THE IMPACT OF THE TAX REFORM ACT OF 1986 ON THE REAL ESTATE AND SAVINGS AND LOAN INDUSTRIES

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ABSTRACT

The Tax Simplification Act of 1986 dramatically restructured many aspects of the taxation of income, particularly income from real estate rentals. Among the unintended consequences of this tax reform was a dramatic reduction in the values of income-producing properties. As a consequence of that reduction in values, many investment properties had value reductions that resulted in values that were less than their mortgage values. During the years immediately following the legislation, there was a near collapse of the savings and loan industry resulting from loan loses.

INTRODUCTION

The Tax Reform Act of 1986 had a profound impact upon the real estate industry and as a result, the Savings and Loan Industry. It has often been suggested that the collapse of the industry during the late 1980s and early 1990s was a result of poor management, fraud, and incompetent appraisals. This paper will suggest that the primary reason for the Savings and Loan difficulties during the late 1980s and early 1990s were the losses incurred through the default of real estate loans caused by the loss in values of the properties used as collateral for those loans. With the implementation of the 1986 Tax Reform Act, this paper will show how the values decreased instantly by about 29-31%. With loan to value ratios of 80%, this reduction left little or no equity in many properties. Where there was market weakness from overbuilding and a decline in the oil industry, many property owners found that they were unable to collect as much rent as they had forecast. When faced with little or no equity in the properties and negative cash flows, many defaulted. These defaults had an even more negative impact as they began a downward spiral in values as the supply of properties increased. As the lenders sold more properties in an attempt to recover on the defaulted loans, prices were driven downward even more. As prices fell further, more owners found themselves paying on mortgages that were greater than the values of the properties that secured them. This spiral became so severe in some markets that prices dropped as much as 75%.

To understand how this occurred, it is important to regress to the end of the Carter Administration in 1980. At that time, the top marginal tax bracket was very high (70%). Taxable income losses from real estate operations could be used to offset earned income without significant limitation. Many doctors sought out real estate investments and structured them so that they would have a positive cash flow but a negative taxable income primarily because of the depreciation deduction.

Depreciation allowances allowed the taxpayer to elect any class life for their real estate property provided that the life was justified. This might allow a depreciable life for a convenience store of 25-30 years, while an apartment building might suggest a life of 40 years. However, while the structure proper had a longer class life, the taxpayer was allowed to depreciate individual building components at more accelerated rates based again upon justification. For example, the value of the roof covering would be deducted from the value of the overall building, and then it would be depreciated perhaps over twenty years rather than the 40 years for the apartment building. Likewise, the carpeting was segregated and depreciated over 5 years. This segregation of building components often was extended to the plumbing, the electrical systems, the mechanical systems, paving, painting, etc. Shenkman (1987) suggested that this effectively gave a property with a 33-40 year class life, an effective life of 22 years. Double Declining Balance depreciation was also allowed, resulting in increasing the depreciation deduction during the early years of the asset's life.

With the major overhaul in the tax code implemented during the Reagan Administration in 1981, the

attractiveness of real estate as a tax shelter was significantly increased. The depreciation calculation was significantly changed in that it allowed a larger depreciation deduction. Taxpayers were relieved of the obligation and expense of justifying class lives, while both double declining balance depreciation and segregating building components were no longer available for new acquisitions. However, the class life for real estate was established under the Accelerated Cost Recovery System (ACRS) at 15 years. Using Shenkman's (1987) estimate of an effective 22-year class life pre-ACRS, this change resulted in about a 47% increase in the depreciation deduction over what it would be under the straight-line method. While taxpayers who opted for double-declining balance would not have benefited as greatly under ACRS during the early years of the class life, nevertheless their depreciation deduction was enlarged.

At the onset of the 1981 Tax Reform Act, market interest rates were 16.82% (FHLMC data for 1981). Just prior to the implementation of the Tax Reform Act of 1986, market rates had fallen to 10.18%. From 1981 to 1986 the ACRS class life ratcheted upward from 15 to 19 years thereby reducing the depreciation deduction and making new acquisitions less beneficial from a tax standpoint. However, the falling interest rates reduced the actual interest expense of ownership. The net result of lower interest costs offset by the reduction in the depreciation tax deduction was still a significant increase in the after-tax cash flow afforded by real property investments. Consequently, there was a construction boom that lead to a significant increase in supply in many more popular markets.

