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 determining a price for buying property. After tax reform, the top income tax rate of 28% reduces the potential value of the tax write-off.

At-risk rules are extended to real estate with tax reform. These rules limit the ability to deduct losses to the amount of equity an investor has in the property. Following is an excerpt from the Summary of Conference agreement on H.R. 3838 (Tax Reform Act of 1986) discussing this topic:

> The at-risk rules are extended to the activity of holding real property, with an exception for qualified nonrecourse financing which is secured by real property used in the activity. Under this rule, real estate joint ventures may obtain financing from an otherwise qualified lender who has an equity interest in the venture, provided that the terms of financing are commercially reasonable and substantially similar to loans made to unrelated parties. Seller financing is not treated as qualified nonrecourse financing.
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> This provision is effective with respect to property acquired after December 31, 1986. (Joint Committee, p. 17)

It is anticipated that the reaction to the above rule will be a disinterest in seller financing which up until now has been a main ingredient to highly leveraged real estate deals.

Losses and credits from passive activities have been severely limited in terms of write-off against ordinary income. An additional excerpt from the conference agreement summary follows:

> Deductions from passive activities, to the extent that they exceed income from all such activities (exclusive of portfolio income), generally may not be deducted against other income of the taxpayer. Similarly, credits from passive activities generally are limited to the tax allocable to the passive activities. Suspended losses and credits are carried forward and treated as deductions and credits from passive activities in the next taxable year. When the taxpayer disposes of his entire interest in any activity, any remaining suspended loss incurred in connection with that activity is allowed in full.
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> Passive activities are defined to include trade or business activities in which the taxpayer does not materially participate (e.g., a limited partnership interest in an activity), and rental activities. . . In the case of rental real estate activities in which an individual actively participates, up to $25,000 of losses (and credits, in a deduction-equivalent sense) from all such activities may be taken in each year against non-passive income of the taxpayer. This amount is phased out ratably between $100,000 and $150,000 of adjusted gross income (determined without regard to passive losses). (Joint Committee, p. 17)

It is important to note that there is a phase-in period for the limitations on passive losses; however, the phase-in is all but eliminated for some taxpayers due to the expanded alternative minimum tax rules. *Capital gains* will be taxed as ordinary income because the Tax Reform Act repeals the exclusion for long-term capital gains. *Depreciation* changes allow for the cost of real property to be recovered using the straight-line method over 31.5 years for nonresidential property and 27.5 years for residential rental property which is considerably less beneficial financially than the previous 18-year accelerated cost recovery schedule. With all of these changes occurring, it becomes easy to see why uncertainty and uneasiness would develop in the market.

Current Reaction and Speculation

One trend that appears to be emerging is cash buyouts of real estate. Rather than securing financing, limited partnerships are being structured for 100% equity deals. The main selling point for this type of offering is that it will provide passive income which can be used to activate the deductibility of passive losses. This type of acquisition may be very attractive to anyone currently active in a tax shelter and losing the ability to deduct passive losses. One report indicates that in the first half of 1986 cash buyouts have out-sold leveraged deals 2 to 1 (Robert Stanger and Co., p. B8). That's not to say that leveraged deals are a thing of the past. As one financier put it:

> If the rates are lower, and the debt constant is lower than your capitalization rate, if you put aside the safety factor of high leverage for the moment, why should you accept a return of 10 or 10.25 percent on your cash when, if you borrow 75 percent of your purchase price, you might be able to leverage that cash-on-cash return up to maybe 11 or 11.5 percent if you can borrow at a debt constant of maybe 9.75 percent, which is certainly available today if you borrow shorter term. (Steinberg, p. 5)

In terms of actual impact, though, the most interesting speculation has occurred over what is likely to happen to real estate values, and of course this strikes at the heart of the agent's interest in tax reform. A recent survey of 100 investors, lenders, syndicators, and developers indicated that overall prices would remain stable (Real Estate Research Corporation, p. S3). However, the same survey concluded that 3 to 4% of commercial real estate is in "genuine difficulty," which is 4 times larger than normal. When considering the commercial market and breaking it down into small ma- and pa-type properties, medium-sized limited partnership-type properties, and large institutional-type properties, a great deal of caution is exhibited toward the middle section.

