FLAT TAX: SLANTED AGAINST REAL ESTATE

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Here's the way it's gonna be
One for you, nineteen for me
"Taxman," by George Harrison

Einstein once said there's a simple answer to everything, and most of the time it is a wrong answer. The rising complexity and cost of compliance with the existing tax system make the flat tax a seductive route to a simpler tax code. But, as far as the real estate industry is concerned, a flat tax, as currently proposed, is Einstein's simple but wrong answer.

The idea of a flat tax has been floating around for years at both ends of the political spectrum, from California's former governor, Jerry Brown on the left, to the new house majority leader, Representative Dick Armey of Texas on the right. A decade ago, no one paid much attention to such a radical overhaul of the tax system. However, with the Republican party sweeping into control of both houses of Congress for the first time since 1954, a flat tax has emerged at the center of the tax reform debate. The new Congress is considering tax measures that would profoundly change the federal tax system. There have been discussions on several tax reforms—a consumption tax and a flat tax—as possible replacements for the federal income tax. This article focuses on the flat tax and discusses the impacts it might have on the real estate industry.

What Is A Flat Tax?

All flat tax proposals have three features in common.[1] One deals with the tax rate and the other two with the tax base.

- *Single Tax Rate*: A single rate applies to all income subject to taxation, as opposed to the graduated rate system that has been in existence for over 70 years. The actual tax rate is different from proposal to proposal.
- *Elimination of Deductions and Credits*: Flat tax proposals eliminate or limit preferential tax treatment on certain behaviors and activities. Examples of such preferential treatment include tax deductions for housing, such as home mortgage interest and property taxes, and nonhousing tax deductions, such as charitable contributions and state and local taxes. Additionally,

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depreciation of capital expenditures would be altered, in some cases moving to an expensing system.

- *High Exemption Thresholds*: The minimum income subject to taxation would be increased substantially from the current law. For example, under current law the 1994 standard deduction for single taxpayers was $3,800. Under Representative Armey's proposal (H.R. 4585), the standard deduction for single taxpayers would be $13,100.

Table 1 summarizes major differences between current law and flat tax proposals.

TABLE 1

Comparison Of Current Law And Flat Tax Proposals

	Current Income Tax	Flat Tax Proposals
Tax Structure	Individuals: from 15% to 39.6% Businesses: 35%	Individuals: 21% - 23% Businesses: 21% - 23%
Income Tax	Net of wages, dividends, commissions and interest less standard deduction or itemized deductions	Gross income not including dividends and interest (no itemized deductions)
Capital Gains	Real Estate: 28% Securities: 28%	Real Estate: Fully Taxable (21%-23%) Securities: No Tax (0%)
Business Deductions	Ordinary and Necessary—Yes Taxes Paid—Yes Interest Paid—Yes Salaries—Yes Benefits—Yes Depreciation—Yes Cost of Assets—Yes	Ordinary and Necessary—Yes Taxes Paid—No Interest Paid—No Salaries—Yes Benefits—No Depreciation—No Cost of Assets—Yes
Business and Personal Taxes	Integrated	Not Integrated

Flat Taxes And Consumption Taxes

Some flat tax proposals involve significant broadening of the income tax base while others actually change the basis of taxation from income to consumption. The latter is referred to as a consumption-based flat tax. In this form of a flat tax, taxpayers claim no deductions for savings, but their returns on savings, whether in the form of interest, dividends, rents, royalties or capital gains, are excluded from the tax base. An income-based flat tax would include the return to savings in the tax base.

The treatment of capital expenditures is one distinguishing feature between a consumption-based business tax and an income-based business tax. In general, consumption-based taxes allow the immediate deduction (expensing) of the cost of capital purchases. Under an income-based system, businesses are only allowed to deduct a portion of the cost of capital purchases each year. A second distinguishing feature is the treatment of interest expenses. They are deductible under an income-based tax as a cost of producing income but are not deductible under a consumption-based tax.

What Is Included In The Tax Base In Current Proposals?