THE TAX REFORM ACT OF 1986

The Tax Reform Act of 1986 (TRA)[1] was sponsored by Representative Richard Gephardt (D-MO) and Senator Bill Bradley (D-NJ) and signed into law on October 22, 1986 by President Ronald Reagan. In his speech before the signing, Reagan remarked "I feel like we just played the World Series of tax reform – and the American people won."[2] Although the TRA included sweeping changes to many areas of tax law, below is a summary of the major changes that had the potential to affect the value of real estate.

- Changes to the Marginal Income Tax Rates

The TRA placed all individual taxpayers into two brackets: 28% and 15%. Previously there had been more than a dozen tax brackets. The top marginal tax rates fell from 50% to 28%, which is a 44% drop. The lowest tax rates increased from 11% to 15%, which is a 36% increase.

- Passive Loss Limitation Rules

Losses generated from passive activity (activities in which the taxpayer did not materially participate) were no longer available to offset gains from non-passive activities. Rental of real property was generally classified as passive income regardless of the extent of the owner-taxpayer's participation. However, if the taxpayer materially participates in the rental activity[3], up to $25,000 of the passive losses may be used to offset earned income. This particular provision had an egregious result for many taxpayers who had purchased significant real estate investment properties to shelter active income. Real estate investments that had positive cash flows yet negative taxable incomes were limited as to their future ability to shelter active income. In effect, it was almost retroactive in penalizing taxpayers in this circumstance.

- Lengthening the Recovery Period for Real and Personal Property

The recovery period (useful life) for depreciable assets was increased dramatically. Real estate could no longer be depreciated in 19 years as it could be just prior to the TRA. Under the 1986 law it was to be depreciated over 27½ years for residential and 31½ years for non-residential properties. Most personal property that would be used in real estate had been depreciated over three or five years prior to the TRA. Now it had to be depreciated over five or seven years.

- Repeal of Non-mortgage Interest as an Itemized Deduction

Prior to the 1986 Act any interest expense was an itemized deduction. After the TRA only mortgage interest was included as an itemized deduction. This put market pressure for mortgage interest rates to rise and non-mortgage interest to fall due to their new status of desirability/non-desirability.

- Repeal of Preferential Treatment of Capital Gains

Only 40% of capital gains had been taxed prior to TRA. Under TRA capital gains were 100% taxable. Since the maximum tax rate prior to TRA was 50%, the maximum effective tax rate on the capital gain was 20% (40% times 50%). Under the TRA, with the repeal of the 60% capital gains exclusion, the effective maximum capital gains tax rate was 28%.

- Elimination of the Investment Tax Credit

Prior to TRA an Investment Tax Credit (ITC) of 10% was given for investment in certain personal property that could be used in real estate. That credit was eliminated with the passage of the TRA.

- Low-income Housing Tax Credit

A Low-income Housing Tax Credit was created in the TRA to offset the anticipated ill-effects the TRA would have on the investment in low income real estate projects.

- Restriction on Banks' Write-off of Bad Debt

Prior to TRA banks could write off as a tax deduction their allowance for (anticipation of) bad debt. After TRA larger (more than $400 million in total assets) banks were permitted to write off only actual bad debts.

EXAMPLES OF THE IMPACT TRA HAD ON REAL ESTATE VALUE

To demonstrate the impact of the TRA on real estate values, an apartment building example and an office building example will be given. In each case, the investment value of the property will be estimated assuming the purchase of a property under the tax law existing just prior to the TRA and then under the TRA. These two types of properties were chosen because of the difference of how residential and commercial properties are treated under the tax law. The projects had similar expected return-on-investments commensurate with those available at the time. A detailed five-year cash flow analysis for each project, its assumptions, and its expected profitability under each tax code is included in the appendix.

