Real Estate Investment

The Ground Rules—and Incentives—For Investing in Real Estate Will be Different in the ’80s

The Economic Recovery Tax Act (ERTA) of 1981, together with tax legislation passed in 1980, has dramatically changed the incentives for investment in income-producing properties, according to Allen Cymrot, President of The Robert A. McNeil Corporation, one of the nation’s leading real estate investment and management firms.

“ERTA has received much publicity, but its significance to real estate investors in particular has not yet been fully understood or appreciated,” said Mr. Cymrot. “Likewise, investors are just beginning to realize the potential impact of the 1980 legislation that liberalized the rules governing installment sales of real estate and the ‘unrelated business income’ tax. The combination of these tax laws will be a driving force behind a very promising market in the 1980’s.”

“At the same time,” he added, “two other economic forces have continued to enhance the bright prospects for investors: the relatively low cost of purchasing existing properties and persistently high rates of inflation.”

In elaborating on the significance of the ERTA, Mr. Cymrot emphasized not only the reductions in maximum tax rates but also the switch to depreciation over a 15-year fixed period. “The new act,” he noted, “makes real estate an inherently more valuable investment, by providing more aggressive depreciation schedules and, more importantly, by eliminating the depreciation period as a matter of debate with the IRS. New and used residential property will be depreciated over 15 years on a straight-line or accelerated basis. Also, for the first time, accelerated depreciation has been allowed for commercial property.

“Often overlooked, however, is the fact that the depreciable life of a property is now audit-proof for the first time. Previously, an owner would estimate the depreciation according to what he thought the life would be. Apartment owners generally chose 25 to 30 years, while a longer period was designated by owners of commercial buildings. Naturally, such a wide variation did not add to the credibility of our industry, and it automatically placed property owners in an adversarial relationship with the IRS-hardly a way in which to stimulate investment in real estate.

“Now, however,” Mr. Cymrot continued, “depreciable lives are audit-proof. Investors can depreciate property over 15 years and the government cannot attack that depreciable life for any reason.

“ERTA’s reduction of the individual and capital gains tax rates is a major development as well,” Mr. Cymrot said. “The investor is in a substantially improved position after the sale of an investment property, because (1) individual tax rate reductions totaling 23% take effect on a step basis beginning in 1981 and extending into 1984, (2) the maximum tax rate will be reduced from 70% to 50% in 1982, and (3) the maximum capital gains rate drops to 20% effective June 9, 1981. Further, the investor will be benefiting from the new recapture provisions, which assign to him a far smaller recapture liability than in the past, or perhaps not any at all, if a transaction is structured correctly.”

Two Vital Elements . . .

The passage of the ERTA, Mr. Cymrot stated, “has obscured two pieces of legislation which were enacted in 1980 and which are critically important to the promising outlook for real estate investment throughout the decade. One was the Installment Sales Revision Act, which substantially changed the rules governing installment sales of real estate. This act has improved the ability of the parties to a transaction to gain greater control of the tax ramifications of a sale, thereby increasing the liquidity of real property.

“Previously,” Mr. Cymrot said, “in order to receive installment sales treatment, no more than 30% of the selling price could be received in the year of sale, and payments had to be received in at least two tax years. Now, however, the 30% requirement has been eliminated altogether, as has the two-year rule. Under the present act, a lump-sum payment received in the year following the year of sale can qualify for the installment method of reporting gain. Effectively, then, the contracting parties have much more flexibility in structuring their transaction.”

The other key development last year was an amendment to the tax code affecting qualified retirement plans, Mr. Cymrot said. “The potential impact of this change is awesome indeed, since this nation’s pension fund assets are estimated to be $700 billion, and so far only 1 to 2% of these assets has been invested in real estate, largely because of the tax restriction that had existed until late 1980.

“Prior to the amendment to the tax code, Keogh, corporate pension and profit-sharing plans, and other retirement funds-to the extent they earned ‘unrelated business income,’ were subject to an ‘unrelated business income tax.’ Income or other gain earned from a mortgaged portion of a real estate investment was unrelated

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business income and, thus, was subject to the unrelated business income tax. As a result of the amendment, however, qualified retirement plans can invest in real estate on a leveraged basis, with certain exceptions, and still retain their tax-exempt status.

"From all indications," Mr. Cymrot stressed, "there is great pressure on these retirement plans to enter the marketplace, and their presence is likely to unleash a tremendous new demand for investment properties-but without a correspondingly greater supply of such properties, as a result of the lag in construction activity. That imbalance in the supply-demand equation is an important element in the investment outlook for the 80's."

Ability to Pay . . .

Commenting on the other driving forces in the real estate marketplace, McNeil's President noted that single-family dwellings are increasingly outstripping the ability of an average family to afford them, while multi-family completions continue to decline. Through the first nine months of 1981, he said, the total number of completions in buildings of five units or more was 242,300, a 27% decrease from the 333,400 completions for the same period in 1980.

"It is all too apparent," Mr. Cymrot said, "that in the foreseeable future there will be continually growing pressure on the American public to find decent, affordable rental housing. It was such a demand for product that created the countless investment opportunities that existed in the 1970's.

"As we look ahead into the 80's, the cost of constructing rental units exceeds the cost of buying existing units. In order that the cost of construction can be justified, there is intensifying pressure to increase rents and thereby increase the income stream that a property produces. The average family will have a far greater ability to absorb rent increases than to buy a new house, and the larger income stream will benefit the investor as well as stimulate new construction."

Citing inflation as another major factor in the prospects for real estate investment in the years ahead, Mr. Cymrot noted that it "has shown a tendency to moderate, but that there remains a long-term outlook for significantly high levels of wage and price increases. Further, the ever-larger projections of the federal government's budget deficits remain an important variable, as do the so-called off-budget deficits, involving government credit programs for loan guarantees, direct loans, and borrowing by public agencies.

"From available evidence, off-budget credit allocations, which have exceeded the budget deficits for years, mainly support inefficient economic activities and thereby hurt productivity and economic growth. Thus, the off-budget items not only are competing for scarce capital in the credit markets and helping to keep interest rates high but also are contributing to inflation. So far, only a small chunk has been taken out of the huge structure of off-budget demands, as the government's attention has directed toward on-budget items.

"In short, the country may well be in the process of stabilizing inflation, but it is likely to stay at high levels relative to the historical experience of the United States, and this will expand the opportunities open to the investor," Mr. Cymrot said.

The Robert A. McNeil Corporation, headquartered in San Mateo, California, specializes in the acquisition of office buildings, apartment complexes, and shopping centers in the fastest-growing areas of the United States. Since 1965, the company's purchases on behalf of its 68 investment groups or affiliated limited partnerships have amounted to over $1,096,000,000 with 212 properties acquired in 26 states and 116 cities.

The McNeil Corporation manages a total of 167 properties representing more than 37,000 residential units and over 4.2 million square feet of commercial space in 26 states and 92 cities.