In order to impose a low single rate, the base must be broadened from current law. Dozens of tax expenditure provisions, including the home mortgage interest deduction, the charitable contribution deduction, deductions for state and local income taxes, the earned income tax credit and the dependent care credit, were contained in the original law or added to the tax code by Congress. All are intended to provide incentives for particular kinds of activities or to provide relief to particular kinds of taxpayers. In principle, a pure flat tax would be free of all behavioral bias and would be focused on raising specific amounts of revenue in the simplest possible fashion.

In practice, however, the actual tax base varies from proposal to proposal. For example, all deductions were eliminated under Representative Armey's 1994 flat tax proposal, but the flat tax proposed by Senator Arlen Specter of Pennsylvania would provide deductions up to $2,500 for charitable contributions and up to $100,000 for mortgage interest paid on loans. As an aside, the variety of specific flat tax proposals suggests that once passed, no law would be immune from Congressional tinkering to reward or punish different sectors or groups.

Arguments For A Flat Tax

There are a variety of valid reasons for adopting a flat tax.

- *Simplicity*: At the heart of the flat tax approach is the redefinition of the tax base; the replacement of multiple tax rates with a single rate is really a sideshow. By eliminating deductions, the flat tax simplifies record keeping and fosters tax compliance. In fact, under most proposals, the high exemption threshold removes the need of many taxpayers to even file a return.
- *Pro-Growth*: The current tax system, with its high rates and double taxation of savings and investment, discourages these activities and ultimately cripples the economy by reducing growth. By lowering rates and, in some cases, excluding returns from savings and investment from the tax base, proponents of a flat tax claim that it boosts the economy's performance. The low marginal tax rate reduces tax distortions, thereby encouraging employment and discouraging unproductive tax avoidance activities.

Arguments Against A Flat Tax

Of course, there are equally valid arguments *against* the flat tax.

- *Discriminates Against Middle Income Taxpayers*: Any flat tax would reduce the tax burden on high-income taxpayers by lowering their effective tax rate and on low-income taxpayers because of high exemption thresholds. The difference in revenues comes from the middle-income taxpayers. Research from the Treasury Department shows that taxpayers earning up to $100,000 of adjusted gross income would actually pay close to $2,000 a year in additional taxes under Representative Armey's 1994 flat tax proposal, compared with current law if the tax rate was increased to the level required to bring in the same revenue under current law (revenue-neutral tax rate).[2] However, families with income over $200,000 would get tax cuts averaging more than $50,000.
- *Inequities Among Taxpayers*: Eliminating tax deductions would create horizontal inequity because individuals base long-term commitments on existing tax law.[3] Taxpayers who made tax-preferred investments under the old tax rules would experience an abrupt decline in their current after-tax income and wealth (the capitalized value of future income). The real estate sector is an obvious victim under a flat tax. If the mortgage interest and property tax deductions are repealed, it will hurt taxpayers who made investment decisions based on tax policy in existence since the inception of the Federal Income Tax in 1913.

Phase-In Period

Proposals such as Representative Armey's do not provide any phase-in period for the transition of present-law income taxation to the new tax. For example, home owners who borrowed money to finance their mortgage in anticipation of interest deductions under the present income tax system would be denied such deductions under the new law. Robert Hall and Alan Rabushka, whose book has been used to model Representative Armey's flat tax proposal, suggest softening the blow to current home owners by allowing them to deduct 90% of the interest paid on existing mortgages.[4] While improving the cash flow of current home owners, it would not materially change the outlook for housing prices. The price a prospective buyer would be willing to pay would still reflect the fact that they would not be granted any mortgage deductibility.

Revenue Neutral Flat Taxes

Major proponents of replacing the income tax with a new tax system, such as Senator Pete Dominici of New Mexico, have stressed the importance of maintaining the same level of federal revenues. However, some flat tax proposals, such as Representative Armey's proposal, do not meet the goal of revenue-neutrality at the proposed tax rate and standard deduction. The Treasury estimates that a revenue-neutral flat tax would need to raise $178 billion more than would the Armey proposal. This requires an increase in the tax rate from 17 percent to 22.6 percent or a decrease in the proposed standard deduction of about 87 percent (or some combination of both).

