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Technical Report

The 1986 Tax Reform Act: Potential Effects on Real Estate Investors

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Summary

The 1986 Tax Reform Act significantly affected the status of real estate as a tax sheltered investment. Because tax benefits were an important component of total returns from income-producing real estate prior to this act, its immediate effect is to reduce after-tax returns from real estate. If market values fall and rents rise, however, after-tax returns from income-producing real estate should be sufficient to attract individual investors. In addition, the 1986 Tax Reform Act should attract more of pension funds and foreign investors to investment real estate.

Prior to the passage of the 1986 Tax Reform Act, income-producing real estate was packaged to appeal to individual investors seeking the benefits of tax shelter and rapid appreciation. This report evaluates the impact of the 1986 Tax Reform Act on individual real estate investors and real estate returns and considers the possibility that the act will make real estate investment more attractive to pension funds and foreign investors than it is at present.

Real Estate: It *Was* a Tax Sheltered Investment

Real estate investment by individual investors escalated sharply in the early 1980s. One measure of this escalation was their purchase of limited partnership interests in public syndications. Syndications allow individuals to invest in a variety of property—residential buildings, office space, retail shopping space, hotels and resort properties—and, therefore, enjoy all the benefits of owning a diversified real estate portfolio. Data published by Robert A. Stanger & Co. indicate limited partnership interests sold in public syndications increased from $1.6 billion in 1981 to $8.37 billion in 1986.[1] Although this is only one of the ways individuals invest in real estate, these purchases are a general indicator of investor interest in real estate. The Economic Recovery Tax Act of 1981 was a principal stimulant of this escalation as individual investors sought to take advantage of the expanded real estate tax benefits provided by the legislation.

Many investments depended heavily on borrowed money to magnify the benefits of tax shelter and expected appreciation for the individual investor. Because investors could deduct interest and depreciation expense on the entire property and enjoy all the benefits of the property's appreciation even though their equity investment might be quite small, their return on equity was enhanced. This use of debt to magnify the rate of return on equity is known as *financial leverage.*

Income-producing real estate provided tax shelter through the deductibility of interest and depreciation expense from a property's net operating income. In 1981 the allowable rate of depreciation was increased greatly; real property could be depreciated in 15 years instead of 25 or more (prior to 1981 the exact number of years was dependent on a property's useful life). Although the period was increased to 18 years in 1984 and to 19 years in 1985, the rate of depreciation was still quite rapid, particularly when accelerated depreciation was used. When the large depreciation expense was combined with the interest expense, income-producing real estate investments usually generated negative taxable income as illustrated in Table 1. Investors used these losses to reduce income tax liability on other income. Because the property was not expected to decrease in value, investors

Table 1. An Illustration of Tax Shelter and Financial Leverage Pre-1986 Tax Reform Act

	75 Percent Debt	90 Percent Debt
Project's net operating income	$246,240	$246,240
Less interest	-220,500	-264,600
Less depreciation	-125,000	-125,000
Project's taxable income	-99,260	-143,360
Investor's taxable income w/o project	250,000	250,000
Times tax rate	x .50	x .50
Tax due without project	125,000	125,000
Investor's taxable income w/o project	250,000	250,000
Less project's loss	-99,260	-143,360
Investor's taxable income with project	150,740	106,640
Times tax rate	x .50	x .50
Tax due	75,370	53,320
Tax due w/o project	125,000	125,000
Less tax due with project	-75,370	-53,320
Tax saved	49,630	71,680
Net operating income	246,240	246,240
Less mortgage payment	-232,110	-278,532
Before-tax cash flow	14,130	-32,292
Plus tax saved	49,630	71,680
After-tax cash flow	63,760	39,388

were not anticipating an actual loss; the only effect of the negative taxable income was to provide tax shelter.

During this period, some investments were made in income-producing properties that had negative before-tax cash flow from operations, often caused by the combined effects of high debt service and low occupancy rates. Before-tax cash flow is equal to the net operating income less the mortgage payment; when before-tax cash flow is negative, the mortgage payment is greater than the net operating income. In such cases, the investment must be fed by the investor. Investors were willing to accept projected negative before-tax cash flow because of the significant tax benefits that were expected. In fact, when the tax benefits were added to the negative before-tax cash flow, after-tax cash flow was expected to be positive. An example of this is presented in the 90 percent debt column of Table 1. Of course, positive before-tax cash flow would have been preferable, and many properties did generate positive before-tax cash flow. Most of these investment properties were highly leveraged and were expected to produce high after-tax returns to equity.

