The Impact of The Tax Reform Act on Rental Properties

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Abstract

The Tax Reform Act of 1986 reduces the tax benefits of investments in rental properties. To compensate for the loss of these tax benefits the investor must either accept a lower after tax cash flow or the rents must be raised. This article suggests that a rent increase of 28% may be necessary in order for the investor to maintain the same after tax cash flow as before the tax law changes.

The Tax Reform Act of 1986 (Reform Act) significantly changes the economics of investments in rental properties. Changes have been made in depreciation, marginal tax rates, limits placed on rental property losses that can offset other income and losses are also subject to a new set of "at risk" rules. The net effect of these new rules will be to either reduce the investor's cash flows from the property or to raise the rents to provide the same cash flows as were obtained under the old set of rules or some combination of these alternatives.

A summary of the changes made by the Reform Act follows:

1. The depreciation methods and periods have been changed drastically. Prior to the Reform Act residential real estate could be depreciated over a 19 year period using an accelerated depreciation method (ACRS). The new law requires that residential real estate be depreciated over a 27 1/2 year period using the straight line method. Consequently, depreciation expense will be significantly lower on rental properties. For non residential property the depreciation period is even longer, 31 1/2 years.

2. The tax rates have been reduced substantially; from a previous maximum rate of 50% to a top rate of 28% (starting in 1988). Since rental properties often operate at a tax loss, the amount of taxes saved will now be less.

3. The new law limits the amount of rental

property losses that can be used to offset other sources of income. Taxpayers who have adjusted gross income of under \$100,000 and actively participate in the management of the property may offset a maximum of \$25,000 of rental losses against other sources of income. If the rental losses exceed \$25,000, the excess may be used only to offset other income from passive activities.

Furthermore, if the taxpayer has adjusted gross income in excess of \$100,000 the \$25,000 of losses is reduced by 50% of the income in excess of \$100,000. Therefore, an investor with an adjusted gross income of \$150,000 would no longer get any deduction unless the taxpayer also had income from other passive activities (passive activities are those activities that involve the conduct of a trade or business in which the taxpayer does not materially participate and this does not include interest or dividends which are considered portfolio activities for which there is a different set of rules!). Any losses which the investor can not currently use may be carried forward to future years which are subject to the same restrictions.

4. Real estate losses are now also subject to the at risk rules. Losses are limited to the amount that the investor has invested or is personally liable for. There is an exception for nonrecourse financing that is provided by a third party financial institution. Since most nonrecourse financing is done by third party financial institutions this will probably effect only investors in pro-

erty that is financed by a noninstitutional seller.

The above four items comprise the major changes that will have a bearing on the typical real estate investor. Exactly how these changes will alter real estate investments can be illustrated with an example of a typical small real estate investor who purchases a fourplex as a rental property. Below is a summary of the facts upon which the example is based. First, a fourplex is purchased at a cost of \$175,000 with a \$20,000 down payment and the balance financed over a 25 year period at 11%. Monthly payments are \$1,519 for principal and interest. Of the purchase price, \$15,000 is allocated to the land and \$160,000 to the building. Only the \$160,000 allocable to the building is subject to depreciation. Second, assume that the investor is in the 50% tax bracket under the old tax law and the 28% bracket under the new law. Third, assume that the taxpayer does materially participate in the management of the property and that adjusted gross income is under \$100,000. Fourth, assume that the property has an 8% vacancy factor and that the out of pocket expenses are as follows: property taxes \$1,500, insurance \$800, repairs & maintenance \$1,200, other costs and expenses \$1,200. Fifth, assume that each unit in the fourplex requires a \$550 per month rental from each tenant.

Table 1. below presents a summary of the operating results under both the old and new rules. Table 2. presents a summary of the cash flow that the investor would generate both before and after the tax reform act.

The investor has a cash flow of \$4,840 less under the new tax rules. If the investor wishes to obtain the same cash flow under the new rules an increase in rent would be necessary. How much would the increase have to be?

Table 3. below illustrates that a rent increase of 27.7% would be required to generate the same cash flow as would have been obtained under the old rules.

It is apparent from the above analysis that the impact of the Tax Reform Act of 1986 is substantial. If a small investor in real estate does not change the rent structure, they will suffer two economic consequences. First the net cash flow from the rental property will decrease substantially. Second, a logical result of the decline in cash flow is that these properties will be less attractive and hence their value will be reduced. The burden created by the reform act will have to be borne by either the investor, the tenant in the form of higher rents, or some combination of these alternatives.

Table 1
Operating Results

	Pre Reform	Post Reform
Rent Receipts (4 X \$550 X 12)	\$ 26,400	\$ 26,400
Less 8% estimated vacancy factor	<u>2,112</u>	<u>2,112</u>
Net cash receipts from rents	<u>24,288</u>	<u>24,288</u>
Expenses		
Interest	16,989	16,989
Property taxes	1,500	1,500
Insurance	800	800
Repairs & maintenance	1,200	1,200
Other costs and expenses	1,200	1,200
Depreciation	<u>14,080</u>	<u>5,818</u>
Total expenses	<u>35,769</u>	<u>27,507</u>
Net Loss	<u>\$ (11,481)</u>	<u>\$ (3,219)</u>

Table 2
Cash Flow

	Pre Reform	Post Reform
Rent receipts	\$ 24,288	\$ 24,288
Tax savings from rental loss		
\$11,481 X 50%	5,741	
3,219 X 28%		901
	<u>30,029</u>	<u>25,189</u>
Expenditures		
Mortgage payments	18,230	18,230
Property taxes	1,500	1,500
Insurance	800	800
Repairs & maintenance	1,200	1,200
Other	<u>1,200</u>	<u>1,200</u>
	<u>22,930</u>	<u>22,930</u>
Positive cash flow	\$ <u>7,099</u>	\$ <u>2,259</u>

Table 3
Rent Increase

	Before reform	Post reform with no rent change	Post reform with 27.7% increase
Rental potential	\$26,400	\$26,400	\$33,704
Less 8% vacancies	<u>2,112</u>	<u>2,112</u>	<u>2,696</u>
	<u>24,288</u>	<u>24,288</u>	<u>31,008</u>
Expenses			
Interest	16,989	16,989	16,989
Property taxes	1,500	1,500	1,500
Insurance	800	800	800
Repairs/maintenance	1,200	1,200	1,200
Other	1,200	1,200	1,200
Depreciation	<u>14,080</u>	<u>5,818</u>	<u>5,818</u>
	<u>35,769</u>	<u>27,507</u>	<u>27,507</u>
Net Income (Loss)	<u>(11,481)</u>	<u>(3,219)</u>	<u>3,501</u>

Cash Flow

Rent receipts	24,288	24,288	31,008
Tax savings from loss	5,741	901	
Tax owed from profit			(980)
	<u>30,029</u>	<u>25,189</u>	<u>30,028</u>
Mortgage payments	18,230	18,230	18,230
Property taxes	1,500	1,500	1,500
Insurance	800	800	800
Repairs/maintenance	1,200	1,200	1,200
Other	<u>1,200</u>	<u>1,200</u>	<u>1,200</u>
	<u>22,930</u>	<u>22,930</u>	<u>22,930</u>
Net Cash Flow	<u>\$ 7,099</u>	<u>\$ 2,259</u>	<u>\$ 7,098</u>

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