

IMPACT OF THE TAX REFORM ACT OF 1986 ON THE HOUSING INDUSTRY

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INTRODUCTION

The federal government has long pursued a policy of providing a decent home for all of the citizens of the U.S., whether it be in the form of an owner occupied single family home or a rental unit. The focus of this paper is on the Tax Reform Act of 1986. The provisions of this act are reviewed as they apply to real estate both in the single family and the multi-family housing areas to determine the economic impact and policy implications in the housing industry. Much of the information for this report was derived from testimony submitted in 1985 to the Senate Committee on Finance and the House Ways and Means Committee. It includes such sources as the national Association of Home Builders, the National Association of Realtors, and the National Multi-Housing Council.

Financing First-Time Buyers

The greatest impact on individual homeowners would occur because of the proposed change in the tax exempt status of private purpose municipal bonds.(1) Many states, counties, and municipalities, through their Housing and Finance Agency, offer tax exempt bonds for the primary purpose of aiding first-time buyers to purchase a home at a below market rate of interest on the home mortgage. These mortgage revenue bonds enable first-time buyers to enter the housing market who would not otherwise be able to afford their own homes.

A 1982 General Accounting Office (GAO) report found that 72% of the mortgage revenue bonds went to households with incomes below \$30,000 and

the average mortgage amount was \$48,000. Under the 1984 re-enactment of this law, 246,000 homes were financed by this program, representing about 16.0% of all first-time buyers and 25.0% of all eligible buyers.(2) See Exhibits 1 and 2.

Impact on Home Ownership Rates

The higher interest rates of 1979 and 1980 are credited for having caused the incidence of home ownership to decrease from a peak of 65.6% in 1980 to 64.1% in early 1985. A closer analysis of this Census Bureau data indicated the large part of the decline came from the sharp decline occurring in the home ownership rate of younger households. The average rate of decline of home ownership for heads of households aged 30-34 was 10% from 1980 to early 1985.(3)

Exhibit 3 shows this sharp decline in the home ownership rates of those households headed by younger people. Since the mortgage revenue bonds fund mortgages primarily for this age group, the implication is that further declines would certainly result if the mortgage revenue bond program is discontinued.

Policy Implications for Single Family Homes

The combined impact of the Administration's proposals to eliminate the state tax deductions and to repeal the mortgage revenue bonds would impact the younger and low-to-middle income households most severely. The implications of these combined acts tend to indicate a move away from the policy

of historical significance of providing a housing opportunity for the blue collar, middle class worker. The price reduction in housing, which might occur if these recommendations are adopted, would not be sufficient to offset the long term tax benefits the buyer would otherwise derive from the existing law.

MULTI-FAMILY HOUSING

The new law has several sections which will have a decided impact on rental units and construction in the multi-family housing market. The specific changes discussed in this section of the report are:

- 1) The change from Accelerated Cost Recovery System (ACRS), 18 year depreciation schedule put into effect by ERTA (1980) and modified by DRA (1984), to the straight-line 27 1/2 year depreciation schedule.(4)
- 2) Elimination of the capital gains treatment on the sale of depreciable assets.(5)
- 3) The repeal of tax exempt financing for low and moderate income rental housing.(6)
- 4) Repeal of rapid write-offs for the rehabilitation of low income units.(7)
- 5) Restriction of the deductibility of limited partners interest.
- 6) Extension of the "at risk" rules to real estate activities.(8)

The National Multi-Housing Council estimated that the elimination of the incentives for the production of these rental units would eliminate them as a competitive investment option.(9) The cost of investment capital would increase 44% by 1991, according to a study by economists from Harvard University and Wharton Econometric Forecasting Associates.(10) In such a case, rental housing would be unable to attract private investment capital because the typical tenant could not afford the projected increased rent payments. The cost to the families would be in the form of rent increases and reduced quality housing. These costs may

exceed any federal income tax savings realized from the proposals by as much as 600%.(11)

Reduced Number of Housing Starts

The impact on single-family homes would be short lived. The National Association of Home Builders estimated that this market would initially decline because of the loss of mortgage revenue bonds, but would recoup its earlier losses by the year 1990.(12) This is in sharp contrast with the impact of the proposals in multi-family homes.