Because of the emphasis on tax benefits, which appeared to be automatic, and because there were similar expectations about property appreciation, sometimes individual investors and syndicators analyzed the actual property only superficially. Data concerning the supply and demand for space, rents, vacancy rates, operating expenses and the actual rates of property appreciation for surrounding property often were ignored.

The conditions of the early 1980's that fueled individual real estate investment expansion changed significantly by late 1986. Because of the extensive unneeded development that took place in some areas during the early 1980s, many lenders were reluctant or were unable to finance property development and investment. Also, the prospect for property appreciation was reduced greatly by the excess supply of income properties in many areas. In addition, the 1986 Tax Reform Act significantly affected the status of real estate as a tax-sheltered investment.

Effect on Individual Real Estate Investors

This section is not intended to be a comprehensive review of all the provisions of the 1986 Tax Reform Act and its impact on the possible transactions of the individual real estate investor. The transition rules bridging the gap between the old and the new legislation likewise are of no concern in this report. **Rather, conclusions are drawn about the more general effects of the act on undertaking additional real estate investments by individuals.** First, how has the act affected the **need for tax shelter?** Second, how has the act affected real estate's **ability to produce tax shelter?**

Need for Tax Shelter

Investors seek tax shelter to offset the effects of high tax rates; thus, the framers of the 1986 Tax Reform Act expect the reduction in maximum rates from 50 percent to 28 percent to reduce the demand for tax-sheltered investments. The reduction in maximum rates in 1981 might have had a similar effect except for two reasons. First, although the marginal tax rate was reduced from 70 percent to 50 percent, 50 percent was still a substantial tax rate. Second, the liberalization of depreciation allowances for income-producing real estate provided a substantial increase in tax shelter benefits from depreciation; this attracted investors.

Ability of Real Estate to Produce Tax Shelter

Two provisions have the most potential impact on real estate as a tax shelter. First, real estate operating losses cannot be used to offset investors' other taxable income. Second, the preferential taxation of capital gains is eliminated. Of decidedly less importance are the changes in the allowable rate of depreciation and changes in the at-risk rules.

Passive Investment Income

Income is segregated into active trade or business income, passive investment income and portfolio income. All real estate income from operations or gains is classified as passive investment income. If the property produces an operating tax loss after the deduction of interest and depreciation, the loss can be used only to offset positive income from other passive investments. If the real estate investor has no other passive investments that produce positive income, the loss can be carried forward and used to offset positive passive income in the future, or it can be written off when the property is sold. Thus, the project may not produce any taxable income for a number of years but neither will it produce tax shelter. **Unless an investor has properties that are producing taxable income, investing in a property that produces losses will have little attraction. Prior to the 1986 Tax Reform Act, the opposite was true.**

There is an exception to the foregoing effect for some investors. Annual operating losses on rental real estate of up to $25,000 can be used to offset active trade or business income for investors with adjusted gross incomes of up to $100,000. The offset is reduced 50 cents for each $1 more than $100,000 of adjusted gross income; thus, for investors with adjusted gross incomes of $150,000 or more, there is no allowable offset. Investors who use this exception must be actively engaged in the management of the rental real estate; they may not be limited partners and must own at least a 10 percent interest in the rental real estate.

Taxation of Capital Gains

The 1986 Tax Reform Act ends the preferential tax treatment of capital gains. Previously, 60 percent of the capital gain was excluded from taxation; with a maximum marginal tax rate of 50 percent, the maximum effective capital gains tax rate was 20 percent. Presently, the maximum marginal tax rate is 28 percent, but 100 percent of the capital gain is taxed. This is not the whole story, however. The prior capital gains tax treatment of real estate allowed current income to be converted to capital gain; in this way, the higher rate of tax on income was postponed until a later time and then taxed at a lower rate.

This is best illustrated by the data in Table 2. Assume the property is purchased in an all-cash transaction and that it has the following cost: $100,000 land and $900,000 depreciable building. During a holding period of five years, the property is depreciated by the straight-line table percentages.