Less concern seems to be shown toward the smaller and the larger projects. The probable reason being that the typical investor involved in small ma- and pa-type projects will still be able to deduct passive losses, and the degree of reliance upon the sheltering effect of real estate has not been as great. The large institutional quality properties were always cash deals and were never intended for a tax sheltering effect on other income, and therefore the removal of certain tax benefits would have little if any impact on the market value of this class of property. It's the middle range, highly leveraged, limited partnership-type properties that have some people nervous. The above study projects as much as a 20% drop in value. A recent article in the *Minneapolis Star and Tribune* indicates that a silent crash has already occurred in the office and hotel markets (Downs, p. M6). The problem of tax reform on certain commercial properties is compounded in the office and hotel market by the glut of available vacant space. The same study mentioned above, conducted by the Real Estate Research Corporation of Chicago, forecasted a 50% drop in starts of hotel and office space next year. The vacancy problem is occurring nationally, and it is well apparent here in the Twin Cities (Minneapolis and St. Paul) office market which has a record vacancy rate of about 17% this year. To bring it down to a healthy 6% level, construction would have to halt for 4 years (MIT, p. A1).

Despite all of this pessimistic talk, at least one source was optimistic about the immediate future of real estate (Payne-Webber, p. 3). However, the source is in the business of selling real estate securities, and therefore the optimistic advice must be taken with a grain of salt. In addition though, earlier this year in the *Appraisal Journal* another source indicated that "... tax shelter is, and should be, a relatively minor component of the value of real assets." From this they concluded that tax reform would have little impact on market values (Albert, p. 117). Yet, this conclusion was refuted later in the same journal when another set of researchers, using the same model but different cash flow assumptions, came to the conclusion that the earlier authors "... incorrectly concluded that tax shelter is an insignificant contributor to value" (Haight, p. 550).

Before and After Comparison

To test the impact that the tax law changes will have on investment decisions, the following discounted cash flow analysis model has been developed, by the author, applying past tax law and new tax law to the same property as if the property were offered for sale. And as part of the test, three different financing schemes were used to compare how different types of investors might react. Below are the assumptions made by the author about individual property characteristics and the market to apply the cash flow analysis:

Property type	Rental residential
Sale price	$1,000,000
Land value	$200,000
Holding period	6 years
Front overall rate	9%
Back overall rate	9½%
Net operating income	3% rise per year
Sale expense	7% of price
Passive income	Assumed available after, for write-off
Before marginal tax rate	50%
After marginal tax rate	28%
Financing schemes	(A) 100% equity (B) 25% equity 75% loan @ 10% 30 years (C) 10% equity 75% loan @ 10% 30 years 15% loan @ 14% interest only 7 years

In developing the discounted cash flow analysis, three scenarios were produced, corresponding directly to the preceding financing schemes. Each scenario has two parts, part one is a before-tax reform discounted cash flow analysis to determine the rate of return to equity after tax. Part two is the same type of analysis, only after-tax reform laws are used. Each part has four

Table 1. After-Tax Cash Flow Summaries Before Tax Reform (B.T.R.) and After Tax Reform (A.T.R.)

Equity	Tax	Time 0	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
100%	B.T.R.	$(1,000,000)	81,000	82,350	79,740	77,172	78,648	989,274
100%	A.T.R.	$(1,000,000)	72,945	74,889	76,892	78,954	81,077	1,049,791
25%	B.T.R.	$(250,000)	38,941	40,063	37,203	34,359	35,531	231,003
25%	A.T.R.	$(250,000)	14,386	16,203	18,065	19,972	21,927	275,631
10%	B.T.R.	$(100,000)	28,441	29,563	26,703	23,859	25,031	70,503
10%	A.T.R.	$(100,000)	(734)	1,083	2,945	4,852	6,807	110,511

Table 2. Summary of Internal Rates of Return Before and After Tax Reform

Financing	Return Before	Return After	% Difference
100% equity	6.71%	7.29%	+8.6%
25% equity	12.23%	7.56%	−38.5%
10% equity	21.74%	4.00%	−81.6%

steps; the first is calculating the actual taxable income (loss) from operating the property. The second step calculates the actual after-tax cash flow from operating the property. The third step calculates the payment to be received at the end of 6 years from selling the property (the reversion). The fourth combines the payments, the operating after-tax cash flows, and the reversion into a time line kind of format which can be used to easily discount this overall cash flow to present worth using the Hewlett Packard 12C calculator. Because time 0 is actually the equity investment, subsequent years represent positive (negative) returns on and of equity. The rate of return indicated by this discounting process then is the after-tax internal rate of return.