For any flat tax proposal, increasing the tax rate or decreasing the standard deduction would reduce its attractiveness. While Representative Armey claims that he would achieve *deficit* neutrality by spending cuts, this is a separate issue and could be achieved under the current tax system (allowing rates to be decreased) by a more disciplined Congress.

Negative Impacts On The Real Estate Sector

Under any flat or consumption-based tax system, expenses incurred in raising debt capital (e.g., mortgage or construction loan interest) are not deductible. Thus, debt-financed activities are discouraged. Since real estate activities are generally highly-leveraged, they tend to suffer under a flat tax system relative to current law.

Flat tax proponents claim the lost deduction would be made up through declining interest rates. According to Hall and Rabushka, exempting interest from taxation will bring about lower interest rates. Lower interest rates reduce monthly mortgage payments, which offset the loss of the mortgage interest deduction for most taxpayers.[5] However, for the lost deduction to be made up through declining interest rates, rates would have to fall by about two to three percentage points. Given the spread between taxable and tax-exempt yields of similar risk bonds, a large decline in the interest rate does not seem likely. In 1994, the interest rate on 10-year U.S. government bonds averaged 7.08 percent, while tax-exempt bonds yielded about one percentage point lower. For example, the Bond Buyer index of municipal general obligation bonds was 6.19 percent. Perhaps a one percentage point decline in interest rates seems plausible, but this will not be enough to offset the loss of the mortgage interest deduction. As a result, housing affordability will decline.

The Impact Of A Flat Tax On Home Prices

The total cost associated with owning an asset is imputed into the purchase price of the asset. For example, the price of property in a county with high property taxes will be lower than for a similar property in a county with lower taxes. Thus, higher costs of owning a home are associated with lower purchase prices. Since income tax deductions for mortgage interest and property taxes have long been a part of the income tax system, home owners

expect and depend on these deductions to afford their homes. A flat tax that eliminates the mortgage interest and property tax deductions would increase the cost of owning a home and therefore, depress home prices.

According to the Congressional Budget Office (CBO) and based on calculations from the Joint Committee on Taxation, eliminating the deductibility of mortgage interest would raise the taxes of about 28 million home owners by an average of $2,100 in 1996 and raise revenues by about $313 billion between 1996-2000. The CBO argues that eliminating the mortgage interest deduction would increase net mortgage payments sharply for current home owners, making it impossible for some to meet their monthly mortgage payments. It would also cause the value of homes to fall and would hurt home builders.[6]

TABLE 2

Tax Savings From Mortgage Interest Deductions

Tax Bracket	Before-Tax Payments	After-Tax Payments	Present Value of Tax Savings
15.0%	$ 9,118	$ 7,862	$ 15,372
20.0%	$ 9,118	$ 7,444	$ 20,496
25.0%	$ 9,118	$ 7,025	$ 25,620
30.0%	$ 9,118	$ 6,607	$ 30,744
39.5%	$ 9,118	$ 5,803	$ 40,582

Assumptions: Home price of $109,800, 10% down payment, 30-year fixed-rate mortgage at 8.5%, 2 points, the discount rate used to calculate the net present value is 5%.

The impact of eliminating the mortgage interest deduction would hit home owners differently, depending upon their income tax brackets, as shown in Table 2. For a typical example, assume that an individual purchases a 1994 median-priced home for $109,800. Under current law, a home buyer in the 20% tax bracket (federal and state) can expect a tax savings equal to 20% of all the interest on the loan. During the first year after purchase, before-tax principal and interest will be $9,118. The mortgage interest deduction will lower the after-tax principal and interest by $1,524. The net present value of this deduction, throughout the life of the loan, is equal to $20,496. If the mortgage interest deduction is eliminated, the tax savings disappear. As a result, home prices would be forced downward. In this example, the home owner would suffer a net present value loss of about 18.7% of the home price ($20,496/$109,800). The effects of a flat tax on home price could be even greater if the property tax is repealed as well.

