Preferential Tax Treatment of Land Income
By Dr. Mason Gaffney

Article citation:
Gaffney, Mason. “Preferential Tax Treatment of Land Income.” No date. Notes.

Fair Use Disclaimer
The Robert Schalkenbach Foundation, a non profit private foundation, is publishing this article, at no cost, pursuant to the Fair Use provisions of Section 107 of the Copyright Act which states that under certain circumstances, the fair use of a copyrighted material for purposes of criticism, comment, teaching, scholarship and research is not an infringement of copyright. If you have any concerns about the publication of this article, please contact us at **info@schalkenbach.org.**

The Robert Schalkenbach Foundation’s Digital Collections and Archives is an extension of the Robert Schalkenbach Foundation’s Engel Georgist Library. It collects, organizes, preserves, and provides free online access to researchers and the general public of Georgist literature including books, newspapers, pamphlets, scholarly articles and archival materials.

RSF is particularly proud to offer free online access to the works of the late Georgist scholar Mason Gaffney, made possible through the generosity of the Danica Foundation and with the consent of the Mason and Letitia Gaffney Trust.

Robert Schalkenbach Foundation: https://schalkenbach.org/
Engel Georgist Library: https://www.librarycat.org/lib/EngelGeorgistLibrary
RSF Digital Collections and Archives: https://schalkenbach.starter1ua.preservica.com/

TRUNCATED VERSION

"Preferential tax treatment of land income"

Mason Gaffney

Introduction and definitions

The structure of the federal income tax was put back "in play" in 1989, after the supposedly iron compact of 1986, as Congress struggled with President Bush's initiatives to cut taxes on "capital gains." It has remained in play ever since. A related live issue was and is how to promote domestic capital formation. Champions of this tax cut hold it will stimulate investing, the motor that drives the GDP. Twist

(1)

The name "capital gains" needs specification. Cutting tax rates on newly formed capital would have the desired effect. Bush's original proposal was limited to certain new investments, (as was the old Investment Tax Credit, killed in 1986). The limited proposal was swept aside, however, and in October, 1989, The House sent forward a bill to cut gains taxes on all the old assets ever before labeled as "capital assets", over 50 years of expanding that category. Most of these tax benefits will go to land, not capital. (Note, 1999: the final result was a deal with House Democrats, who accepted a cut in the capital gains rate in return for a hike in the top bracket rate on ordinary income. This maneuver put Bush in the position of violating his "read my lips" pledge, "No new taxes," and helped Clinton unseat him in 1992. That Bush was willing to take this risk, and ultimately pay this price, is a measure of what high priority he gave to cutting the tax on capital gains.)

When tax benefits go to land, the word "incentive" takes on a new and lesser meaning. Land, by definition, is something not formed by saving or other human effort. Incentives to buy and hold land will raise the demand for land, but not the supply. The incentives created are not the kind that produce anything or employ anyone.

Some tax benefits will also go to old capital. It is less than a half-truth, however, to make that a rule. It is in the nature of most capital to depreciate with time, usually fast.

(2)

Land is the asset that commonly appreciates over the period of ownership. A small class of biological assets, e.g. trees, do rise in value over time, like land, but they are the exception. So "capital" gains is an obfuscatory misnomer; land gains is the main subject.

Corporate shares also yield "capital" gains. What makes these shares rise is the rise in value of corporate assets. The writer has shown elsewhere that a large share of corporate assets consist of land (in the generic sense of natural resources). Another source of the rise is the plowback of undistributed profits. Some of this goes to create real capital. (The rest goes to acquire old capital and land.) By this indirect route, a portion of any cut in capital gains taxes will actually foster investment; but the portion is small. If the main purpose were to encourage new investment, fast write-off of new capital is the obvious tool. All the benefits of that go where intended. The main effect of untaxing land gains is to redistribute wealth.

Evolution of the income tax base

(snip - this section already distributed)

Deductions for landowners

In 1986 Congress closed most loopholes which encouraged investment in new capital, but did not close them for land, even though capital formation was lagging, and land prices soaring. Here is a list of the preferences enjoyed by those who own or buy land.

a. Covert depreciation of land.

