the Mortgage with respect to E is 325,700. The aggregate amount of interest for 1973 expected to be prepaid in 1972 on the P construction loan and permanent financing is $132,300. The amount of interest to be prepaid in 1972 on the T Purchase Agreement is $200,000. Although it is contemplated that prepayments of interest will be made in future years, the exact amount of such prepayments, if any, cannot be determined at this time, except for the mandatory annual prepayment of $200,000 made pursuant to the T Purchase Agreement. Whether prepaid interest is fully deductible in the year made, or whether the deductions must be allocated over the taxable years involved is determined by the application of Revenue Ruling 68-643, which provides in part as follows:

> "A deduction for interest paid in advance on each indebtedness for a period not in excess of 12 months of the taxable year immediately following the taxable year in which the prepayment is made will be considered on a case by case basis to determine whether a material distortion of income has resulted. Some of the factors to be considered in determining whether the deduction of prepaid interest gives rise to a material distortion of income include but are not limited to the amount of income in the taxable year of payment, the income of previous taxable years, the amount of prepaid interest, the time of payment, the reason for prepayment, and the existence of a varying rate of interest over the term of the loan. If interest is prepaid for a period extending more than 12 months beyond the end of the current taxable year, the deduction of such prepaid interest in the taxable year of payment will be considered as materially distorting income. Where a material distortion of income has been found to result from the deduction of prepaid interest, the Service will require the taxpayer to change his method of accounting with respect to such prepaid interest in order to allocate it over the taxable years involved."

The Partnership does not intend to prepay interest in any year in excess of the Federal tax deductions allowable in such year with respect to such payments. However, there can be no assurance that any amounts of prepaid interest deducted by the Partnership will be fully allowed by the Internal Revenue Service, or that they will be allowed for the year that the Partnership claims them, since the facts of each case are analyzed individually in relation to the laws, regulations and rulings against which they are applied. It is not known whether the Internal Revenue Service ruling interprets the term "material distortion of income" to mean the income and expenses of the Partnership or the individual partners. Although a Partnership is not a taxpayer, it files an information return which is subject to audit. A determination of "material distortion of income" on the Partnership return is more significant at this level, since any deficiency adjustments would subject each of the Limited Partners' income tax returns to assessments of additional tax, and possible audit.

Fees and Other Expenses. The Partnership will pay management and supervisory fees to the General Partners and legal and accounting fees, including fees for tax advice and services, some of which will be deductible and the balance of which will be capitalized. To the extent that the Internal Revenue Service requires any of the fees deducted by the Partnership to be capitalized the income tax loss of the Partnership may be decreased or income tax gain may be increased.

Tax Loss or Profit From Property. It is anticipated that the Partnership's tax losses from the ownership and operation of properties will decline over time and eventually result in taxable income in excess of cash flow from normal operations. This will occur as the annual depreciation deductions under accelerated depreciation methods decline from year to year. In addition, under a level payment mortgage, the portion of each payment which represents nondeductible amortization of principal increases from year to year and the portion representing deductible interest decreases. Thus, it may be economically desirable to sell a property, or for a Partner to sell his Partnership interest, prior to the end of respective useful lives of each of the properties. In the event of a sale of any of the properties of the Partnership, the gain recognized for federal tax purposes by each Partner is, in effect, measured by the difference between the original cost basis of the property to the Partnership as adjusted by additions for improvements and capitalized items and as reduced by depreciation deductions, and selling price less expenses of sale. The entire gain will be taxed as a capital gain (1) to the extent the Limited Partner is not a "dealer" in securities and (2) the Partnership is not a "dealer" in real estate for Federal income tax purposes and (3) the depreciation recapture rules do not apply. The General Partners do not intend to operate the Partnership's business in such a manner as to make it a "dealer" for tax purposes. The excess of accelerated depreciation over straight-line depreciation on depreciable real property, other than residential rental property, is subject to being fully recaptured as ordinary income when the property is sold regardless of how long it is held before such sale. Excess depreciation on residential rental property is subject to being fully recaptured only if it is held for less than 100 months. The recapture of excess depreciation on residential rental property is decreased by 1% for each month such property is held beyond 100 months so that there will be no recapture if the property is held more than 16 years and 8 months. Gain will be realized in excess of the net proceeds after paying the mortgage balance, mainly due to the fact that the depreciation deductions will have reduced the tax basis of the property to less than the amount of the outstanding mortgage balance. Similarly, in the event of a forfeiture of the Partnership's interest in a property, recapture of depreciation as ordinary income is possible to the extent of gain resulting from the forfeiture.