The multi-family sector will receive a dramatic initial impact from which it will not recover in the near (five to ten years) future. It is anticipated that there will be a 28.0% drop in multi-family unit starts during the first year the new policies are implemented. See Exhibit 4.

A large portion of multi-family housing units are financed by industrial development bonds. These tax exempt bonds permit quality construction at a reasonable cost of capital. The removal of these incentives will have far reaching implications. Exhibit 5 shows the estimated decline in the number of starts for all housing, single-family, and multi-family construction.(13)

Construction Activity

Of particular importance to policy planners will be the impact of the previously discussed changes on the volume of construction. For the typical large scale development, the new law will have an impact on investors' returns similar to those which would be realized with a 3.5% to 4.5% increase in nominal rates. For those financed by IDBs, the effect will be similar to a rate increase of 5.5% to 6.5%.

Most of the multi-family starts are built for rent. Without the incentive offered by industrial development bonds, these starts will not be feasible

without substantial rent increases. This will be true for the 100,000 to 150,000 units financed by tax-exempt bonds.

Under the current law, in 1986 the starts for structures with five or more units is likely to be 450,000 and starts for smaller, two-to-four unit buildings, is expected to be 100,000. Of these projections, 150,000 starts of five or more units will be financed by IDBs. With the TRA 100,000 of the IDB financed units will be lost. Another 100,000 units plus 15,000 condominium units and 15,000 two-to-four unit buildings will also be lost. Thus, a total decline of 230,000 units in 1986 would be expected because of the new tax law.(14)

As can be seen from Exhibit 5, there will be a significant decline in housing starts both at the single family and multi-family level. The data also indicates that a large proportion of the decline will occur at the lower price ranges for housing financed by IDBs, and at the lower rent levels for apartments financed by IDBs. The net effect will be fewer homes and apartments for the lower income groups—those groups who so desperately need adequate housing. The number of housing starts is a key economic indicator. Normally, this indicator lags other indicators by two or three months. When the new tax law takes effect housing starts will be a leading indicator. The consumer incentives which the Administration has proposed to improve economic productivity are believed too inefficient to offset the long term major economic implications of this policy.

Impacts on Required Rents

The National Association of Home Builders constructed a simulation model to study the effects of the 1986 tax law on multi-family rents. The basis for this model was to take current rents and adjust them to allow investors to earn returns of 14% (pre-TRA

86 returns) after the imposition of the new tax provisions.

Under the current law, using market financing, a new rental unit costing \$43,000 to build would rent for \$414 to meet investor requirements (the model assumed this to be 14% after taxes with an expected inflation rate of 6%.) Considering only the provisions for capital gains, depreciation, and construction period interest and taxes, the required rent would be \$502, an increase of 21%.(15)

The effect of the financing rules changes were harder to quantify, but the maximum impact of the "at risk" rule and interest limitation will be an increase in required rent to \$530 or 28% above the current law example.

The other major impact will occur because of the loss of the Industrial Development Bond's tax free financing. In the past, many low rent (for low income families) projects have been possible only with IDB financing. The average case mentioned above would require a rent of only \$365 per month with IDB financing. There are other current benefits for low income projects such as more favorable depreciation and recapture, which would tend to reduce these rents even more, but those were not considered in this model.

Employment

The reduced number of housing starts will result in a reduction of employment in the housing industry. Unemployment will increase in both the construction area and the supplier area of the industry. See Exhibit 7.

Employment in the housing industry is not expected to fully recover through 1990. Unemployment will be "permanently" increased by 54,000 man-years because of the policy implications for multi-family housing. One estimate was that 120 jobs would

be lost for every one million dollars of reduced construction.(16)

Impact on Housing Supply

The first impact of the aforementioned provisions of the tax law change would be a decline in the construction of rental units as well as a drop in the price of existing units on the resale market. However, new construction only adds one to two percent annually to the existing supply; thus, the adjustment process for changing rents would not happen over-night. The supply would decline due to demolitions and conversions to condominiums, and the demand would show an increase not only from population growth but also from those who find home ownership too costly because of the increase in the after tax cost of home-ownership. Both of these trends will result in lower vacancy rates and eventually will lead to higher rents. It will probably take five to ten years for the total 20.0% or more increase in rents to be felt in the market place. This, of course, assumes that there will be no other factors to increase rents over that time period; but if costs of utilities, etc., increased, then this 20.0% increase will be in addition to whatever those costs would be.