Cumulatively, household wealth would be significantly reduced. Even though some home owners may pay less in income taxes under the flat tax, it would take years of low tax rates to recover the loss in the value of their homes.

If a flat tax bill is enacted, it is uncertain whether taxpayers will be able to count on future tax rates being as low as the rate initially set in the bill. But a look back gives cause for concern. In the Tax Reform Act of 1986, numerous deductions and credits were eliminated in return for lower income tax brackets. Since then the number of tax brackets has increased from two to five, the top tax rate has increased sharply from 28% to 39.6% and the number of deductions has continued to be limited.

The Impact Of A Flat Tax On Property Taxes

Reductions in house values would reduce the property tax revenues of local governments proportionally. For example, a 10% decline in housing values could reduce the tax base by up to 10% and, unless property tax rates are adjusted, local revenues would also decline. A revenue loss of this magnitude would strain local government budgets. Spending on education, the primary use of local property tax revenues, would be particularly hard hit.

The Impact Of A Flat Tax On Housing Construction

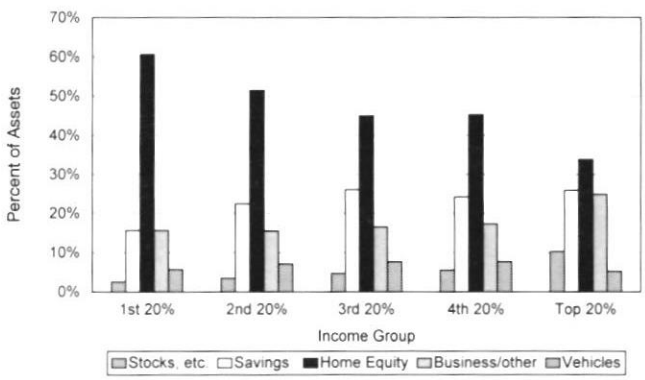
The decrease in housing demand as the after-tax cost of home ownership rises would also adversely impact the construction of new homes. This would lead to a loss of employment in the construction industry. Consequently, a flat tax could lead to a downturn in the construction industry.

The Impact Of A Flat Tax On Net Worth

Home equity is the largest single asset for every income group, but more so for lower-income home owners (see Figure 1). It is also the largest single

FIGURE 1

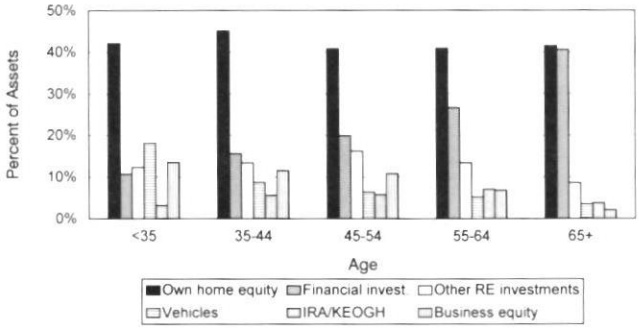
Distribution Of Assets By Income Group



Source: U.S. Department of Commerce, Bureau of the Census, "Household Wealth and Asset Ownership, 1991", Current Population Reports P70-34.

FIGURE 2

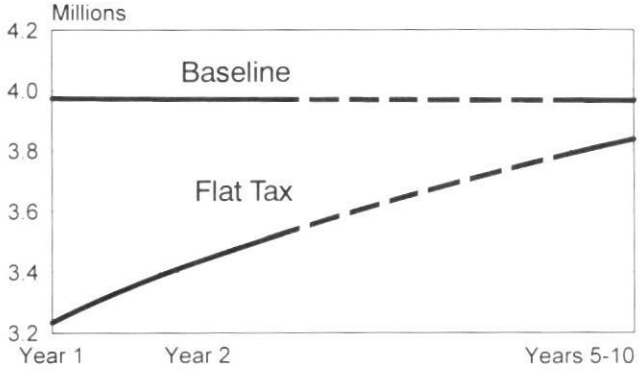
Distribution Of Net Worth By Asset Type And Age



Source: U.S. Department of Commerce, Bureau of the Census, "Household Wealth and Asset Ownership, 1991", Current Population Reports P70-34.

