IRET Congressional Advisory

June 3, 1993 No. 20

THE TAX TREATMENT OF REAL ESTATE: TWO STEPS BACK, ONE HALF STEP FORWARD

Overlooked in much of the debate about President Clinton's budget initiatives are two proposed income tax changes that directly target real estate investment. The House of Representatives proposes to lengthen the cost recovery period for non-residential real property from the current 31.5 to 39 years. The House also accepted a second Treasury proposal that would relax the rules limiting the deductibility of "passive losses" for "real estate professionals." In terms of reducing the current tax bias against real estate, these changes tug in opposite directions.

The proposed changes in the tax treatment of real estate constitute mere tinkering with the tax code where a complete overhaul is in order.

Lengthening the Cost-Recovery Period: One Giant Step Backward

The Tax Reform Act of 1986 (TRA86) lengthened the cost recovery periods for most capital assets. This had an especially damaging effect on the real estate industry. By lengthening the cost recovery period for most real estate investments from 19 to 31.5 years and by changing the accounting method that was used in calculating depreciation, TRA86 significantly reduced the after-tax return on all real estate investment. These changes also represented a movement away from what sound economics urges is the appropriate tax treatment of such investments.

The lengthening of depreciation periods in TRA86 was based on the fallacy that, for tax purposes, the costs of production facilities should be deductible over the years in which the facilities continue to be used, i.e., over their so-called "economic lives." This argument was invoked once again by the Clinton administration to justify lengthening the depreciation period for real estate. As stated by the Treasury department: "The recovery period for non-residential property under current law results in depreciation allowances that are larger than the actual decline in value of the property...[t]he recovery period for the depreciation of such property should be increased."

Treasury's assessment is wrong. If tax policy is to be efficient, i.e., if it is not to favor one kind of investment over another, the depreciation system should insure that the present value of depreciation deductions per dollar of investment is the same for all property. Tying the cost recovery period to the "life" of the property, and limiting total depreciation deductions to the amount paid for the property, creates a bias against investment in "long-lived" capital, i.e., capital that is expected to be useful for a relatively long period of time, such as real estate.

The House bill would decrease the present value of non-residential real property tax write-offs and, hence, increase the present value of the taxes paid on the return on investment in such property. The result would be a reduction in the value of non-residential real estate. This is because, the present value of any tax write-off is lower the more remote it is in time. A dollar is worth more to someone now than at any point in the future. Therefore, at any given discount rate, the further into the future a dollar of production costs can be deducted for tax

Institute for Research on the Economics of Taxation

IRET is a non-profit, tax exempt 501(c)(3) economic policy research and educational organization devoted to informing the public about policies that will promote economic growth and efficient operation of the free market economy.

1730 K Street, N.W., Suite 910, Washington, D.C. 20006
Voice 202-463-1400 • Fax 202-463-6199 • Internet www.iret.org

purposes, the less that deduction is worth to an investor now. Given two production facilities with equal pre-tax returns, the one that faces the shorter cost recovery period will enjoy a higher after-tax return. By increasing the depreciation period for non-residential real property from 31.5 to 39 years (more than double the pre-1986 write off period), the House provision would decrease the value of such property to both current holders and all prospective buyers. It would worsen a bias against real estate which was heightened by TRA ’86.

Real property already has a longer cost recovery period than any other form of depreciable property. The extension of this period is highly punitive of investment in such property. A constructive policy change that would help to bring the real estate industry out of its sustained slump while reducing the tax code’s bias against the industry would be to reduce, not lengthen, the depreciation period for real property.

