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The 1986 Tax Reform Act has made sweeping changes in the nation's tax Code. While the Code has been totally revamped, the investors of real estate seem to be the main target of the Act. Changes in capital gain treatment, depreciation, limits on passive loss deductions, limits on investment interest deductions, and the extention of at-risk rules to real estate have dealt a severe blow to the real estate investor. Thus through the Act Congress has virtually eliminated the real estate tax shelter. Moreover, while the Act has immediate effects on real estate, the enormous revamping will probably effect real estate in many other ways through other Code provisions. The long-run effect on real estate has yet to be determined.

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NORTHERN ILLINOIS UNIVERSITY

Real Estate and the 1986 Tax Reform Act

University Honors Program
in Partial Fulfillment of the
Requirements of the Baccalaureate Degree
With University Honors

Department of Finance

by
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ABSTRACT

The 1986 Tax Reform Act has made sweeping changes in the nation's tax code. While the Code has been totally revamped, the investors of real estate seem to be the main target of the Act. Changes in capital gain treatment and depreciation, limits on passive loss deductions and investment interest deductions, and the extention of "at-risk" rules to real estate have dealt a severe blow to the real estate investor. Thus, through the Act Congress has virtually eliminated the real estate tax shelter. Moreover, while the Act has immediate, foreseeable effects on real estate, the enormous revamping of the Code will probably effect real estate in many other ways through other Code provisions. The Act's long-run effect on real estate has yet to be determined.

With passage of the 1986 Tax Reform Act, sweeping changes have been made in the nation's Tax Code. Nearly every section of the Code has been revised or altered in some manner. These revisions and alterations effect corporations and partnerships as well as the individual taxpayer.

In writing the Act, Congress wanted to create a fairer system of taxation. They wanted to create an Act which was simpler and provided a stable effective tax rate year to year. In addition, Congress wanted an Act which would not place the nation's tax burden on the "typical middle-class American." Congress made the notion of a reduced tax burden to the middle-class concrete by eliminating most tax shelters used by high-income taxpayers.

The elimination of tax shelters has effected the real estate investment market the most. In fact, from an overall viewpoint, the real estate investor has been the most effected by the changes in the Tax Code. From the elimination of the capital gains deduction to the changes in

depreciation and passive losses, changes in the Tax Code have eliminated many of the advantages to real estate investment. This report broadly examines the provisions of the 1986 Tax Reform Act that have a direct and immediate impact on the real estate investor. As time passes other effects of the new Code will probably become apparent. However, at this point only those key changes in the Code can be examined.

Overview of Tax Rates

Under the 1986 Tax Reform Act, individual taxpayers will face a tax structure that is radically different from that which existed in past years. The new Tax Act simplifies the tax rate structure by reducing the number of tax brackets from 15 to 2 --- 15 percent and 28 percent. However, the tax law also creates a 5 percent surtax for certain income levels.[1] This surtax is designed to reduce the tax advantage given to high-income earners by the 15 percent bracket. Thus, as a result of the surtax many high-income earners will face a 33 percent marginal tax rate for certain income levels.

The tax rate structure for a single individual taxpayer with no dependents appears as follows for 1988:[2]

If taxable income is:	The tax rate is:
$17,850	15%
17,851 - 43,150	28
43,151 - 89,560	33 (28+5)
89,561+	28

In this case, the 5 percent surtax is only applicable to the income earned between $43,561 and $89,560 by the single taxpayer. The rate drops(the surtax is removed) to 28 percent for all income earned above $89,560. This uncharacteristic rate decrease was probably designed to promote (or at least not discourage) investment in the economy by high-income earners.

Equally unique to this tax act is the inflation adjustment of the tax brackets. For the tax years after 1988, the tax brackets (not the tax rates) will be adjusted for inflation. The taxable income bracket at which a tax rate begins will be adjusted upward to reflect the impact of inflation. The inflation adjustment will be made on or before December 15 of each calender year and will be based on the difference in the Consumer Price Index(CPI) for that year and the CPI for the preceding year.[3] Thus, the effective tax rate shall remain the same year after year for each bracket. This maintenance of a real(true) tax rate is in sharp contrast to past Acts which had no inflation adjustment. In previous years, inflation would increase

an individual's earned income but the tax brackets remained the same. The resulting effect was that each year an individual faced a higher effective tax rate.

Capital Gains

Under the prior tax law, individuals were allowed to deduct 60 percent of their net capital gains in arriving at taxable income. Since the highest tax bracket was 50 percent, the maximum tax rate for capital gains was 20 percent (40 percent of reported capital gains times 50 percent tax rate).