The apartment project is typical of the kind of property that provides an appropriate tax shelter for investors prior to the TRA 1986. It was analyzed using the average market interest rates and financing terms commonly available in 1986. The project is a 40 unit apartment building with a purchase price of $1,606,000. Land value is estimated at 15% of the sales price. The investor's pre-1986 marginal tax rate was assumed to be 50%. That was lowered to 28% by the 1986 TRA.

The office project is also typical of the kind of property investors seeking a tax shelter pre-1986 TRA would have sought. Again, it was analyze using the prevailing market interest rate and terms commonly available at the time. The project was a three-story 12,000 sq. foot suburban office building. Land was again estimated at 15%. The building purchase price was $1,250,000. The same assumptions were made about the taxpayer's income tax rates.

Table A summarizes the investments under the pre-1986 TRA and the 1986 TRA. An examination of these cash flows demonstrates how dramatically the after-tax cash flow for the investor was reduced. The after-tax cash flow was reduced by 25% and 26% for the apartment and office investments, respectively. This reduction in value was solely due to the Tax Reform Act of 1986. More disturbing, when the investments are examined for their investment values before and after the implementation of the TRA, the investment values for both types of investments fell below the values of the mortgages on each property. This is particularly significant in that the investment value gives an indication of what investors would pay to acquire the property if available for sale, thus it is indicative of its market value. In times of financial difficulty, the likelihood of default substantially increases when the balance due on the mortgage is greater than the market value of the property.

CONCLUSION

The collapse of the Savings and Loan Industry has been attributed to many things, but this paper demonstrates that perhaps one of the more significant causes of their financial failures was the decline in the collateral base of their commercial real estate loans caused primarily by the changes in the 1986 Tax Reform Act. This Act not only caused the decline in property values outright, but also because the provision limiting the offset of active income by passive losses was not restricted to new acquisitions, many taxpayers found that previously purchased real estate assets no longer afforded the tax sheltering benefits. As a consequence, many chose to liquidate those assets. This resulted in a further increase in the supply of investment properties that lead to a further drop in real estate prices.

Table A

	Apartment		Office	
	Pre-1986 TRA	**1986 TRA**	**Pre-1986 TRA**	**1986 TRA**
Rent Revenue	$174,096	$174,096	$136,864	$136,864
Less Interest	$131,393	$131,393	$101,679	$101,679
Less Loan Points	$3,855	$3,855	$2,983	$2,983
Less Depreciation	$71,855	$47,577	$53,591	$32,325
Taxable Income	-$30,012	-$8,728	-$21,389	-$123
Taxes	-$15,006	-$2,444	-$10,695	-$34
Rent Revenue	$174,096	$174,096	$136,864	$136,864
Less Annual Debt Service	$138,171	$138,171	$106,925	$106,925
Less Income Taxes (Savings)	-$15,006	-$2,444	-$10,695	-$34
After-Tax Cash Flow	$50,931	$38,368	$40,634	$29,973
After-Tax Overall Rate[4]	0.031709579		0.032506973	
Given Investment Value	$1,606,164		$1,250,000	
Calculated Value		$1,209,996		$922,063
Mortgage	$1,284,931	$1,284,931	$994,354	$994,354
Loan-to-Value Ratio	80%	106%	80%	108%
Expected IRR	16.42%	13.08%	16.90%	13.65%

[1] PL99-514

[2] The Official Web Site of the Ronald Reagan Presidential Library
http://www.reagan.utexas.edu/resource/speeches/1986/102286a.htm

[3] A taxpayer-property owner can materially participate if the taxpayer-property owner either functions as the property manager or is the employer of the property manager. Thus a taxpayer-property owner who hires a property management firm to manage the property (rent and maintain) is still materially participating.

[4] The After-tax Overall Rate is computed by dividing the After-Tax Cash Flow by the value of the property. The ratio can then be used to compute the investment value of similar investment properties by dividing their After-tax Cash Flow by the After-Tax Overall Rate. Investment Value = After-Tax Cash Flow ÷ After-tax Overall Rate.