In Table 1, the reader will find summarized the time line cash flow (mentioned in step 4) for each financing scheme before and after tax reform, beginning with the analysis of a 100% equity position. Time 0 is the equity investment at purchase. Year 6 includes after-tax income and after-tax gain on sale. Table 1 provides a visual representation of how tax reform alters after-tax cash flow, all other things equal, for different equity amounts. The reader will note that the greatest change appears to be occurring in the 10% equity position.

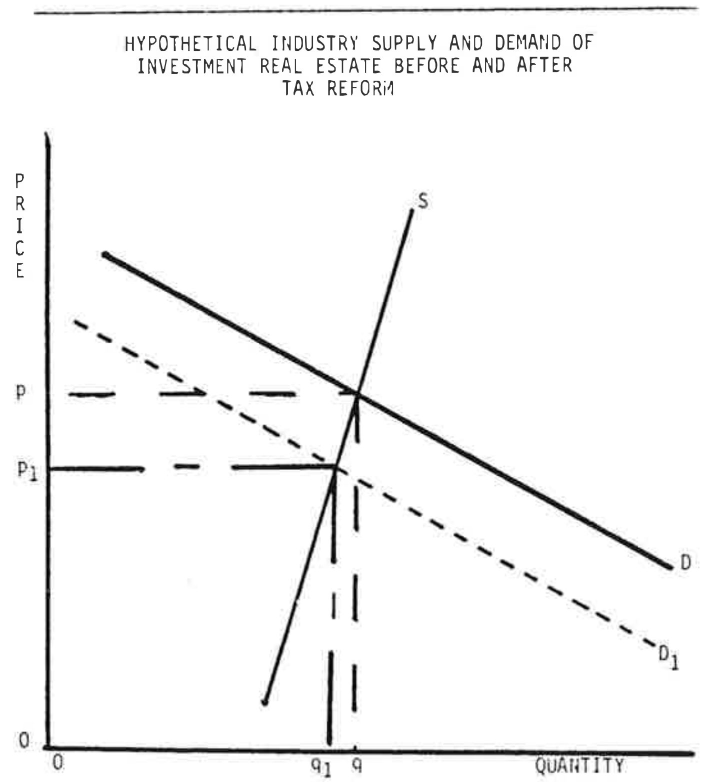
In Table 2, the after-tax internal rates of return, generated for each equity position before and after tax reform, have been summarized along with the calculated percentage change.

Observations

From the tables, we can observe that, with highly leveraged property, tax benefits play a very important role in providing after-tax returns on investment. At the 10% equity position, the drop in after-tax internal rate of return is calculated to be over 80%. On the other hand, in the 100% equity position, there appears to be a slight increase in after-tax internal rate of return. This tends to substantiate some of the speculation reported earlier about the impact of tax reform on highly leveraged property. It is clear that, after tax reform, the potential after-tax return on such a property will drop considerably. Other factors that were not considered in developing this model, such as the inability to deduct passive losses against active income, the negative effect of lower overall rates (or conversely the positive effect of higher overall rates; lower overall rates place a higher importance upon income from tax write-off), adjustments that may follow in state income tax systems, and current high vacancy rates in certain markets, would all tend to widen the gap between before and after internal rates of return.

Conclusions

It is clear from the foregoing data and remarks that tax reform will have a negative impact on the potential returns available to some investors. Yet just as it is " . . . impossible to predict what tax reform means to the economy as a whole" (Mackles, p.



Line S represents the supply curve of investment real estate; as price increases, so does the quantity that producers are willing to supply. Lines D and D_1 represent industry demand curves before and after tax reform (respectively); as prices fall, the quantity demanded will rise. Point p, q represents an equilibrium price before tax reform. After tax reform, investors leave the market and the demand curve shifts to the left (D_1), and the new equilibrium price is established at p_1, q_1, which is somewhat lower than the original equilibrium.

2), it is impossible to predict precisely how investors will react to the drop in potential internal return rates; however, this researcher believes that some investors will choose to leave the real estate market because of tax reform (particularly those interested in high returns from highly leveraged property) and consequently demand will fall. We know from learning and experience that when demand falls and when supply is static, market value (equilibrium price) falls. This is illustrated in (see accompanying figure).

Only experience based on new tax reform law and observed (post-tax reform) market transactions will allow appraisers to make sound conclusions as to the impact of tax reform on real estate values. Therefore, it is most important to re-emphasize the need for post-tax reform data in preparing future appraisals. IRWA

End Notes

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