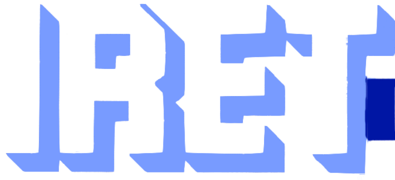

POLICY BULLETIN

February 12, 1991
No. 48

DESTROYING REAL ESTATE THROUGH THE TAX CODE

Real estate is a major sector of the U.S. economy, and the level and growth of activity in real estate development, construction, finance, and sales exert significant influences on production and income throughout the economy. The sharp decline of the real estate industry occurring over the past five years is one of the prime sources of the Nation's current recessionary woes. Many of the problems in real estate markets since 1987 can be traced to tax code changes that were made in 1986. In constructing the Tax Reform Act of 1986 (TRA86) legislators could not have done a better job of destroying this market if they had consciously set out to do so. As a consequence, TRA86 had an important hand in creating the mess that currently faces the savings and loan industry and, as a result of the Bush bailout program, the tax-paying public.

All of the important evidence shows that a serious downturn in housing and real estate markets began shortly after the enactment of TRA86. There has been a reduction in housing starts every year since enactment of the tax reform legislation. All housing starts were down by 36% in the 1986-1990 period with multifamily housing starts, primarily built for investment purposes, down by 71%.

Three major changes in the tax law contributed to this result – the elimination of the capital gains tax differential, the passive loss limitation rules, and the lengthening of the tax write-off period for real property. Each of these tax changes represented a movement away from economically efficient tax policy. Combined, these changes in the law made real estate investment less attractive and reduced the market value of existing real estate. These tax changes not only reduced investment in new housing and construction, they also created an incentive to unload properties that were currently being held while increasing the difficulty of doing so.

Probably the most widely debated change to take effect as part of TRA86 was the 40% increase in the capital gains tax. This tax increase itself reduced the market value of all real estate investments held at the time.

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 market economy.

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

Most returns on investment in real estate are realized in the form of capital gains. Under pre-1986 tax law, which allowed a 60% capital gains exclusion, an individual in the top 50% tax bracket would pay, after the exclusion, a marginal rate of 20% on any realized capital gains. TRA86, while lowering marginal tax rates on other income, ended up increasing the top rate on capital gains by eliminating the exclusion and treating capital gains as ordinary income. This meant an increase from a top marginal rate of 20% to as high as 33%. More concretely, someone in the top tax bracket who made an investment in real estate before 1986 expecting to keep $.80 on every dollar of capital gain was suddenly faced with a situation in which that return would be reduced to $.66 if the person were in the new 33% tax bracket (i.e., the bubble) or $.72 if they were in the 28% bracket. This depressed the value of real estate generally, causing property values to decline. Many profitable real estate investments became marginal or sub-marginal.

Adversely affecting real estate even further was TRA86's lengthening of the write-off period for depreciable real property. This also had the effect of reducing the market value of real estate.

Before 1986, under the Accelerated Cost Recovery System, the cost of an investment in real property could be written off over 19 years, using the 175% declining balance method of depreciation. This method allows a larger proportion of the investment cost to be written off in the earlier years of the depreciation period. The 1986 Act not only lengthened the cost recovery period of most real property – non-residential property to 31.5 years and residential rental property to 27.5 years – it also eliminated the 175% declining balance write-off method. Instead, it required the use of the straight line method. This method of depreciation simply divides the entire cost of the investment by the number of years in the cost recovery period and allows this amount to be deducted from taxable income in each of the years.

These changes in the cost recovery provisions significantly decreased the present value of real property tax write-offs and, hence, increased the present value of the taxes to be paid on the returns on investment in such property. The result was a reduction in the value of these investments. Everything else equal, the value of any tax write-off is reduced as the cost recovery period is lengthened. This is because a dollar is worth more to someone now than it is at any point in the future; the further into the future the dollar can be realized the less it is worth today. At any given discount rate, therefore, the further out in time that a dollar can be deducted from taxable income, the less that dollar is worth to the investor now. By increasing the cost recovery period over 60% and by shifting much of the cost that could be recovered from the earlier to the later years of the period, TRA86 decreased the value of real estate both to current holders and to all prospective buyers.

This further compounded the problems that were created in hiking the capital gains tax. The longer write-off period reduced the market value of the property and therefore reduced the amount of any capital gain. To add insult to injury, these reduced capital gains are now taxed at a higher rate.

Some might argue that the negative consequences of increasing the capital gains tax would be reduced by the lengthening of the cost recovery period. To be sure, extending this period, together with the slower write-off method, reduces the capital gain subject to tax even if market prices were unaffected. These tax changes slow the decrease in the basis of the property for tax purposes. Therefore, given the proceeds of any specific sale, the amount of the taxable gain is reduced. One might conclude that this change in allowable write-offs would offset, at least in substantial part, the adverse effects of exposing capital gains to ordinary tax treatment. Any such offset, however, would be minor compared with the tax-induced decrease in the market value of real property.