Prior to the 1986 Tax Reform Act, if the marginal tax rate was 50 percent, $22,500 in tax was saved the first year and $27,000 in the second through the fifth years—a total of $130,500 during the five years. Assume the property was sold for $1 million at the end of the fifth year. Note that the selling price is equal to cost; there was no increase in price during the holding period.

Thus, the depreciation reduces the tax on current income during the holding period by $130,500, but, because the depreciation results in a capital gains tax of $52,200, the net tax saved was $78,300. In addition to the savings from the lower capital gains tax, the postponement of taxes also provides a time value of money benefit.

If one compares this with another investment—common stocks, for instance—the advantage of real estate is obvious. Holding a common stock for five years and selling it at the same price for which it was purchased results in no capital gains tax, but the common stock does not generate a tax saving during the holding period either.

Under the 1986 Tax Reform Act, the tax rate on income and capital gains is the same. If the property produces a sufficient taxable income, the reduction of taxes by depreciation during the holding period will be offset by the tax on the capital gain at the end of the period. This is demonstrated in Table 3 using the same assumptions as in Table 2. If the marginal tax rate is 28 percent, $7,661 in tax is saved in the first year and $7,988 in years two through five—a total of $39,614 during the five years. As in Table 2, assume the property is sold for $1 million at the end of the fifth year. In this example, note that the tax saved during years one through five is exactly equal to the amount of capital gains tax at the end of the fifth year. There will, of course, continue to be a time value benefit.

Other Changes

The 1986 Tax Reform Act increased the period during which real estate must be depreciated and eliminated the use of accelerated depreciation for real estate. The depreciable period was increased from 19 years to 27.5 years for residential real estate and to 31.5 years for non-residential real estate. The impact of this reduction should not be great in the short run because the major benefit of the former high rate of depreciation was the negative tax-

Table 2. Conversion of Current Income to Capital Gains, Pre-1986 Tax Reform Act

Year	Net Operating Income ($)	Depreciation ($)	Taxable Income ($)
1	100,000	45,000	55,000
2	100,000	54,000	46,000
3	100,000	54,000	46,000
4	100,000	54,000	46,000
5	100,000	54,000	46,000

Total tax saved in years one through five is $130,500.

Selling price	$1,000,000
Adjusted tax basis	739,000
Capital gain	$ 261,000
Effective tax rate	.20
Capital gain tax	$ 52,200
Total tax saved in years one through five	$130,500
Capital gain tax at sale	52,200
Net tax saved	$ 78,300

Table 3. Impact of the 1986 Tax Reform Act on the Conversion of Current Income to Capital Gains

Year	Net Operating Income ($)	Depreciation ($)	Taxable Income ($)
1	100,000	27,360	72,640
2	100,000	28,530	71,470
3	100,000	28,530	71,470
4	100,000	28,530	71,470
5	100,000	28,530	71,470

Total tax saved in years one through five is $39,614.

Selling price	$1,000,000
Adjusted tax basis	858,520
Capital gain	$ 141,480
Effective tax rate	.28
Capital gain tax	$ 39,614
Tax saved in years one through five	$39,614
Capital gain tax at sale	39,614
Net tax saved	-0-

able income that it generated. Had the higher rate of depreciation been maintained, losses would have to be carried forward. Of course, if real estate provides higher amounts of taxable income over time, depreciation still can shield the project's income from taxation.

The at-risk rules concern the deduction of losses and, except for real estate, disallow deducting losses against other income unless the investor's funds are at risk. Previously, the real estate investor could use non-recourse financing from any source—lenders, sellers and others—and deduct all interest and depreciation. Non-recourse financing means that the lender does not have any recourse against the borrowers in case of non-payment of the loan; the lender's only recourse is against the property. If a loss resulted, the investor could use it to shelter other income despite the lack of risk. The 1986 Tax Reform Act requires that non-recourse financing be provided by a qualified third party—i.e., the lender must be in the business of lending—if the investor is to be considered at risk.