PRE-1986 TRA APARTMENT INVESTMENT

Cost	$1,606,164		Operating Expenses		35%	V&C	4%
# of Units	Mo. Rent	Annual Rent	Rental Increases		3%		
30	550	$198,000		Land	15%	$240,925	
10	675	$81,000		Building		$1,365,239	
		$279,000		Owner's MTR		50%	
Holding Period		5	YRs	Depreciable Life		19	
				Month Placed in Service		1	
Capitalization Rate		10.9%		Selling Expenses		8.0%	
Term	10		Interest	10.25%		Points	3%
Amort. Period	30		Pay/Yr	12		DSCR	1.26
Principal	$1,284,931		Points	$38,548		ADS	$138,171

Year	1	2	3	4	5	6
Gross Potential Income	$279,000	$287,370	$295,991	$304,871	$314,017	$323,437
Less Vacancy	$11,160	$11,495	$11,840	$12,195	$12,561	$12,937
Adjusted Gross	$267,840	$275,875	$284,151	$292,676	$301,456	$310,500
Less Expenses	$93,744	$96,556	$99,453	$102,437	$105,510	$108,675
Net Operating Income	$174,096	$179,319	$184,698	$190,239	$195,947	$201,825
Less Annual Debt Service	$138,171	$138,171	$138,171	$138,171	$138,171	
Before Tax Cash Flow	$35,925	$41,147	$46,527	$52,068	$57,775	
Less Mortgage Interest	$131,393	$130,664	$129,858	$128,964	$127,975	
Less Depreciation	$68,861	$71,855	$71,855	$71,855	$71,855	
Less Points Expensed	$3,855	$3,855	$3,855	$3,855	$3,855	
Tax Income	-$30,012	-$27,055	-$20,869	-$14,435	-$7,738	
Taxes	-$15,006	-$13,528	-$10,434	-$7,217	-$3,869	
Before Tax Cash Flow	$35,925	$41,147	$46,527	$52,068	$57,775	
Less Taxes	-$15,006	-$13,528	-$10,434	-$7,217	-$3,869	
After-tax Cash Flow	$50,931	$54,675	$56,961	$59,285	$61,644	
Sale Price (Year 6 NOI/Capitalization Rate)			$1,854,839			
Less Selling Expenses			-$148,387			
Amount Realized			$1,706,451			
Less Mortgage Payoff			-$1,242,929			
Before-Tax Cash Flow from Reversion			$463,523			
Basis Calculation		Cost				$1,606,164
		Accumulated Depreciation Taken				$356,280
		Adjusted Basis				$1,249,884
Amount Realized			$1,706,451			
Less Adjusted Basis			$1,249,884			
Capital Gain			$456,567			
Less Exclusion (60%)			$273,940			
Taxable Gain			$182,627			
Less Unexpensed Loan Points			$19,274			
Taxable Income from Reversion			$163,353			
Tax on Reversion			$81,676			
Before-Tax Cash Flow from Reversion			$463,523			
Less Tax on Reversion			$81,676			
After-Tax Cash Flow from Reversion			$381,846			
Expected Holding Period Internal Rate of Return			16.42%			

APARTMENT INVESTMENT UNDER 1986 TRA

Cost	$1,606,164		Operating Expenses		35%	V&C	4%
# of Units	Mo. Rent	Annual Rent	Rental Increases		3%		
30	550	$198,000		Land	15%	$240,925	
10	675	$81,000		Building		$1,365,239	
		$279,000		Owner's MTR		28%	

