tax and financial ISSUES

The Withdrawal of Tax Subsidies for Residential Real Estate

Background

In the early 1980s interest rates were in double digits, and the real estate industry was in a state of disarray. The response of the Reagan administration was to allow 15 year accelerated depreciation of real estate. This sparked a construction and tax shelter syndication boom that continued into 1986.

The Tax Reform Act of 1986 pulled the rug out from under the syndication business via the enactment of the passive activity loss rules. This led to a collapse in the pricing of commercial and multi-unit residential real estate as buyers did not have tax advantages comparable to the sellers.

Changes to the Internal Revenue Code currently being discussed in the House-Senate conference committee are eerily reminiscent of what happened 30 years ago.

Real estate tax subsidies in play

Both the House and Senate versions of the tax act that has gone to conference committee have provisions that are very unfavorable to the pricing of residential real estate.

• Repeal of interest deductions on 2nd homes (House bill only)

Existing law allows for interest deductions related to $1.1 million of indebtedness secured by two personal residences. Starting in 2017, interest deductions would be confined to primary residences.

• Limitation of amount of qualifying mortgage debt (House bill only)

Taxpayers are currently allowed interest deductions related to $500,000 of mortgage debt where the proceeds were used to acquire or improve a residence ($1,000,000 on a joint return). The tax act limits the qualifying indebtedness to $250,000 ($500,000 on a joint return).

Interest on debt incurred before 11/2/2017 up to $1,000,000 for the acquisition or improvement of a primary residence can continue to be deducted. There are restrictions on the ability of homeowners to refinance grandfathered debt.

• Interest deductions on $100,000 of home equity debt are eliminated. (House and Senate bills)

A loan is considered home equity debt if the proceeds are not used to purchase or improve a residence.

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Under existing law there is a 2 of 5 years ownership and occupancy requirement. That is being extended to 5 of 8 years. Only one qualifying sale can occur in a 5-year period.

For the first time, high income taxpayers are precluded from taking the exclusion. If a taxpayer's average Adjusted Gross Income from the current and prior 2 years exceeds $250,000 ($500,000 for a joint return), the maximum exclusion is reduced dollar-for-dollar by any excess.

- Beyond the repeal of specific deductions, the expansion of the standard deduction will act to eliminate much of the tax benefit of itemized deductions that remain.

Buyers will be quick to realize that their housing costs will be paid in after tax dollars.

The pricing of residential real estate will be affected by the withdrawal of these tax subsidies.

This rollback is rather abrupt. These deductions have been in place for a long time.

- The deductions for mortgage interest and real estate taxes have been around since the age of the dinosaurs. Only starting in 1987 were interest deductions restricted to two residences.

- The $250,000 exclusion of gain on sale of a principal residence ($500,000 on a joint return) was enacted in 1997.

All of these tax benefits have had a salutary effect on the pricing of residential real estate. A rollback will clearly have negative consequences for pricing. The unanswered question is "How much?"

Look for price erosion in the following areas.

- Real estate located in states with high income taxes. It will be unattractive for taxpayers to have residency in these states.

- Communities with high real estate taxes. This would be homes in suburbs with expensive school districts. Downsizing will occur sooner rather than later.

- Places with a high percentage of second homes.

- Communities with a concentration of high priced homes that cannot be financed with tax deductible interest.

This is prime time for the disciplined buyer.