This change may affect some properties whose resale is dependent on seller financing, but in general the impact of the provision should not be significant. Because losses from passive investments cannot offset other income, they must be carried forward until there is taxable income from passive investments to offset or the property is sold. On the other hand, the loss from a property financed by an unqualified lender must be put in a suspense account until the property is sold. These seem to be rather similar in their effect and, therefore, the provision would not appear to be a significant factor in the investment decision.

Impact on Real Estate Investmest Returns

The 1986 Tax Reform Act has removed the tax shelter benefits of real estate for individual investors. The effect of these changes on the structure of real estate returns can be studied by comparing the results of discounted cash flow analyses for a proposed investment under both the old and the new law.

For this analysis of a proposed investment, a non-residential income-producing property is used. Other assumptions are shown in Table 4. These assumptions are intended to reflect market conditions prior to the adoption of the 1986 Tax Reform Act. For both pre- and post-1986, these assumptions result in a positive before-tax cash flow except when 90 percent of cost is financed as reported in Table 5. For pre-1986, these assumptions generate a negative taxable income except when 100 percent equity financing is used; however, a positive after-tax cash flow is generated for all years. For post-1986, these assumptions generate a positive taxable income for 100 percent and 50 percent equity financing and a negative taxable income when 75 percent and 90 percent of the total cost is financed with borrowed funds. At 90 percent financing, the post-1986 results generate both a negative before-tax cash flow and a negative after-tax cash flow except in year five. The positive rate of return with 90 percent financing results from the project's appreciation.

The data reported in Table 5 reveal that expected after-tax internal rates of return (IRR) are reduced by the effects of the 1986 Tax Reform Act, holding all other variables constant; there is no effect on the before-tax IRR. **Furthermore, as a result of these changes in the tax law, after-tax returns are less than before-tax returns—a condition quite unlike that prevailing under the previous tax law.** An extension of this result is that a positive after-tax cash flow cannot be achieved without a positive before-tax cash flow—

Table 4. Assumptions Used in Table 5 Calculations

Cost of land	$300,000	
Building	2,500,000	
Total cost	$2,800,000	
Financing terms:		
Interest rate	10.5 percent	
Term	30 years	
Loan amounts:		
$2,520,000	-	90 percent of total cost
2,100,000	-	75
1,4000,000	-	50
0	-	0
Operating data:		
Annual gross rent	$410,400	
Vacancy rate	5 percent	
Annual operating expenses	$143,640	
Growth rates:		
Gross rent	4 percent	
Operating expenses	4 percent	
Resale assumptions:		
Holding period	5 years	
Capitalization rate	8.8 percent	
Tax rates:		
Pre-1986	Marginal tax rate	50 percent
	Capital gains tax rate	20 percent
Post-1986	Marginal tax rate	28 percent
	Capital gains tax rate	28 percent
Depreciation:		
Pre-1986	Straight line (19 years)	
Post-1986	Straight line (31.5 years)	

Table 5. Rate of Return Calculations for a Real Estate Investment Calculated with Pre-1986 and Post-1986 Tax Laws

Loan/cost ratio (percent)	0	50	75	90
Pre-1986 Tax Reform Act				
Before-tax IRR (percent)	12.07	13.45	15.78	20.66
After-tax IRR (percent)	8.68	11.85	17.55	31.47
Positive BTCF	yes	yes	yes	no
Positive taxable income	yes	no	no	no
Positive ATCF	yes	yes	yes	yes
Post-1986 Tax Reform Act				
Before-tax IRR (percent)	12.07	13.45	15.78	20.66
After-tax IRR (percent)	8.97	10.28	12.22	16.18
Positive BTCF	yes	yes	yes	no*
Positive taxable income	yes	yes	no	no
Positive ATCF	yes	yes	yes	no*

*Yes in year five

Table 6. Rate of Return for Real Estate Investment Post-1986 Tax Reform Act

Loan/cost ratio (percent)	0	50	75	90
Post—1986 Tax Reform Act Using Assumptions from Table 4				
Before-tax IRR (percent)	12.07	13.45	15.78	20.66
After-tax IRR (percent)	8.97	10.28	12.22	16.18
Positive BTCF	yes	yes	yes	no*
Positive taxable income	yes	yes	no	no
Positive ATCF	yes	yes	yes	no*
Post-1986 Tax Reform Act Using a Project Cost of $2,520,000 and Year One Gross Rent of $451,440				
Before-tax IRR (percent)	18.98	27.01	43.55	55.67
After-tax IRR (percent)	14.39	21.30	36.45	47.53
Positive BTCF	yes	yes	yes	yes
Positive taxable income	yes	yes	yes	no**
Positive ATCF	yes	yes	yes	yes

*Yes in year five

**Yes in years four and five

tax shelter no longer exists. Finally, the data in Table 5 indicate that financial leverage still works: **leveraged returns are greater than unleveraged returns.** As reported in Table 5, there is no change in the before-tax IRR for the project when, except for the changes in the tax law, all variables are held constant.