Holding Period		5	YRs	Depreciable Life		27.5	
				Month Placed in Service		1	
Capitalization Rate		10.9%		Selling Expenses		8.0%	
Term	10		Interest	10.25%		Points	3%
Amort. Period	30		Pay/Yr	12		DSCR	1.26
Principal	$1,284,931		Points	$38,548		ADS	$138,171
	Year	**1**	**2**	**3**	**4**	**5**	**6**
Gross Potential Income		$279,000	$287,370	$295,991	$304,871	$314,017	$323,437
Less Vacancy		$11,160	$11,495	$11,840	$12,195	$12,561	$12,937
Adjusted Gross		$267,840	$275,875	$284,151	$292,676	$301,456	$310,500
Less Expenses		$93,744	$96,556	$99,453	$102,437	$105,510	$108,675
Net Operating Income		$174,096	$179,319	$184,698	$190,239	$195,947	$201,825
Less Annual Debt Service		$138,171	$138,171	$138,171	$138,171	$138,171	
Before Tax Cash Flow		$35,925	$41,147	$46,527	$52,068	$57,775	
Less Mortgage Interest		$131,393	$130,664	$129,858	$128,964	$127,975	
Less Depreciation		$47,577	$49,645	$49,645	$49,645	$49,645	
Less Points Expensed		$3,855	$3,855	$3,855	$3,855	$3,855	
Tax Income		-$8,728	-$4,845	$1,341	$7,775	$14,472	
Taxes		-$2,444	-$1,357	$375	$2,177	$4,052	
Before Tax Cash Flow		$35,925	$41,147	$46,527	$52,068	$57,775	
Less Taxes		-$2,444	-$1,357	$375	$2,177	$4,052	
After-tax Cash Flow		$38,368	$42,504	$46,152	$49,891	$53,723	
Sale Price (Year 6 NOI/Capitalization Rate)				$1,854,839			
Less Selling Expenses				-$148,387			
Amount Realized				$1,706,451			
Less Mortgage Payoff				-$1,242,929			
Before-Tax Cash Flow from Reversion				$463,523			
Basis Calculation			Cost				$1,606,164
			Accumulated Depreciation Taken				$246,157
			Adjusted Basis				$1,360,007
Amount Realized				$1,706,451			
Less Adjusted Basis				$1,360,007			
Capital Gain				$346,444			
Less Unexpensed Loan Points				$19,274			
Taxable Income from Reversion				$327,170			
Tax on Reversion				$91,608			
Before-Tax Cash Flow from Reversion				$463,523			
Less Tax on Reversion				$91,608			
After-Tax Cash Flow from Reversion				$371,915			
Expected Holding Period Internal Rate of Return				13.08%			

PRE-1986 TRA OFFICE INVESTMENT

Cost	$1,250,000		Operating Expenses		35%	V&C	6%
# of Sq. Ft.	Rent	Annual Rent	Rental Increases		3%		
8000	21	$168,000		Land	15%	$187,500	
4000	17	$68,000		Building		$1,062,500	
		$236,000		Owner's MTR		50%	
Holding Period		5	YRs	Depreciable Life		19	
				Month Placed in Service		1	
Capitalization Rate		10.9%		Selling Expenses		8.0%	
Term	10		Interest	10.25%		Points	3%
Amort. Period	30		Pay/Yr	12		DSCR	1.26
Principal	$1,284,931		Points	$38,548		ADS	$138,171
	Year	**1**	**2**	**3**	**4**	**5**	**6**
Gross Potential Income		$279,000	$287,370	$295,991	$304,871	$314,017	$323,437

Less Vacancy	$11,160	$11,495	$11,840	$12,195	$12,561	$12,937
Adjusted Gross	$267,840	$275,875	$284,151	$292,676	$301,456	$310,500
Less Expenses	$93,744	$96,556	$99,453	$102,437	$105,510	$108,675
Net Operating Income	$174,096	$179,319	$184,698	$190,239	$195,947	$201,825
Less Annual Debt Service	$138,171	$138,171	$138,171	$138,171	$138,171	
Before Tax Cash Flow	$35,925	$41,147	$46,527	$52,068	$57,775	
Less Mortgage Interest	$131,393	$130,664	$129,858	$128,964	$127,975	
Less Depreciation	$68,861	$71,855	$71,855	$71,855	$71,855	
Less Points Expensed	$3,855	$3,855	$3,855	$3,855	$3,855	
Tax Income	-$30,012	-$27,055	-$20,869	-$14,435	-$7,738	
Taxes	-$15,006	-$13,528	-$10,434	-$7,217	-$3,869	
Before Tax Cash Flow	$35,925	$41,147	$46,527	$52,068	$57,775	
Less Taxes	-$15,006	-$13,528	-$10,434	-$7,217	-$3,869	
After-tax Cash Flow	$50,931	$54,675	$56,961	$59,285	$61,644	
Sale Price (Year 6 NOI/Capitalization Rate)			$1,854,839			
Less Selling Expenses			-$148,387			
Amount Realized			$1,706,451			
Less Mortgage Payoff			-$1,242,929			
Before-Tax Cash Flow from Reversion			$463,523			
Basis Calculation		Cost				$1,250,000
		Accumulated Depreciation Taken				$356,280
		Adjusted Basis				$893,720
Amount Realized			$1,706,451			
Less Adjusted Basis			$893,720			
Capital Gain			$812,731			
Less Exclusion (60%)			$487,639			
Taxable Gain			$325,092			
Less Unexpensed Loan Points			$19,274			
Taxable Income from Reversion			$305,818			
Tax on Reversion			$152,909			
Before-Tax Cash Flow from Reversion			$463,523			
Less Tax on Reversion			$152,909			
After-Tax Cash Flow from Reversion			$310,613			
Expected Holding Period Internal Rate of Return			16.90%			