When an investor buys land under an old grove, or old building, the IRS says he must allocate his basis between the depreciable capital and the non-depreciable land. The requirement is reasonable, since buildings and fruit trees generally do lose value with time, while land does not.

IRS is extremely lax and "generous" in letting buyers overallocate basis to the depreciable building or grove of trees. Thus they contrive to depreciate for income tax not just the building or trees, but much of the land value.

By this simple device, the Treasury compensates an owner for his land in advance, before beginning to tax its income. A taxpayer in a 70% bracket, for example, reduces his taxes by 70% of all the land value he writes off. To make it simple, say he writes off all the land he bought. That means the Treasury has paid for 70% of the land. After that, the Treasury gets 70% of the land's income. It is only getting a return on what it paid for. The taxpayer put up 30% of the cost, and on that investment he gets a tax-free return.

The taxpayer gets this tax-free return in perpetuity, i.e. forever, unless he sells. At that time there may be some recapture. We show later why this is minimal.

In fact, taxpayers do not write off all their land purchases, but only part. It is on the part written off that they achieve tax-exemption until resale. Much evidence indicates they write off large fractions of their land value. Here, for example, is an ad from the L.A. Times, Nov. 25 1962, telling buyers they can depreciate over 80% of what they pay for citrus groves in Redlands. Redlands at that time was a city rapidly converting citrus to housing, where only 20% of what they paid was likely to be for the depreciable trees (which weren't really depreciating anyway, except as the rising land value underneath them eroded their citrus value). Locational obsolescence

5 (b.) Fast write-off of land

In the Redlands ad cited, full depreciation is promised in 10 years. The tax code has elaborate guidelines and (at that time) "reserve ratio tests" to avoid fast write-off of new capital. But for old capital, and the land value that bleeds into it, very fast write-off is allowed.

5 (c.) Expensing carrying costs

Interest on debt incurred to acquire land, or refinance land, is fully deductible each year as a current expense. If the land is held for appreciation, the appreciation to which each year's expense contributes is not taxed until later when (and if) the land is sold in such a way that a gain is recognized as taxable income.

$P = \frac{a + \Delta V}{i}$

In today's market all land is held for appreciation in part, even if the land is fully used. All land prices are higher than current cash flow justifies, because of expected future increases. Any interest paid on debt secured by that speculative premium is expensed currently, even though the resulting income is not recognized until sale.

To be fair, interest on debt secured by rising land should not be deductible until the land is sold and the gain is taxable. The advantage of deducting it currently can be great, if the holding period is long, because of the time-value of money. Thus, a dollar a year for 60 years comes to $60; but a dollar a year with interest at 7.2% comes to ~~$785~~ $875, nearly ~~13~~ ~~15~~ ~~18~~ 15 times as much. ~~$\frac{63}{.072} = \frac{63.00}{.072}$~~ 986

What is true for interest is equally true for property taxes.

Neither of these carrying costs is ever deducted from basis, as a depreciation deduction is.

(6) ~~V~~ The inadequacy of "recapture"

Anyone defending the system would point out that excess depreciation is "recaptured" when property is sold. Excess depreciation, even of land, lowers the "basis" and results in higher gains at time of sale. Thus the tax exemption is not perpetual, but ends with the sale.

There are several reasons why such recapture is too little and too late to offset the advantages of early depreciation and deduction.

6 - (a) Some owners never sell

6-a-(1) "Dynastic" owners. Some owners never sell as a matter of "policy", a management rule that overrides any apparent economic consideration. In Hawaii the "Big Five" have followed this policy for a century. One, the Bishop Estate, owns 340,000 acres, or 8% of Hawaii, including 11,000 lots in metro Honolulu. Ground leases are for 55 years. As they expire, the landowner takes his gains in the form of higher rents. In the early '80s, some ground rents were jumped from $200/year to $10,000/year.

In California the S.P.R.R., the largest landowner ever since the time of statehood, followed this policy for a century or more. In the early 90s its real estate was spun off to the Catellus Co., which still does not sell, but is currently acquiring more land. The Irvine Company, with some 60,000 or 70,000 acres in Orange County, never sells, but only leases. (The Irvine Water District, serving the City of Irvine, recently had some 50,000 registered voters, but only four voters qualified to vote in District elections, because voting rights, until recently, were limited by State law to landowners.)