FIGURE 4

Existing Single-Family Home Sales



Source: DMI/McGraw-Hill.

asset for every age group (see Figure 2). Repealing the mortgage interest deduction and the property tax deduction would reduce the value of homes and depress the value of the most important asset for home owners. This would have a tremendous impact on the value of household net worth (household assets minus household liabilities).

The most comprehensive analysis of Representative Armey's flat tax proposal is one conducted by DRI/McGraw Hill Inc. For a relevant comparison with the current tax system, the study uses a tax rate of about 21 percent to maintain revenue neutrality. The results of the study suggest that the impact of such a tax on residential real estate would be immediate and enormous. In the first year of a flat-tax regime, starts of new homes and sales of existing single-family homes would be significantly lower than under the current law (see Figures 3 and 4). After a second year of flat taxes, the average price of single-family homes sold would be 15% lower, a depressed level which would remain well into the next decade (see Figure 5).

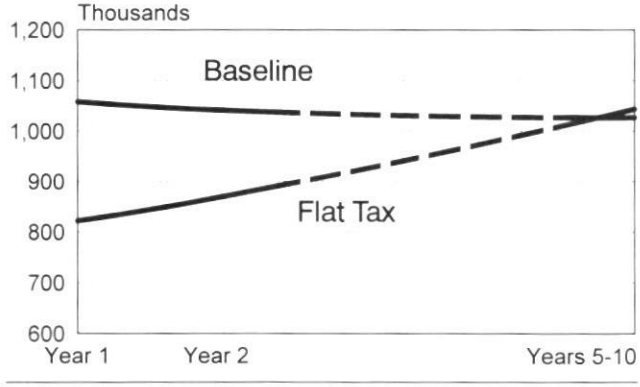
The Impact On Commercial Real Estate

The flat tax proposals also alter the tax treatment of commercial real estate—no deduction for interest paid, no deduction for property taxes paid, and the full purchase price is deducted on acquisition, with an allowance for carrying forward any unused deductions. However, no depreciation deductions are allowed and the full sales price is taxable on sale after operating expenses and the remaining tax carryforward have been deducted from the sale price.

As with residential real estate, neither interest nor tax expenses are deductible. Thus, all investors would experience an increase in carrying costs and, with no deduction for taxes paid, double taxation would exist.

FIGURE 3

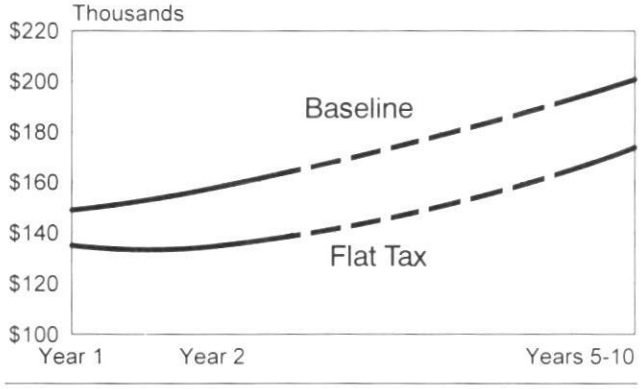
Housing Starts



Source: DRI/McGraw-Hill.

FIGURE 5

Average Price Of Existing Single-Family Homes Sold



Source: DRI/McGraw-Hill.

Additionally, for all its claims to neutrality, the Armey flat tax introduces distortions among forms of investment. Under the flat tax, capital gains on financial assets (e.g., stock, bonds, derivatives) escape the tax base. By contrast, the full amount of any real estate gains would be subject to tax at the maximum rate of the tax regime. Moreover, the taxable amount of gain would be the full sales price less tax carryforward and operating expenses. Using the sales proceeds as the measure of the gain would have the same effect as requiring full ordinary income recapture under the current system.

