The Impact of the Tax Reform Act of 1986 on Real Estate and Right of Way Agents

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With the recent tax changes, the real estate and right of way agent must be prepared to make good, sound business decisions.

On October 22, 1986, President Reagan signed into law the Tax Reform Act of 1986. Because of the numerous law changes directly related to real estate, it is certain that the nature of real estate investment will change, and right of way agents must be ready to react to changing market conditions.

When making real estate appraisals, appraisers often use historic market data (sales information) that may predate the appraisal by up to 3 years or more. Since the rules have changed this year with regard to the taxing of real estate income, appraisers may no longer be able to trustingly rely on data that predates the tax reform act; rather every effort must be made to locate post-tax reform comparable data on which to base their appraisals.

To develop a better understanding of the problem of tax reform and its impact on real estate, the following research was conducted. First, background information was obtained to determine the underlying need for tax reform. Second, details of the tax law changes were reviewed to determine and summarize those changes that would affect real estate. Third, other expert opinions were sought out regarding the impact of tax reform on real estate. Fourth, a simple before- and after-tax reform model was developed to test the impact of tax reform on after-tax internal rate of return. Internal rate of return is the net return on an investment from all sources, i.e., annual net income, appreciation, and tax benefits. Internal rate of return can be calculated before tax or after tax. However, because tax shelter investments can derive an income stream from the tax system, after-tax internal rate of return is the important unit of comparison when selecting a tax shelter investment. Using the test model, three different financing scenarios were employed because of the speculation raised by other sources that highly leveraged property might be affected more dramatically than others. Leveraged or leveraging simply refers to financing; highly leveraged indicates that the investor borrowed a substantial amount of the purchase price of the property or a substantial amount of the property's value in a refinance. Fifth, observations were drawn from the model and its different after-tax internal rate of return conclusions. Finally, it was concluded that tax reform reduces after-tax internal rate of return potential and that consequently the demand for, and the value of, real estate investments will fall.

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Background

During the 1981 and 1982 legislative sessions, a successful lobbying effort by the real estate industry generated lucrative tax benefits, and as one local industry leader put it, "Not only did we get it, but we chose to flaunt it as an industry by hyping tax shelters, tax free income" (Fransen, p. 18).

Because of the tax benefits received by the industry, unprofitable properties became attractive for acquisition, and developers began to ignore market conditions when making a decision as to whether or not a project should be built. This is clearly exhibited by the glut of office space vacant in the market right now.

Another side effect of the early 1980's tax law legislation is the spread of tax shelter abuse. In excess of $3 billion tax dollars was lost in 1982 alone, due to abusive tax shelters (Egger, p. 233). In 1983, the Internal Revenue Service had 16,300 tax shelter abuse court cases pending with over $1 billion in potential adjustments, and an additional 325,000 tax shelters were under examination (Blank, p. 182). For these reasons, it becomes easy to see why tax reform developed into a major political issue.

In writing the Tax Reform Act, some of the stated goals of Congress were to remove loopholes, develop equity in the tax code, broaden the tax base, and simplify reporting procedures (Arthur Anderson and Co.). Each person can decide whether or not Congress achieved this goal; however, in response to simplification, a number of professionals have labeled the act as the tax accountant's and attorney's relief act of 1986.

Summary of Pertinent Changes

Rate Reduction. Previous to the Tax Reform Act, there were as many as 15 income tax brackets in the system, with the highest rate at 50%. After tax reform, there will be essentially two brackets with the highest rate at 28%. Previously, when investors would deduct losses from a real estate investment against their ordinary income, their tax liability could be reduced by as much as 50% of the loss. This is an important calculation, especially when you consider the fact that included in the loss is depreciation, a noncash expense. In essence, this write-off provided an additional cash flow to the property which investors typically took into consideration when de-