Standard of Living

The standard of living for low and middle income families and for the elderly will be effectively reduced, *ceteris paribus*. The major contribution to the reduced standard of living will be the increased rents charged for the low income housing. One estimate was that rent increase of 20% to 24% over 1984 - 1985 rent levels will prevail in the low income and elderly housing market.(17)

The end result will be a lower standard of living for these families because a higher percentage of their disposable income must be spent on rent. Should the government elect not

to authorize the higher rents (rent is controlled for most of the government subsidized rental housing for low income and elderly families), the families would be forced to live in alternative units. These alternative housing units would be viewed as substandard relative to the subsidized housing, and thus further contribute to a lower standard of living.

From Exhibit 8 one can see the income spent by households currently and the projected percent of income that will have to be spent on rental housing after a 20% increase in rents is absorbed in the market. Although the share spent on rents will increase for all income groups, the shares and increases will be felt most severely by those with household incomes below \$15,000. From other Census data, this will impact 57% of the renters--those least able to afford to absorb such rent increases.

Loss of Tax Revenue

The increase in unemployment, the decrease in housing starts, and the reduction of investment incentives all imply that the changes passed will have the effect of reducing tax revenue. The intention of the law provisions is to be revenue neutral; that is, they will neither increase nor decrease tax revenues to the Treasury. However, it was interesting to note that every person or agency which presented testimony before the Senate Finance Committee, whose testimony was reviewed for this report, testified that the reduction of the real estate investment incentives will result in an immediate loss of tax revenue and that the loss will probably continue for the foreseeable future.(18)

STRAIGHT LINE DEPRECIATION

The implications of the straight line depreciation can be developed from Exhibit 9. The Exhibit presents a comparison of the straight line (27 1/2

year) and the ACRS (18 year) depreciation and present value schedules for a \$1,000 investment with inflation at 6% and a discount rate of 8%.

Even with a 6% adjustment for inflation, the straight line schedule is less desirable than the ACRS schedule when the present value is discounted at 8%. The lower the inflation rate relative to the discount rate, the less desirable straight line becomes. At five years, the present value of depreciation is 14.5% of the initial cost with straight line and 28.3% of the initial cost with ACRS, a 100% improvement under the current system. At eighteen years the present value depreciation for CCRS is 33.9% and for ACRS it is 42.7%, a 26% improvement over the straight line method.

The net effect on the investment income, as shown in Exhibit 9, will be to increase taxable income because of the shelter loss due to the difference in the depreciation charges. With these losses in deductible expenses, the after tax return to investors will decrease, which will lead to a decrease in investment dollars into the real estate market.

CAPITAL GAINS TREATMENT

Under the TRA the gain on the sale of depreciable property (i.e., buildings) will no longer be subject to long term capital gains treatment. Only the land itself, a nondepreciable asset, will benefit from the capital gains provisions of the tax law. Thus, any gain on the sale of a depreciable asset after January 1, 1986, will be treated as ordinary income which would be taxed at a maximum rate of 35%; whereas, capital gains would be taxed at from 17.5% to 20.0% maximum rates. The rationale was that by adjusting the base for inflation, much of the capital gains will be lost. In any event, the loss of this preference item would again make investing in real estate less desirable.

"AT RISK" RULES AND LIMITED PARTNERSHIPS

The "at risk" rule as adopted by the TRA will affect the amount of interest which can be deducted by investors, particularly limited partnership investors. Under current regulations all interest deductions and depreciation deductions may be proportioned by the relative share of the total amount of the limited partner's investment. Thus, both interest expense and depreciation expense flow through to these investors and produce tax free, or at least, tax reduced income. However, since most real estate mortgages are made with real estate as security, limited partners are not legally liable for the loan should any losses result; thus they are not "at risk." The TRA disallows such pro-rata deductions, and thus limited partners will lose a large tax benefit and be less likely to invest in real estate developments. The model developed by the National Association of Homebuilders finds that a 7.0% rise in rent will have to occur because of the change in the "at risk" rule to allow investors to earn a 14.0% after tax rate of return.