The 1986 Tax Reform Act repeals the 60 percent capital gains deduction. According to the new Act, all gains must be reported in full as ordinary income. However, while the capital gains deduction is no longer permitted, the tax Act has specified that gains classified as capital gains shall not be taxed at a rate greater than 28 percent. So while the preferential treatment of capital gains has been eliminated, the Act has retained the provisions relating to the classification of income as ordinary or capital. According to the Conference Committee Report, the structure has been retained "in order to facilitate the reinstatement of a capital gains rate differential in the event of a future tax increase."[4]

Depreciation

The Economic Recovery Act of 1981 introduced the accelerated cost recovery system (ACRS). Under ACRS, an investor's depreciable basis in a porperty is recovered over a period arbitrararily assigned to the class to which the property belongs rather than the property's expected useful life. To the delight of real estate investors, the original class life assigned to all real estate was 15 years. In addition, the method of depreciation under ACRS was an accelerated 175 percent declining balance method. The short recovery period combined with the accelerated depreciation method produced an amazing first-year deduction of 12 percent of depreciable basis.[5]

While the class life for real estate was lenghtened in May 1985 to 19 years, the accelerated declining balance method of depreciation was retained an investors continued to enjoy large depreciation deductions from their properties.

The 1986 Act establishes a new, very different accelerated cost recovery system. To begin with, real estate is now divided into two classes --- residential and nonresidential. Residential property is defined as property which earns 80 percent or more of its gross rental income from dwelling units (excluding hotels, etc.). Nonresidential property is defined as property which is not residential. The new recovery period for residential property

is 27.5 years and the recovery period for nonresidential property is 31.5 years. Additionally, the Act specifies that both classes of real estate must be depreciated on a straight-line method of depreciation.[6]

The following example illustrates the difference between the 1981 Tax Act and the 1986 Tax Act in recovery of depreciable property basis.

	Annual Depreciation of a $1 million Property	
Year	1981 Act	1986 Act
1	$ 100,000	$ 30,000
2	92,000	32,000
3	84,000	32,000
4	77,000	32,000
5	72,000	32,000
6	67,000	32,000
7	63,000	32,000
8	58,000	32,000
9	55,000	32,000
10	47,000	32,000
11	42,000	32,000
12	39,000	32,000
13	36,000	32,000
14	33,000	32,000
15	31,000	32,000
16	29,000	32,000
17	27,000	32,000
18	24,000	32,000
19	23,000	32,000
	$1,000,000	$606,000

Thus, a$1,000,000 nonresidential property depreciated under the 1981 Act will be fully depreciated in 19 years. Additionally, the property owner will experience larger yearly depreciations deductions in the first years the

the property is held, and smaller deductions the last years it is held. This was particularly appealing as most investors plan to dispose of property before it is fully depreciated. In comparison, under the 1986 Act the $1,000,000 nonresidential property will be approximately 60 percent depreciated after 19 years. Also, the owner receives the same yearly depreciation deduction from the property each and every year the property is held. Thus, by comparing the treatment of the property under both Acts it can be seen that the revamping of ACRS will have a dramatic effect on the real estate market. No longer can properties be quickly depreciated nor will the majority of the depreciation come in the first years the property is held.

At-Risk Rules

The previous tax Act imposed an at-risk limitation on all losses incurred by taxpayers from business and income producing activities. The rule was designed to prevent a taxpayer from deducting losses larger than his actual economic investment in the activity.

Under the previous Act, the at-risk rule did not apply to real estate investments. Thus, an investor in real estate could deduct losses up to the full cost of the

property, even though the losses far exceeded the investor's economic investment.[7] Moreover, these large loss deductions enabled the investor to offset ordinary income from other business activities and thus avoid any tax liability attributable to that ordinary income.

The 1986 Tax Reform Act extends at-risk limitations to real estate acquired after 1986. In general, a taxpayer's losses are now limited to the amount of his at-risk investment. Taxpayers are considered at-risk to the extent of 1) their cash investment, 2) any property contributed, 3) any amount borrowed for the activity, but only to the extent that they are personally liable to repay the loan or have pledged assets to secure the loan. Additionally, the investor is considered at-risk to the extent that the property is secured by qualified nonrecourse financing. Qualified nonrecourse financing is a nonrecourse mortgage given by a lender who normally deals in that type loan. It cannot be a loan from a person related to the taxpayer or from the seller of the property.[8]

The extention of at-risk rules to real estate will have a large impact on the real estate market. Real estate syndication's use of (nonqualified) nonrecourse financing allowed the syndication's limited partners to take loss deductions far exceeding their at-risk investment and thus shelter large amounts of otherwise taxable income. With

passage of the new tax Act, this is no longer possible. And thus, syndications will become less prevalent as investors look to other investments to serve as tax sheltering investments.