At the time TRA86 was being debated some argued, as a justification for the change, that the pre-1986 tax treatment of real estate provided a tax preference for investment in real property. Because of this, it was argued, the tax law was causing inefficient over-investment in real estate at the expense of more productive investment in other kinds of capital. The change in the law was seen, then, as a move in the tax code to a more efficient treatment of real estate investment.

This assessment is wrong. If tax policy is to be efficient, i.e., if it is not to favor one kind of investment over another, all investment costs should be expensed, that is they should be written off in the year that they are incurred. Equivalently, if costs are to be written off over an extended period of time, the depreciation system should insure for all properties that the present value of the deductions equals the cost of the property. Tying the cost recovery period to the "life" of the investment actually creates a bias against investment in "long-lived" capital, i.e. capital that is expected to be useful for a relatively longer period of time, such as real estate.

This goes back to the point that the longer the cost recovery period the less valuable any tax write off becomes. Given a choice between two investments that would be of equal value in the absence of taxes, one in real estate with a 31-year amortization period and the other in an investment that allows a shorter cost recovery period, the real estate investment will look relatively less attractive after taxes are considered. The less valuable tax write offs for real property reduce its value relative to other possible investment alternatives. A tax code that allows expensing of costs puts all investment on an equal footing in the eyes of the tax collector and the investor. Because TRA86 moved away from this ideal, it did not eliminate a bias in favor of investment in real estate but exacerbated a bias against it.

The third strike against the real estate industry was the rule limiting the deductions of so-called "passive investment" losses. This change divided people's capital income into two categories – passive and active. For income to be categorized as active, the taxpayer must "materially participate" in the activity that generates the income. The rule allows costs associated with passive investments to be deducted only against passive sources of income. Real estate is especially discriminated against under this provision. With minor exceptions, all income from investments in real estate is considered "passive," regardless of the level of the investor's participation in the activity that generates the income. 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 is for investors in rental property who actively participate in the investment and have an adjusted gross income (AGI) of under $100,000. This class of investor can deduct up to $25,000 in losses from "active" income sources. Nondeductible costs may be carried over to future years when passive income might be realized, but as shown above, this deferral of the deduction must reduce its present value. For investors exposed to this limit, then, the present value of their tax liabilities on the investment's returns increased. In turn, this exerted a significantly depressing effect on the market value of real property.

Prior to 1986, much real estate investment was done by passive investors. It was common for syndicates of investors to pool their resources in order to invest in property, commercial or residential. They would then hire management companies to run the operation. TRA86 reduced the value of these kinds of investments by limiting the extent to which losses associated with them could be deducted from the investor's gross income. This, in turn, encouraged the holders of loss-generating properties to try and unload them, which contributed further to the problem of sinking real estate values. This turmoil and repositioning in real estate markets was caused not by changes in market conditions but completely by changes in the tax law.

There is no sound economic reason for making a distinction between "passive" and "active" income. The division is completely arbitrary. It promotes the fallacy that income that isn't obtained through physical labor is somehow "unearned," and consequently, should be more heavily taxed than labor compensation. In fact, such "passive" investments are one of the fundamental engines of economic growth. Their primary function is to provide the capital by which other, non-passive activities, grow. This was clearly the case in real estate. These investments helped significantly to increase the stock of housing and other structures. The fact that the investors hired others to manage the operations was simply the result of an efficient division of labor within the market. To penalize this efficiency is absurd.

The adverse effects of the 1986 tax changes on real property values were a major contributing factor in the collapse of many savings and loan institutions. Mortgages and similar real property loans constitute a significant portion of S&Ls' portfolios of assets. Significant declines in the market value of real properties, then, would result in the erosion of the value of these institutions' major assets. In the final analysis there could be a reduction of their capital to perilously low levels – leaving some institutions with negative capital values.

The S&L bailout program, itself, has also contributed to distress in the real estate industry. Efforts by the Resolution Trust Corporation to dispose of properties taken over in the closing of failed or failing S&Ls artificially add to the stock of real property on the market and exert downward pressure on market values. This additional decline in real property values further imperils lending institutions that might otherwise be in relatively good financial condition.

In this case, the interest of one industry is also in the interest of the economy as a whole. The changes brought about by TRA86 concerning capital gains taxation, the cost recovery periods and

write-off methods for real property, and the deductibility of passive losses were all at odds with good tax economics. These changes should be rescinded. To do so would not only add new life to a sagging real estate industry but would help to put the economy as a whole on a sounder footing.

Roy E. Cordato
Senior Economist

Note: Nothing 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 the Congress.