Of particular importance to the housing market is the rehabilitation of existing units for low income households and the elderly. Michael Liberty from the Liberty Group, Inc. of Portland, Maine, testified before the congressional hearings that limited partnerships were the prime vehicle by which he financed the renovation of 1,000 housing units in the State of Maine. The "at risk" rule will make such endeavors beyond the realm of economic feasibility in the future. Mr. Liberty is only one developer in one state; so it does not take much imagination to see the impact of this new rule nationwide.(19)

POLICY IMPLICATIONS

The economic impact of the TRA of 86 will be realized in the reduction

of housing starts for single family units, rental units, higher levels of multi-housing construction unemployment, lower standards of living for low income families, lower standards of living for elderly, and loss of tax revenues.

The combined impact of the TRA's provisions to eliminate the state tax deduction and to repeal the mortgage revenue bonds will impact the younger and low to middle income households most severely. These combined acts tend to indicate a move away from the national policy that was designed to provide an opportunity for home ownership to the blue collar, middle class worker. The price reduction in housing which might occur will not be sufficient to offset the long-term tax benefits the buyer would otherwise derive from the existing laws.

Non-subsidized housing, resulting from the elimination of industrial development bonds, will have initial impact on the elderly and low income families. A countervailing policy to offset the reduced standard of living for these groups is necessary. The reduced tax rates proposed by the administration are insufficient to offset the increased cost of housing for these affected families. Full impact of the tax decrease will have minimal impact on these income levels, who normally would be expected to pay little or no taxes because of their family size, income levels, and age. The real implication may well be defined by some as discriminatory.(20)

The reduction of tax incentives for construction and rehabilitation of rental housing will eliminate all special

incentives for investing in rental housing for young couples from low income and moderate income households and the elderly. The market may never recover from this potential loss.

CONCLUSION

There are several prevailing themes which seemed to appear evident throughout the TRA. The act which is supposed to be tax neutral was found to be far from tax neutral, mainly because tax revenues would fall. The housing industry would suffer from lower output which would have two undesirable results:

- 1) An increase in unemployment due to lower activity by contractors and suppliers,
- 2) An increase in rents both because of the need to cover higher cost and because of decline in supply relative to demand.

Higher rents and higher house prices will be felt most by those at the lower household income levels who would have to spend a larger share of their incomes on housing, and thus would have smaller shares available for other consumption. Their standard of living will be reduced. The National housing policy would appear to be moving away from one designed to benefit the working-class and the elderly. It would appear that the impact of the TRA on real estate will have decided policy implications which run counter to the goal of providing every American citizen with decent housing at a price he or she can afford.

NOTES

- 1 [Code Sec 103(b)(1)].
- 2 National Association of Home Builders, *op. cit.*, pp. 11-13.
- 3 *Ibid.*, pp. 15-16.
- 4 [Code Sec 168(c)].
- 5 [Code Sec 1201(a) as amended by '86 Act SS 311(a)].

- 6 [Code Sec 103(b)(1)].
- 7 [Code Sec 42(d)(4)] and [Code Secs 42(e)(1) and (2) as added by '86 Act SS 252(a)].
- 8 [Code Sec 469(c)(1)] and [Code Sec 469(h)(1)]
- 9 Allyn Cymrot, "Statement on Behalf of the National Multi-Housing Council Concerning the Impact of the President's Tax Reform Proposals on Rental Housing," July 16, 1985, pp. 2-3.
- 10 *Ibid.*, p. 4.
- 11 *Ibid.*, p. 1.
- 12 National Association of Home Builders, *op. cit.*, p. 1.
- 13 *Ibid.*, p. 42.
- 14 *Ibid.*, p. 41.
- 15 *Ibid.*, pp. 27-31.
- 16 Michael A. Liberty, "Testimony Before the Senate Finance Committee," Liberty Group, Inc., July 16, 1985, p. 3.
- 17 Allyn Cymrot, *op. cit.*, pp. 1, 5, 7.
- 18 In each of the testimonial statements shown in the references and notes, the consensus was that revenue would be less with the proposals than without them. See National Association of Home Builders, especially pp. 57-62.
- 19 Allyn Cymrot, *op. cit.*, pp. 6-9, and Michael Liberty, *op. cit.*, pp. 2-3.
- 20 Joseph A. Shepard, "Statement to the Committee on Finance, U.S. Senate," National Council for Rural Housing and Development, July 16, 1985, p. 8.