Flat tax proponents argue that capital gains from financial assets arise from the increased earnings of the corporation, and thus reflect a gain in value that already has been once-taxed before a sale. To avoid double taxation, such gains from the sale are not a taxable event. But many real estate practitioners believe that capital gains on real property stem from increasing rents that also would be taxed once before the sale of the property.

This approach to the taxation of capital gains destroys the level playing field of current law. At present, income-producing properties generally qualify for capital gains treatment. These flat tax proposals put real estate at an immediate disadvantage compared to financial assets, because they fail to recognize the unique qualities of real estate. Thus, real estate could be made a less liquid investment, especially when compared with cash equivalents or financial assets.

The next section analyzes the impact of the flat tax on a hypothetical office building. It describes how the flat tax will have a negative impact on the cash flow and the internal rate of return of a typical real estate investment project.

Project Analysis

The flat tax represents a radical departure from how tax liability currently is calculated. Under the flat tax, taxable income is calculated by subtracting operating expenses from project income. Unlike the current tax system, items such as mortgage interest and depreciation would not be deducted from project income to determine tax liability. Consequently, the amount of income subject to taxation will increase substantially.

Perhaps the largest difference between the two tax systems is that the flat tax would allow 100% of the purchase price to be expensed against the income of a project during the year of purchase. This creates a large operating loss for the year the project is purchased. The operating loss is then multiplied by the flat tax rate of 21%, the same rate used in the DRI study to calculate the loss carry over. The loss carry over is escalated at 6% annually and is credited against income tax liability.

Since income from the sale of the property is treated as ordinary income, it creates a spike in the project's income upon the sale of an asset. After operating expenses have been deducted from income, the operating income is taxed at 21%. The tax carryforward will offset operating income for a period of years. However, under the flat tax, tax liability at sale is higher than under current tax code.

For example, a hypothetical $10 million office building is analyzed here to compare the tax liability under the existing tax code and the flat tax. The income, expense and building size assumptions utilized in the analysis are from published secondary sources. (A detailed spreadsheet of the project is available upon request.)

The total tax liability for the office building is $2,086,425 under the flat tax, versus $1,400,741 under the current tax code. Despite the lower tax rate of 21% under the flat tax, compared to 39.8 percent under the current tax code, the overall tax liability under the flat tax is higher.

The larger tax liability under the flat tax has a direct impact on the internal rate of return (the overall rate of return received on the funds invested in a project). The internal rate of return for the sample project was 9.1% under the flat tax and 10.5% under the current tax code. The results of the analysis shown indicate that the flat tax could have a negative impact on a typical real estate investment project. The internal rate of return is depressed because of the large tax payment required when a project is sold.

Figure 6 compares the after-tax cash flows of the office project under the flat tax and under the current tax code. Figure 7 shows the difference between the after-tax cash flows. After-tax cash flow

