

IMPACT OF NEW TAX REFORM LEGISLATION ON REAL ESTATE

A revamped real estate scene is about to emerge as the tax reform act takes hold.

by John McMahan, CRE

Since it became apparent Congress would pass some form of tax reform legislation this year, there has been considerable speculation as to what it would mean for real estate. Now that there is a final bill, it is important to re-examine its impact on real estate investment.

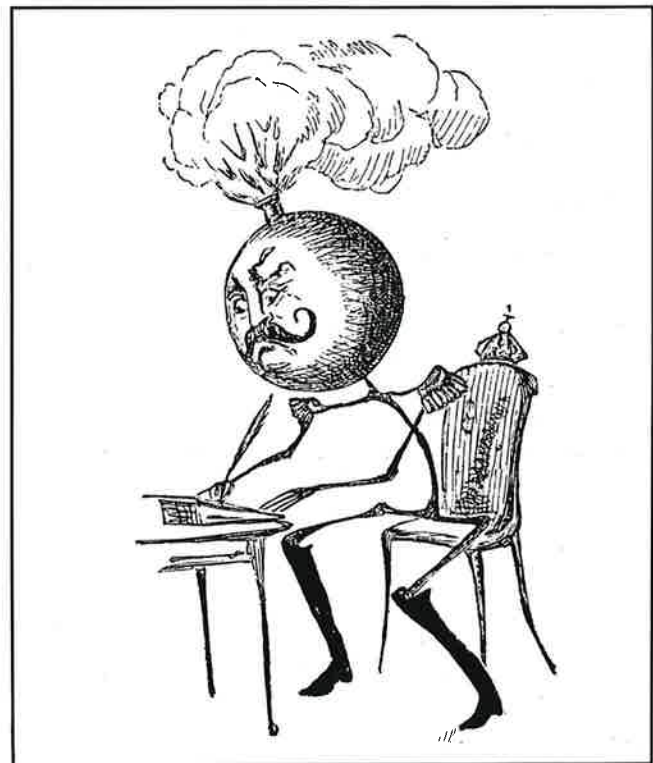
Historical Perspective

In the 60s and 70s real estate, along with other assets and industries, received moderate tax subsidy through the deduction of interest and depreciation. Certain elements were singled out for favorable treatment (e.g., housing; downtown development; etc.) to meet public policy objectives, but generally real estate was not treated any different than other investment assets.

In 1981 however, real estate received an unexpected windfall from Congress. In order to spur business investment, the recovery period for the depreciation of investment assets was reduced substantially. This was further compounded by the successful efforts of the real estate lobby to have real estate exempted from new at risk rules which would limit deductions to the amount of funds invested. The combination of large capital investment financed largely through nonrecourse debt, made real estate very attractive to taxable investors.

Although the recovery period standards were modified somewhat by the tax bill of 1984, the subsidy still was significant. This was particularly true when compared with other types of investments which were losing investor appeal. At the same time, financial institutions were investing more capital in real estate development as a result of diminished opportunities in other areas (banks) or as a response to deregulation (savings & loans).

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The net result was a major infusion of new capital in the industry and the production of significantly more product development—particularly office buildings—than the market required. This spectacle of overbuilding, loudly trumpeted in the media, made it very difficult for the real estate lobby to effectively argue that investment in real estate should receive continuing subsidy from the U.S. taxpayer.

At the same time, pressure was building for tax reform.

Objectives Of Legislation

The major objective of the recent tax reform legislation

is to reduce individual rates to promote savings and economic growth. Secondary, but related goals are to restore a greater degree of fairness to the tax system and not increase the budget deficit (i.e., revenue neutral).

A consensus has evolved in Congress that the best way to achieve these objectives simultaneously is to shift a greater amount of the tax burden to corporations, particularly those that have not been paying taxes, and reduce or eliminate tax loopholes, specifically those benefiting wealthier individuals.

In attacking the loophole closing part of the strategy, real estate is targeted because it is one of the last remaining loopholes (fairness) that represents significant tax revenue (revenue neutral).

Features Affecting Real Estate

As passed, the bill affects real estate in a variety of ways.

- For most investors, operating losses from real estate investments are no longer deductible against ordinary income (e.g., wages, salary, dividends, royalties, interest, etc.) They continue, however, to be deductible against other passive income (other than interest and dividends) and can be carried forward indefinitely and deducted upon sale or dissolution.
- The recovery period for real estate is extended from 19 to 31.5 years for commercial property and 27.5 years for residential, both computed on a straight line basis.
- The Investment Tax Credit is eliminated for real estate placed in service on or after January 1, 1986. Historical buildings still will receive favorable treatment, but considerably less than before.
- The at-risk rule is extended to cover real estate, although nonrecourse financing will continue to be treated as an amount at risk if it is nonconvertible and borrowed from an independent third party lender (not a seller or related party).
- Investment interest expense is deductible only to the extent of investment income.
- Favorable capital gains rates for individuals are eliminated for real estate and other investments.

The above features eliminate the subsidy for real estate. Henceforth such investment will rise or fall on its own merits, without a friendly assist from Uncle Sam.

Impact On Real Estate Industry

Syndication

Passage of the bill creates severe near-term dislocations for certain portions of the real estate industry, namely those individuals and firms dependent upon the tax shelter business. Since few real estate syndication firms believed tax reform would pass, they did not diversify their businesses away from tax sheltered investments.

There has been some movement in the syndication community towards so-called economic or cash flow offerings in which the investor looks primarily to a cash yield

rather than tax shelter. Syndicators began offering this type of product in 1985 and the first half of this year. The amount of funds raised through public syndication increased slightly in the first quarter (\$2.28 billion vs. \$2.25 billion in 1985), indicating that investors initially may be attracted to this type of product.