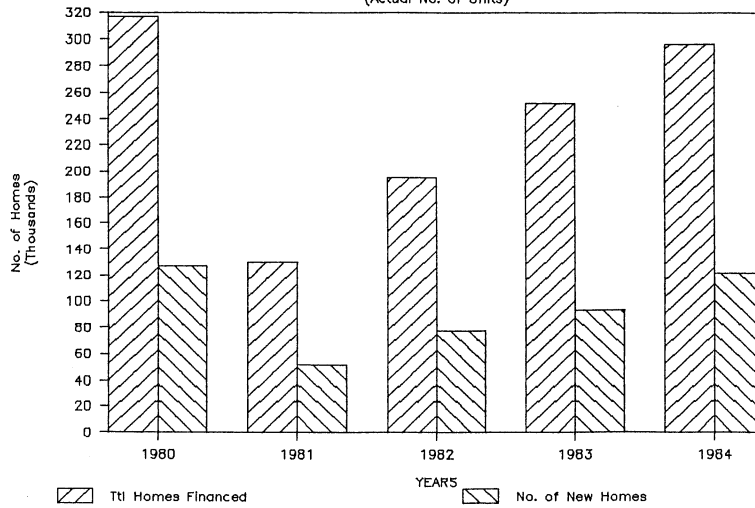
BIBLIOGRAPHY

- 1 American Council for Capital Formation: Center for Policy Research, "Main Tax Proposals Before the 99th Congress," June 10, 1985.
- 2 Allyn Cymrot, "Statement of Allyn Cymrot on Behalf of the National Multi-Housing Council Before the Committee on Finance, United States Senate," July 16, 1985.
- 3 Michael A. Liberty, "Testimony Before the Senate Finance Committee," July 16, 1985.
- 4 George E. Moody and Don P. Holdren, "Policy Implications for the Housing Industry of the President's Tax Proposal Based on Testimony Before the Senate Finance Committee," *Southern Ohio Business Review*, Fall, 1985.
- 5 National Association of Home Builders, "Impact of the President's Tax Proposal on Housing," July 1, 1985.
- 6 National Association of Home Builders, *Home Building After Tax Reform*, November, 1986.
- 7 National Association of Realtors, "The Impact of the President's Tax Proposals on Housing and Real Estate," July 16, 1985.
- 8 L.F. Payne, "Statement of the American Land Development Association to the Senate Finance Committee on The President's Tax Reform Proposal," July 16, 1985.
- 9 "The President's Tax Proposal to the Congress for Fairness, Growth, and Simplicity," May 1985.
- 10 J.D. McDonald Williams, "Statement of the National Realty Committee on Real Estate Tax Issues Contained in President Reagan's Tax Reform Proposals," July 16, 1985.
- 11 Joseph A. Shepard, "Testimony for Council for Rural Housing and Development," July 16, 1985.

EXHIBIT 1

HOMES FINANCED BY MRBs

(Actual No. of Units)

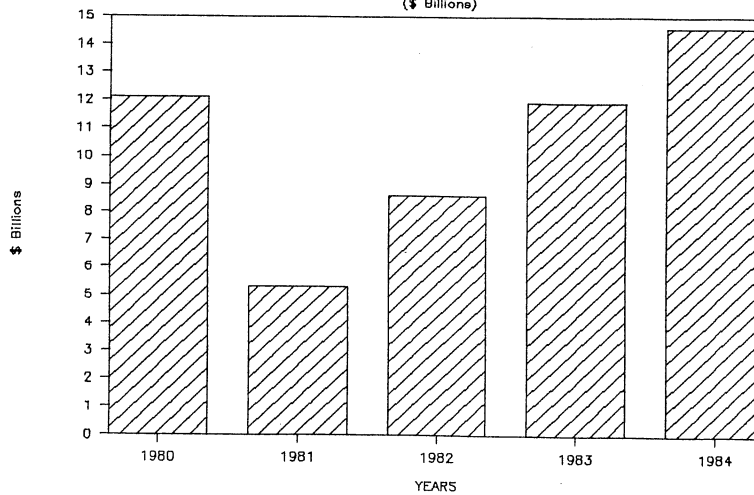


Source: Council of State Housing Agencies and National Association of Home Builders, June 20, 1985.