Passive Loss Relief: One Small Step Forward

A second change in the tax treatment of real estate, proposed in the House bill, also has its roots in TRA ’86 and what is typically referred to as the "passive loss limitation rule" (PLLR). The PLLR creates a distinction for tax purposes between "passive" and "active" investments. For investments to be categorized as "active", the taxpayer must "materially participate" in the activity associated with the investment. For example, a person who invests in a race horse would have to actively participate in the training and maintenance of the horse in order to have income received from the investment categorized as "active." Losses that are associated with "active" investments can be offset against any other source of income that the taxpayer might have. On the other hand, losses that arise in connection with "passive" investments can only be offset against passive income. In other words, the amount of passive losses that may be claimed in a taxable year is limited by the amount of "passive" income that the tax-payer has earned in that year. Excess losses may be carried over to future years when, and if, passive income is realized.

The PLLR is even stricter with respect to real estate. Unlike other investments, all income from real estate, with minor exceptions, is considered "passive." This would be true even if the investor managed the property, took care of maintenance, or otherwise was an active participant in maintaining the investment. If, in a given year, a real estate investor has losses with no passive income to offset them, then those losses cannot be deducted from taxable income in that year. The only exception to this unbalanced treatment of real estate investments has been for investors in rental property who actively participate in the investment and have an adjusted gross income of under $100,000. This class of investor can deduct up to $25,000 in losses from "active" income sources. (There is a phase out range above $100,000 AGI.)

The major target of the PLLR were individuals who participated in investment "syndicates," usually organized as a limited partnerships and often involving real estate, that produced tax losses in its early years. By highly leveraging their real estate investments with non-recourse loans, the investors were able, under the pre-1986 tax code, to take advantage of tax write-offs that were disproportionately large relative to the initial investment for which they were at risk. The alleged purpose of the PLLR was to prevent such investors from sheltering their "active" income from tax by claiming deductions with respect to their leveraged investment as well as their equity investment in the real property.

The actual rule, however, was much broader than this, partially retroactive, and especially severe with regard to real property investments. It has had a profoundly negative impact on the real estate industry. Like the changes that were made in depreciation schedules, this aspect of the tax code has no grounding in the economics of taxation and, in fact, runs counter to any considerations of economic efficiency.

As incorporated in the House bill, President Clinton’s proposal would offer some real estate investors limited relief, but would retain the punitive treatment of real estate overall. The proposal would create a distinct category of real estate investor — referred to in the President's original proposal as "real estate professionals" — who would face the same passive loss limitation rules as non-real estate investors. A taxpayer would meet the eligibility requirements if more than half of the personal services the taxpayer performs are in real property trades or businesses in which he materially participates. Clearly, income to such investors should never have been categorized as "passive" in the first place.

The President and the House should be applauded for recognizing the disadvantages that are being suffered by a taxpayer whose principle business is real estate. But it should be equally clear that anyone who invests in real estate, whether it is his principle business or not, is disadvantaged under current law. The distinction being made between "real estate professionals" and those who, for example, might own an apartment building as one of many investments.

Tax reform for real estate investment, in addition to shortening the cost recovery period, should eliminate the differential and punitive treatment of real estate investment entirely. Beyond this, if the President and the Congress are truly interested in changing the tax code with an eye toward economic growth, and not just government growth, they should consider complete elimination of the PLLR. This rule has no legitimate justification except as a means of enhancing the flow of revenue to the Treasury. It simply adds an additional layer of bias against saving and capital formation to the tax code.

Conclusion

The proposed changes in the tax treatment of real estate constitute mere tinkering with the tax code where a complete overhaul is in order. TRA '86 hit the real estate industry particularly hard. In addition to the lengthening of the depreciation period for real property and the blanket categorization of income and losses from real estate as passive, TRA '86 reduced the after tax returns to real estate investments by significantly increasing the capital gains tax. These changes were not just bad for real estate, but were bad for the economy as a whole. The House proposals do little to change the overall tax penalty against real estate. In this regard they pull in opposite directions. The Senate should reject lengthening the recovery period for real property and make fundamental changes in the PLLR.

Roy E. Cordato
Senior Economist

Note: Nothing written here is to be construed as necessarily reflecting the views of IRET or as an attempt to aid or hinder the passage of any bill before Congress.