The problem with this strategy is that it is still expensive to aggregate small units of capital and these costs will no longer be offset by tax subsidy. Although syndicators have tried to reduce fees, they still have to motivate their distributors. Once the impact of these costs on a non-subsidized yield are fully understood, investor interest will begin to wane.

In addition to the problems involved in raising new capital, syndicators could face increasing difficulty with existing investors as they try to collect on notes issued under staged contribution plans. Many investors may walk from their obligations with their investments no longer deductible against ordinary income.

The outlook for the syndication industry, therefore, is one of shake-out, consolidation, and extensive litigation with a reduction in both the number of firms and the level of assets managed.

Real Estate Development

In terms of real estate development, the greatest impact will be felt by developers involved with assets which were especially favored through tax subsidy—apartment, hotels, and rehabilitated office buildings. Undoubtedly there will be less construction of new apartments and hotels until projects can be supported on an economic (nonsubsidized) basis. Rehabilitation of older office buildings will not suffer as much because the new bill retains some subsidy features.

Other products—new office buildings, shopping centers, industrial and R&D buildings—will be less affected because they have not received as high a level of subsidy. Development activity in these areas will be more closely associated with institutional capital flows and demand/supply conditions in local markets.

With reduced development activity, architects and engineers can expect reduced demand for their services more from demand/supply forces than from the loss of the tax subsidy.

Investment brokers (not affiliated with syndicators) should be largely unaffected as the number of transactions will not change dramatically or, if anything, may increase as syndicators attempt to unload projects to obtain greater liquidity. Property managers and leasing brokers will continue to be very active in working out the problems of overbuilt markets.

Impact On Metropolitan Areas

Geographically, the near-term impact will be greatest in those markets where tax-subsidized development has concentrated, particularly apartment complexes in the sunbelt.

A more subtle impact will be how the tax bill influences

economic growth and job formation, the major driving forces underlying demand for real estate. Geographical areas dominated by firms with high capital investment in plants and equipment will be hardest hit due to lower depreciation write-offs and the elimination of the Investment Tax Credit. More favored will be areas dominated by service and manufacturing firms with high labor/capital ratios such as Boston, New York, Washington, D.C., Atlanta, Dallas, Phoenix, San Diego, Los Angeles, San Francisco, Seattle, etc.

Impact On Real Estate Returns

There was considerable discussion in the media about the overpricing of real estate as a result of the tax subsidy. Further speculation implies that with removal of the subsidy, real estate prices will decline.

It is difficult to draw this conclusion without distinguishing between various types of real estate products and considering demand/supply conditions.

Apartments, for example, are heavily influenced by the affordability of ownership housing, local employment conditions, and the vacancy level of the existing inventory. Lower interest rates have made single family housing more attractive, reducing overall apartment demand in most markets. Reduced employment opportunities in the energy industry further have impacted markets in Houston, Denver, Tulsa, and Oklahoma City. Most of these markets also have been subject to a high level of oversupply indicating a strong possibility of further decline in before and after-tax returns.

In many markets, however, apartment demand remains strong. Areas such as Boston, New York, San Francisco, Washington, D.C., etc., have not tended toward oversupply (often as a result of severe growth restrictions) and with strong local economies, they represent reasonably good apartment markets. Although after-tax yields will decline in these markets, it is expected that before-tax yields will remain relatively firm.

Looking ahead, the removal of the tax subsidy will restrict new apartment construction which will raise rents and returns to a level comparable to other real estate assets. For the investor willing to wait out this period, the appreciation potential may prove significant.

For the hotel industry, the story is different. Here there are declining occupancy levels in most markets caused by severe overbuilding. The removal of the tax subsidy will aggravate an already bad situation and further

declines in yields are expected on a before and after tax basis.

For less subsidized investments such as industrial, shopping centers, and newer office buildings, the impact will be determined more by local demand/supply conditions. As a result of overbuilding, capitalization rates for new office buildings have increased about 100 basis points over the last 12 months, indicating a price reduction of approximately 12-15%. Presently, rates appear to be stabilizing (or trending slightly down), indicating most of the price move is over. Since these properties are generally purchased by tax-exempt or low-tax investors, further price erosion is not expected.

Shopping centers have not been overbuilt in most markets, maintaining relatively constant returns over the last 12 months. Lower individual tax rates are expected to translate into more disposable income which is positive for retail sales and shopping centers. This type of investment will continue to be attractive to tax-exempt investors and will maintain or improve price levels.

Industrial buildings also have maintained a reasonable level of demand/supply equilibrium with relatively constant returns. Demand for manufacturing and R&D facilities should expand because of reduced corporate tax rates and improved cash flow. The demand for distributive warehouses will decline due to the lower value of the dollar causing a slowdown or reduction in the growth of imports. On balance, a major decline in price levels is not expected as a result of the tax bill, particularly in those segments of the market where the tax exempt investor is active.

More important, the passage of the tax bill removes the market distortions created by tax subsidy and restores demand/supply equilibrium to the market place. This only can be beneficial to the tax exempt investor seeking the stable, long-term investment yields possible with quality real estate. Nothing in the tax bill removes the inflation-hedge characteristics of real estate. This enables investors to remain confident that future earnings will retain their real value, even if the nation experiences periods of unanticipated inflation.

Meanwhile, real estate cash yields are strong, indicating a classic buy signal for those investors committed to a long-term favorable view of the asset and willing to take action when others are hesitant.

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