The Wrigley Company apparently hewed to this policy on Sta. Catalina Island. Most of Avalon ground is leased on medium terms to the owners of the buildings. In recent years, the Wrigley's placed the land in a "charitable" conservation trust, for which they would have received a full write-off.

Dynasties are not lightly relinquished. The Hawaii Land Reform Act of 1967 gave lessees rights to buy, but the Bishop Estate challenged the law and had it overturned in the U.S. 9th Circuit Court, 29 March 1983.

E.g Harvard, Allston; Penn; Yale; RCC; UCR; OCS

6-a-(2) Anticipatory owners. Some owners buy well in advance of their own anticipated future needs, e.g. for "future expansion." They benefit from the gain, but never get taxed because they need not sell to themselves. In the process they turn many urban land markets to glue. E, Side Mkt, NW Life

6-a-(3) Owners who reserve valuable rights. An owner may sell the shell of land title to another for a low price,

reserving for himself valuable land rights. One of these is a covenant not to compete, such as Gimbels' Store reserved when it sold the adjoining block at 3d and Michigan Streets, Milwaukee. The value of such a reservation may be appreciated by the fate of an East Bay builder and his wife who in 1981 or so put up a motel at a well-selected site by a new interchange. They did so well at first that four major chains built around them, and now they struggle just to survive.

Other owners do not bother with the covenant not to compete, but hold competing land preemptively. They take their gains in monopoly rents from the land they retain.

(4.) Owners who refinance. To take cash out of appreciated land without selling, it is common to mortgage. One "realizes" the value by borrowing on it; but no taxable income is "recognized."

This is one reason deregulated S&Ls overexpanded so fast in the '80s; and the share of interest in national income has risen.

(5) Owners who "milk" properties. A common way to take out cash is to neglect maintenance and repair, thus increasing cash flow in the short run. The proverbial economic penalty for such prodigality is loss of asset value, but when the land value under the building or industrial plant is rising, this is a way of turning the increments into cash without paying tax on the gains. Land appreciation offsets building depreciation so value is retained, while the owner draws off cash for other uses.

(6) Owners who barter. This traditional route to deferring gains taxes grows more sophisticated every year. The "3-way corporate swap" is a new wrinkle too complex to describe in a few words here. For $700 you may attend USC's 42nd Annual Institute on Federal Taxation, held at the Century Plaza Hotel next January 18, and hear an expert discussion of "Like-kind exchanges of real estate" by Joseph Knott, CPA, of Kenneth Leventhal & Co. Deferral of recognition of gains is big business, with top experts.

6-a-(7) Residential owners who "roll over." No taxable gain is recognized on sale of a primary residence provided a replacement residence is bought within 18 months before or after the sale -- a three-year window. In effect the sale is treated like barter, even though cash was received.

A seller's motive is to stretch the definition of a "residence." To most sellers a residence is a residence, but what about those in the "Hunt Club" neighborhood of Potomac, in Montgomery County, Md., where each residence used to come with about 100 acres of land? In the 1970s these estates were being sold to developers. How much land is part of the "residence"? There is no easy answer, which is why some sellers retain tax lawyers and get themselves a good deal.

A new wrinkle, the corporate rollover, is too complex to describe here.

Residential owners must eventually sell or die. But when they die, as we see next, all accumulated gains are forgiven forever.

(6)-~~a~~-b. Step-up of basis at time of death.

At time of death, all property is appraised when passed on to heirs or other legatees. The legatee's basis is the appraised value at time of receipt. All prior appreciation is wiped out, tax-wise. Hence tax deferral over any period of ownership before death culminates in total exemption.

Recall that earlier excess depreciation lowers the "basis" of property, resulting in a higher gain upon sale. But with step-up of basis, any expected "recapture" of earlier excess depreciation is a promise (or threat) that never comes true.

(6)-~~b~~ a-9 c. Non-resident aliens are exempt.