FIGURE 6

Comparison Of Flat Tax And Current Tax Code

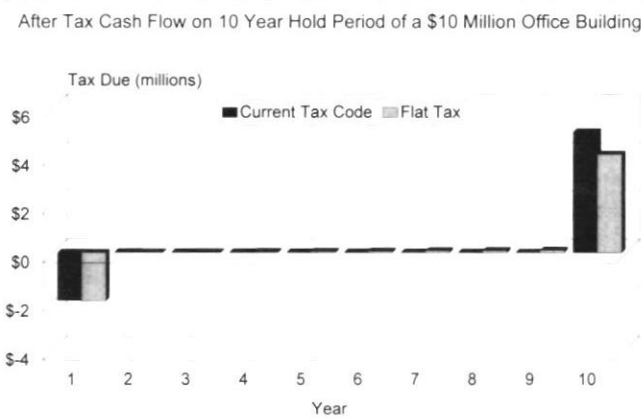
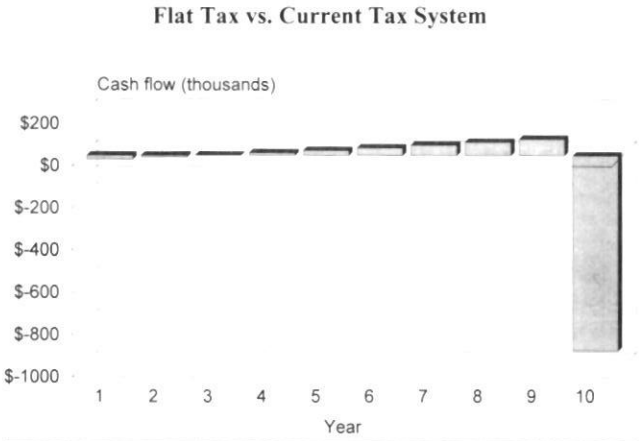


FIGURE 7

After Tax Cash Flow Differential



Note: Based on a 10 year hold of a $10 million office building

under the current tax system is greater than under the flat tax. The large negative cash flow in year one of both scenarios reflects the $2 million equity contribution. After the first year, the after-tax cash flow remains positive under the current tax code. Because all taxes are paid when the project is sold under the flat tax, the yearly cash flow is higher than the current tax code. However, taxes due at the sale of the project, $2.1 million for the flat tax, versus $1.1 million for current law, far outweigh the higher yearly cash flows.

Overall, the flat tax will have a detrimental impact on investment real estate for two reasons. First, the total amount of taxes paid would be higher than under the current tax code, despite a lower tax rate. Second, the flat tax will backload the tax liability of a project. This creates a problem similar to what exists today with high capital gains taxes. Owners tend to hold on to investment real estate longer because of potential difficulties in paying the taxes when the project is sold. This is especially true for owners who have refinanced their projects and have already expended their equity positions. The high taxes paid upon the sale of the project will deter the transfer of properties and will inhibit the efficient transfer of capital.

The Treatment Of Self-Employment Income

Despite claims of simplifying the tax process, flat tax proposals also could complicate the filings of many real estate practitioners, chiefly through their separation of baskets of income—one for individual income, consisting of salary, pension distributions and wages, and one for business income, such as commissions and rents. Moreover, the flat tax proposals are not clear or are silent on a number of issues, such as deductions for rental losses from income and mortgage revenue bond purchases which are crucial to the real estate industry.

Conclusions

A flat tax claims some benefits; however, it would hurt many taxpayers who have relied on longstanding tax policy. Owner-occupied housing is the biggest investment made by most Americans. It encourages neighborhood maintenance and socially responsible behavior. Damaging home ownership, indeed, all forms of real estate, is too high a price to pay for tax reform.

NOTES

1. On March 2, 1995, Senator Arlen Specter introduced S. 488. On January 4, 1995, Congressman Philip Crane introduced H.R. 214, "The Tithe Tax," in the House of Representatives. On June 16, 1994, Congressman Richard Armey introduced H.R. 4585, "The Freedom and Fairness Restoration Act of 1994." In the 103rd Congress, on January 26, 1993, Senator Jesse Helms introduced S. 188, "The Tithe Tax." Each of these bills may be generally described as flat taxes.
2. U.S. Treasury Department, Office of Tax Analysis, "A Preliminary Analysis of a Flat Rate Consumption Tax", 1995.
3. Feldstein, Martin, "Compensation in Tax Reform," *National Tax Journal, Vol. XXIX, No. 2,* June 1976, p.123.
4. Hall, Robert E. and Alvin Rabushka, "The Flat Tax", Hoover Institution Press, Stanford University, CA, Second Edition, 1995.
5. *Reducing the Deficit: Spending and Revenue Options*: Congressional Budget Office, February 1995, p. 343.
6. Hall, Robert E. and Alvin Rabushka, *op. cit.*, p. 110.