EXHIBIT 2

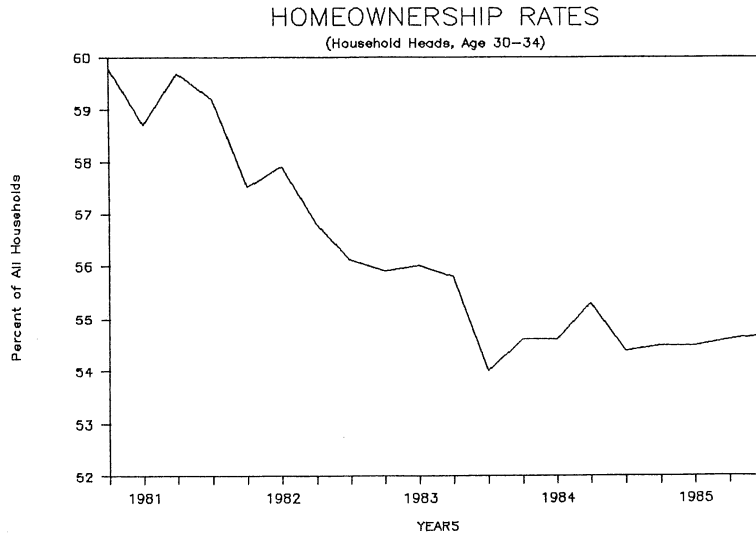
MRB FINANCED SINGLE FAMILY HOMES

(\$ Billions)



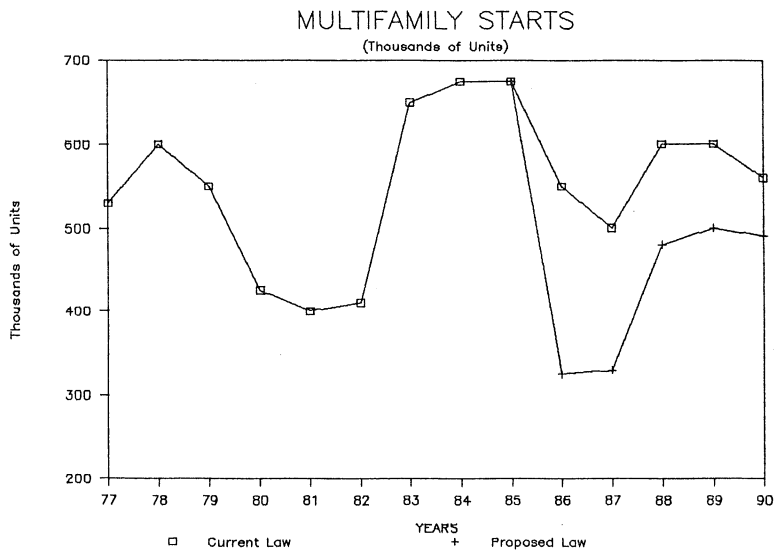
Source: Council of State Housing Agencies and National Association of Home Builders, June 20, 1985.

EXHIBIT 3



Source: National Association of Home Builders.

EXHIBIT 4



Source: Adapted from National Association of Home Builders.

EXHIBIT 5

POLICY IMPLICATIONS FOR HOUSING STARTS

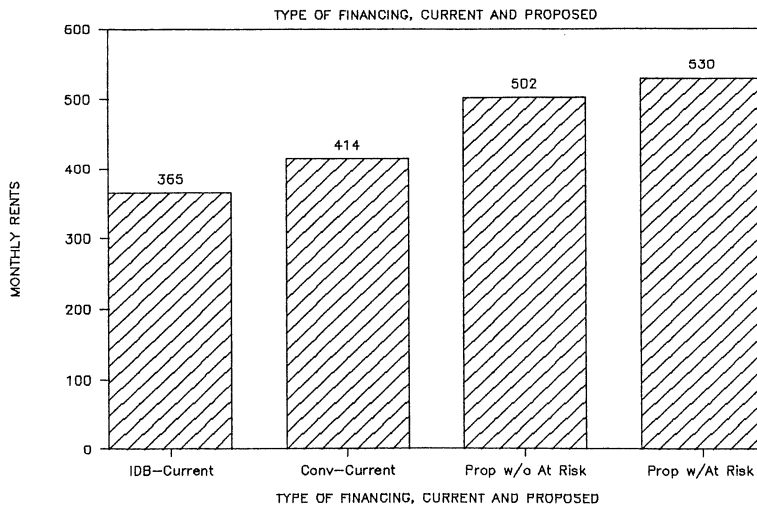
<u>Year</u>	<u>All Housing</u>	<u>Single Family</u>	<u>Multi-Family</u>
1986	- 325,000	- 95,000	- 230,000
1987	- 230,000	- 60,000	- 170,000
1988	- 160,000	- 35,000	- 125,000
1990	- 65,000	- 0	- 65,000

Number of Housing starts in 1984 = 1,749,000
 Number of Single Family starts in 1984 = 1,084,000
 Number of Multi-Family starts in 1984 = 665,000

Source: Adapted from National Association of Homebuilders, "Impact of the President's Tax Proposal on Housing."