OFFICE INVESTMENT UNDER 1986 TRA

Cost	$1,250,000		Operating Expenses		35%	V&C	6%
# of Sq. Ft.	Rent	Annual Rent	Rental Increases		3%		
8000	21	$168,000		Land	15%	$187,500	
4000	17	$68,000		Building		$1,062,500	
		$236,000		Owner's MTR		28%	
Holding Period		5	YRs	Depreciable Life		31.5	
				Month Placed in Service		1	
Capitalization Rate		10.9%		Selling Expenses		8.0%	
Term	10		Interest	10.25%		Points	3%
Amort. Period	30		Pay/Yr	12		DSCR	1.26
Principal	$1,284,931		Points	$38,548		ADS	$138,171

Year	1	2	3	4	5	6
Gross Potential Income	$224,000	$230,720	$237,642	$244,771	$252,114	$259,677
Less Vacancy	$13,440	$13,843	$14,258	$14,686	$15,127	$15,581
Adjusted Gross	$210,560	$216,877	$223,383	$230,085	$236,987	$244,097
Less Expenses	$73,696	$75,907	$78,184	$80,530	$82,945	$85,434
Net Operating Income	$136,864	$140,970	$145,199	$149,555	$154,042	$158,663
Less Annual Debt Service	$106,925	$106,925	$106,925	$106,925	$106,925	
Before Tax Cash Flow	$29,939	$34,045	$38,274	$42,630	$47,117	
Less Mortgage Interest	$101,679	$101,116	$100,491	$99,800	$99,035	

Less Depreciation	$32,325	$33,730	$33,730	$33,730	$33,730	
Less Points Expensed	$2,983	$2,983	$2,983	$2,983	$2,983	
Tax Income	-$123	$3,141	$7,994	$13,042	$18,294	
Taxes	-$34	$879	$2,238	$3,652	$5,122	
Before Tax Cash Flow	$29,939	$34,045	$38,274	$42,630	$47,117	
Less Taxes	-$34	$879	$2,238	$3,652	$5,122	
After-tax Cash Flow	$29,973	$33,165	$36,036	$38,978	$41,994	
Sale Price (Year 6 NOI/Capitalization Rate)			$1,455,623			
Less Selling Expenses			-$116,450			
Amount Realized			$1,339,173			
Less Mortgage Payoff			-$961,850			
Before-Tax Cash Flow from Reversion			$377,323			
Basis Calculation		Cost				$1,250,000
		Accumulated Depreciation Taken				$167,245
		Adjusted Basis				$1,082,755
Amount Realized			$1,339,173			
Less Adjusted Basis			$1,082,755			
Capital Gain			$256,418			
Less Unexpensed Loan Points			$14,915			
Taxable Income from Reversion			$241,503			
Tax on Reversion			$67,621			
Before-Tax Cash Flow from Reversion			$377,323			
Less Tax on Reversion			$67,621			
After-Tax Cash Flow from Reversion			$309,702			
Expected Holding Period Internal Rate of Return			13.65%			