Gain on Sales of Limited Partnership Interest. Long-term capital gains will be realized on the sale of a Limited Partnership Interest by a holder who (1) is not a "dealer" in securities, (2) has held the Limited Partnership Interest for longer than six months, and (3) is not an investor in a Partnership which is deemed to be a "dealer" in real estate for Federal income tax purposes. The General Partners do not intend to operate the Partnership's business in such a manner as to make it a "dealer" for tax purposes. To the extent that a portion of the gain realized attributable to the sale proceeds includes the holder's share of Partnership "unrealized receivables" and "inventory items which have substantially appreciated in value," as defined in Section 751 of the Internal Revenue Code and regulations pertaining thereto, which provision includes the excess of accelerated depreciation over straight-line depreciation on depreciable real property, other than residential rental property, such excess depreciation is subject to being fully recaptured as ordinary income regardless of the length of time the Interest is held. On residential rental property held longer than 100 months, the recapture of excess depreciation on residential rental property is decreased by 1% for each month such property is held beyond 100 months so that there will be no recapture if the property is held more than 200 months (16 years and 8 months).

Income Tax Rates. The Tax Reform Act of 1969 made certain changes in the Internal Revenue Code that may affect returns from investments similar to that of the Limited Partners in the Partner-

ship. The Act increased the maximum rates at which capital gains are taxed to both individuals and corporations. The 1969 Act imposed on both corporations and individuals an annual 10% tax, in addition to present corporate and individual income taxes, on certain "tax preferences" in excess of $30,000, plus the regular tax liability for that year (adjusted for certain credits) plus carry over of unused tax liability (adjusted for certain credits) not offset against tax preference items of the previous seven years subsequent to 1969 less $30,000. Depreciation taken on real estate in excess of amounts allowable under the straight-line method is a tax preference item. One-half of the amount by which the net long term capital gain exceeds the net short term capital loss in the case of individuals and approximately three-eighths of such amount in the case of corporations are also tax preference items. The 1969 Act reduces the maximum income tax rate on earned income in the case of individuals to 50% for taxable years beginning after December 31, 1971. However, the amount of earned income qualifying for such reduction in rate will be reduced by tax preferences in excess of $30,000 subject to certain tax preference adjustments. There are other tax preference items, such as percentage depletion, which should be checked by an investor with his tax advisors, since his overall tax situation will determine the extent to which minimum tax, maximum tax and capital gain rates will apply.

The 25% alternative tax rate applicable to the excess of long term capital gains over short term capital losses is generally limited to the first $50,000 of gain in any one year (except capital gains received before January 1, 1975 from sales or other dispositions under binding contracts entered into on or before October 9, 1969) and for gains that exceed $50,000 the rate increases, in effect, to 35% in 1972 and thereafter. (For corporations the alternative tax rate is 30% on net long term capital gain over short term capital loss with no special tax on the first $50,000 of gain.) Only one-half of long term capital losses incurred in 1970 and thereafter may be used for the $1,000 annual deduction from ordinary income available to individuals.

Section 754 Election. Optional adjustments to the basis of Partnership property for determining depreciation, profits and losses upon certain distributions of Partnership property (Section 734) or transfers of Partnership interests (Section 743) are provided for in the 1954 Internal Revenue Code if a Partnership election has been made in accordance with Section 754. By making this election, transferees of Partnership interests are treated for purposes of depreciation, profits and losses as though they had acquired a direct interest in the Partnership assets and the Partnership is treated for such purposes, upon certain distributions to Partners, as though it had newly acquired an interest in the Partnership assets and therefore acquired a new cost basis for such assets. Once the election is made, it is irrevocable with respect to all current and future transfers and distributions, unless the consent of the Internal Revenue Service is obtained. The tax accounting required to implement such an election is quite complex, and adjustments must be made each time there is a transfer of a Partnership interest or a distribution of property. The General Partners do not presently intend to make such an election; however, Section 10.10 of the Amended Certificate and Agreement of Limited Partnership gives the General Partners discretion to elect these provisions of the Internal Revenue Code. If the election is not made, one effect would be that upon a sale of Partnership property subsequent to a transfer of a Limited Partnership Interest, taxable profits or losses to the transferee of the Limited Partnership Interest will be measured by the difference between his share of the amount realized and his share of the Partnership's tax basis in the property (which, in the absence of a Section 754 election, will be unchanged by the transfer of the Interest to him), rather than by the difference between his share of the amount realized and the portion of his purchase price that was allocable to the property.

The Limited Partners or the Partnership or both may be subject to state and local taxes in jurisdictions in which the Partnership may be deemed to be doing business or in which it owns property or other interests.

IT IS NOT POSSIBLE TO PREDICT THE EFFECT OF THE TAX LAWS ON INDIVIDUAL INVESTORS IN THE PARTNERSHIP. EACH LIMITED PARTNER SHOULD SEEK, AND SHOULD DEPEND UPON, THE ADVICE OF HIS TAX ADVISOR WITH RESPECT TO HIS INVESTMENT IN THE PARTNERSHIP. THE COST OF SUCH ADVICE WILL AFFECT THE YIELD OF THE INVESTMENT.