EXHIBIT 6

IMPACT ON REQUIRED RENTS



Source: National Association of Home Builders.

EXHIBIT 7

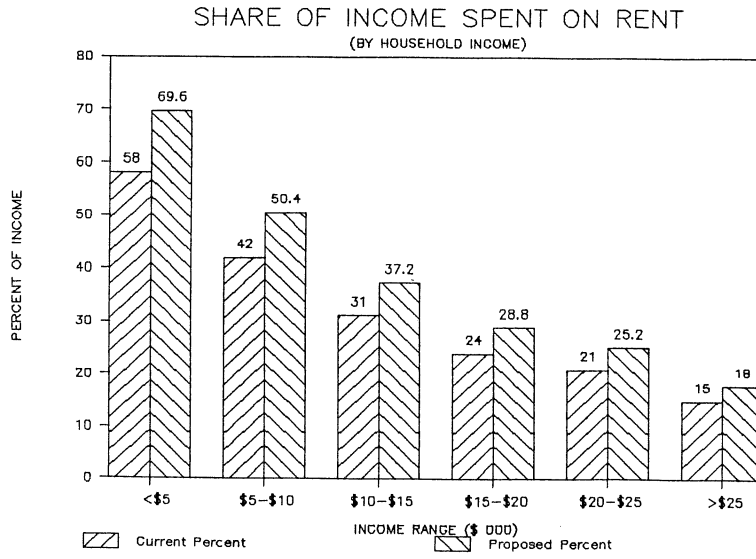
POLICY IMPLICATIONS FOR UNEMPLOYMENT
IN THE HOUSING INDUSTRY
(Thousands of Man Years)

	<u>All Housing Construction Supplier</u>	<u>Single Family Construction Supplier</u>	<u>Multi-Family Construction Supplier</u>
1986	- 133	- 60	- 73
1987	- 92	- 38	- 54
1988	- 62	- 20	- 40
1989	- 41	- 13	- 29
1990	- 21	- 0	- 21

Source: Adapted from National Association of Homebuilders, "Impact of the President's Tax Proposal on Housing," page 42.

When compared with Exhibit 5, 2.4 thousand man years of construction work will be lost for every one thousand reduction in housing starts in 1986. (1,000 man years translates to 2,000,000 man hours of work [40 hours x 50 weeks] [one man working 40 hours a week for 50 weeks] is one man year x 1,000 men = 2,000,000 man hours.)

EXHIBIT 8



Source: National Association of Home Builders.

EXHIBIT 9

COMPARISON OF STRAIGHT LINE (27½ YEARS) AND ACRS DEPRECIATION
(Inflation Rate = 6%)
Per \$1,000 of Investment

Year	STRAIGHT LINE		PV of Total at 8%	ACRS		PV of Total at 8%
	Depreciation Annual	Total		Depreciation Annual	Total	
1	36.36			97		
2	36.36			88		
3	36.36			79		
4	36.36			72		
5	36.36	<u>182</u>	<u>145</u>	65	<u>401</u>	<u>283</u>
6	36.36			58		
7	36.36			54		
8	36.36			48		
9	36.36			44		
10	36.36	<u>364</u>	<u>244</u>	44	<u>648</u>	<u>372</u>
11	36.36			44		
12	36.36			44		
13	36.36			44		
14	36.36			44		
15	36.36			44		
16	36.36			44		
17	36.36			44		
18	36.36	<u>655</u>	<u>339</u>	44	<u>1000</u>	<u>427</u>
19						
20						
21						
22						
23						
24						
25						
26						
27		<u>1000</u>				

Percent Differences in Total Present Value if held through:

5 years: 195%
10 years: 152%
18 years: 126%

Source: Adapted from National Association of Home Builders