Under international tax treaties, non-resident aliens are exempt from the U.S. tax on capital gains. The reason for this apparent giveaway to foreigners is reciprocity -- Americans abroad get the same treatment. The net result,

however, is that a handful of Americans who invest abroad benefit there so that a handful of foreigners can benefit here, at the expense of median citizens who are taxed mainly on wages and salaries and interest.

In addition this provision opens a wide loophole for tax evasion by American citizens posing as non-resident aliens. It is not otherwise evident why residents of Curacao have such an interest in farmland in Imperial County, California.

6-a-(10) Bequests.

Time was when one could donate appreciated land to a favorite eleemosynary institution (church, college, land conservation trust, etc.), deduct its current value, and wipe out tax liability on the gain. It is no longer so simple, but that is still the general idea. Now you can convert your home into a lifetime income for yourself and a surviving spouse or other person, without paying tax. You give the home to a charitable trust, which sells it, invests for high yields, and supports you and yours for life. Your alma mater or church will be glad to supply the details in unctuous detail.

6-a-(11). Miscellaneous

There are several other ways to defer tax liability on gains. One is financing the buyer and selling on installments. Another is taking the buyer as a partner and participating in profits. Another is the sale of options. Another is the "Land Sales Contract" where the seller retains title until all payments are completed, often up to 40 years in the future. All these work in conjunction with step-up of basis at death to defeat recapture entirely in the long run.

In sum, recapture is a certainty only for careless taxpayers, or pinched taxpayers who lack room to maneuver. In general, excess depreciation and illegal depreciation are not recaptured. Tax exemption is achieved in perpetuity. But then the next generation does it again, so over time there

accumulates on each parcel of land a large sum of perpetual tax exemptions.

****

NOTE: THE FOLLOWING IS A SKELETAL OUTLINE ONLY. THE FULL TEXT IS ON RESERVE.

****

(7) Partial recapture

By 1985, 60% of gains had become excludible. In 1987-88, none were. In 1989, under intense pressure, Congress reopened the exemption a crack by lowering the tax rate on gains, and since then the crack has widened year by year.

(8) Recapture at lower tax rate

Excess and illegal depreciation were taken off historically at high tax rates like 70%. Now, if recaptured, it is at 28% (or a max of 33% in odd cases). A fall of tax rates is a giant bonanza for those with previously unrecognized gains.

With corporations, the rate drop was from 46% down to 34%.

(9) Recapture in devalued dollars

Because of inflation, excess and illegal depreciation, and expensed carrying costs, are recaptured (if at all) in later dollars of lesser value. Here is the "phantom income" argument on the other foot. This is "phantom recapture."

(10) Condemnations

No tax is due when real estate is condemned: the gain is rolled over. Condemnation used to be a rarity. Now, with extensive use of redevelopment districts by cities, condemnation has become quite common.

Exemptions

Imputed income of owner-used real estate is exempt. This includes recreational holdings: country club memberships, hunting/fishing clubs, marinas, ski lodges, horse farms, other hobby farms, private beaches, etc.

(11) Gains of exempt owners

Non-profits may increase their wealth without limit, and pay no gains tax. These include churches, cemetery associations, colleges, government agencies, etc. A "government agency" like the Irvine Water District, with only four voters, gives an idea how these public powers and exemptions may be used. Another such case is the Castaic Lake Water Agency, controlled by the Newhall Company.

Every homeowner over 55 may cash out up to $125,000 once in a lifetime, tax free. (Note, 1999: this limit keeps going up, and is now about $400,000.)

(12) Special case of mineral rights, leasehold abandonment

A big topic! See the writer's "Oil and Gas: the Unfinished Tax Reform."

(13) Large unitized developments: the "ski-lift economy"

A typical ski-lift operation loses money, but makes it up on sale of surrounding real estate. The losses are ordinary losses, fully and currently deductible. The sales are (if one is careful) qualified as capital gains.

(14) Rent-seeking expenses

Many natural resources, like water sources, are allocated on an appropriative doctrine: "first in time, first in right." To establish future ownership you must use it now, even if at a loss. The current losses are currently deductible; future sales, if any, will be of a "capital" asset.

(15) Stored up rents

Many assets, like timber, represent stored-up ground rents. These are a way of converting ordinary income (annual rent, e.g.) into a capital asset (timber).