While this rule has a direct impact on the real estate market --- reduced investment in real estate syndications, its indirect effect could be even more dramatic and of much greater social consequence. Real estate syndications, looking to generate losses for their investors, were often the prime developers of low-income housing. If the 1986 Tax Reform Act does reduce investment in real estate syndications, the long-range effect might be the reduction of housing for the low-income earning public.

Limitations on Passive Losses

The 1986 Tax Act states that deductions from passive business activities cannot exceed income from such passive business activities. Or in other words, losses generated from a passive business activitiy cannot be used to offset nonpassive, ordinary income. Any unused passive activity loss may be carried forward and used to offset future passive activity income. This carryforward period is indefinite. In addition, all losses not used may be deducted in full at the time the taxpayer disposes of the passive

activity and may be used to offset nonpassive, ordinary income if the passive income is insufficient.[9]

Losses from one passive activity may be used to offset passive income from any source. A taxpayer has passive income if the activity from which the income is derived is one in which the taxpayer does not materially participate. A taxpayer is considered to materially participate if he is involved in the activity's operations on a regular, continuous, and substantial basis.[10]

Real estate investors, according to the Act, are classified, for the most part, as passive investors. More specifically, the Act defines most rental income as passive in nature, whether or not the taxpayer materially participates in the activity. Thus, real estate investors must succumb to this rule even if they are material participents in a rental real estate venture, and that venture is their principal business activity.[11]

Some relief from this strict rule that all rental activity is passive is given to taxpayers of moderate income levels. The Act provides that an individual may offset up to $25,000 of nonpassive income by using losses from rental real estate activities in which the taxpayer actively participates. The $25,000 amount is reduced by 50 percent of the amount by which the taxpayer's yearly

income exceeds $100,000. Thus, the provision is eliminated when the taxpayer's income reaches $150,000.[12]

The passive loss rule is phased in over a five year period beginning January 1, 1987. During each year of the phase-in period a certain percentage of excess passive losses over passive income is allowed to offset ordinary income. This percentage decreases during the five year period until it reaches zero in 1991.[13]

Interest Deduction Limitations

The new tax act has expanded the categories of interest expense that is denied unlimited deductibility. Interest expense is now divided in to three categories: 1) interest expense incurred in a business in which the taxpayer actively participates --- fully deductible, 2) investment interest expense --- restricted deductibility, 3) consumer debt interest --- restricted deductibility.[14]

Investment interest expense includes all interest expenses on debt used to acquire and/or maintain passive investments; this includes limited partnership interest. However, interest from activities subject to passive loss rules is not considered investment interest.

The amount of investment interest expense that a taxpayer can deduct is limited to the excess of investment

income over investment expense. Dissallowed investment interest can be carried forward and used to offset future investment income. The disallowed interest can be carried forward indefinitely.[15]

The tax act has greatly reduced the amount of consumer debt that is deductible. While the former tax act allowed almost total deduction of consumer debt interest, the 1986 Act allows only the interest on mortgage loans to be deducted. Thus, the deduction for interst on consumer loans is now limited to loans secured by a mortgage on the taxpayer's principal residence or second residence.[16] This could have have an adverse effect on the economy. Because interst deductions for unsecured personal loans and credit cards are no longer allowed, taxpayers may defer their consumption of some items and eliminate others. Thus, in the long run less money could be invested in the economy.

The 1986 Tax Reform Act has made sweeping changes in the nation's tax Code. Whether or not the Act will live up to Congress' expectations has yet to be determined. Did the Act simplify the tax Code? Did it remove some tax burden from low- to middle-income earners? And will this Act be able to generate sufficient tax dollars for the U.S. Government? For all these questions, only time will reveal the

answers.

One immediate assessment can be made about the 1986 Tax Reform Act with relative certainty. The Act has dealt a severe blow to the investors of real estate and to the real estate market in general. From raising the tax rate on capital gains to the limit placed on passive loss deductions to the extention of at-risk rules to real estate, the real estate investor has been the most effected by the new Act. And worse yet, while the Act has immediate effects on real estate, the enormous revamping of the Code will probably effect real estate in many other ways..... but, only time will tell.

Endnotes

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2. U.S. Department of Treasury, Explanation of the Tax Act of 1986, Publication 920, August 1987, p. 2.

3. CCH Tax Law Editors, p. 66.

4. Ibid. pp. 167-169.

5. Ackerman and Kinasz, "The New Tax Law", Real Estate Today, April 1987, p. 54.

6. CCH Tax Law Editors, pp. 308-309.

7. Ackerman and Kinasz, p. 55.

8. Ibid.

9. CCH Tax Law Editors, pp. 364-366.

10. Ibid.

11. Ibid.

12. Ackerman and Kinasz, p. 55.

13. CCH Tax Law Editors, p.381.

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16. Ibid. p. 386.

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