The foregoing analysis was carried out with the assumption that there would be no market response to the changes brought about by the 1986 Tax Reform Act—prices and rents will remain unchanged despite the act's effects on real estate. The analysis assumes investors will simply accept the lower return brought about by the changes in the tax law or leave the market. If, however, the assumed facts are reasonable for the market prior to the 1986 Tax Reform Act, the after-tax rate of return in the post-1986 Tax Reform Act market is low, given the rate of return available on other less risky investments. By extension, therefore, rational investors will leave the market.

Another possibility is that there will be a market response, and real estate yields will rise because of market conditions. In markets with much vacant space and little demand for the properties, market values should adjust downward even if the 1986 Tax Reform Act had not been adopted. In time, however, the space market should tighten and bring about rising rents. The combination of these two expectations should result in an increase in the properties' after-tax returns. A similar conclusion was reached by Brueggeman and Thibodeau in their article "Real Estate Returns and Market Responses to 1986 Tax Reform"[2] and by Follain *et. al.* in their article "The Impact of the 1986 Tax Reform Act on Real Estate."[3]

To test the effect of market changes on the rate of return, assume that property values decline 10 percent and rents increase 10 percent. An investment made after these changes take place will generate a substantially higher expected rate of return under the terms of the 1986 Tax Reform Act than the investment assumed in Table 4. A comparison of the expected rate of return for the investment assumed in Table 4 and the expected rate of return after decreasing the cost 10 percent and increasing the rent 10 percent is reported in Table 6. The highly leveraged returns increased dramatically, but because that degree of financial accommodation is not readily available these results are not likely to be achieved. The rate of return generated when no debt and 50 percent debt are used is sufficiently increased, however, to be reasonable compared to other investments.

Potential Effect on Individual Investors, Pension Funds and Foreign Investors

The combination of the 1986 Tax Reform Act and a general oversupply of commercial real estate in many areas can be expected to significantly change the investment real estate market. How might this combination influence the attitude of particular types of investors toward the U.S. commercial real estate market?

Individual Investors

Wealthy individual investors will continue to invest if the after-tax yield is sufficient relative to the yields of alternative investments. And, if real estate's after-tax yield is attractive, an additional set of individual investors may be attracted to the market. According to a report in the *The Wall Street Journal,* public sales of real estate limited partnerships were at record levels during the first quarter of 1987 as syndicators "recast their products for middle class investors rather than wealthy individuals seeking tax write-offs. . . . The public partnerships, which can be sold in units as small as $1,000 to individuals with annual incomes as low as $25,000, have been redesigned to carry less risk than in the past. Generally, they don't use as much leverage as before."[4]

But, the investment decision will require a different approach. **In the past, many individual investors acted as if they did not believe there was a need to evaluate carefully the investment merits of properties in which they were investing substantial amounts of equity.** Perhaps this was because the principal expected benefits were, first, tax shelter which was "guaranteed" by the government and, second, appreciation which to many seemed to be equally assured. Furthermore, in those cases involving the syndication of new developments, commercial banks often were financing a major portion of the development cost; the equity investors believed these lenders were knowledgeable about the property's worth. In those cases involving existing properties, lenders previously had advanced funds on a nonrecourse basis; this seemed a reasonable indication of the property's merit. Now, the tax shelter characteristics of real estate have been eliminated, many properties have declined in value rather than increased as expected and the attitude of commercial banks and permanent lenders toward financing the development of new and existing properties has hardened.

As a result, the focus of investment analysis now must shift to property economics. This involves answering questions such as: Is there a demand for the space? How much rent will the project produce? What are the expected operating expenses and how much net operating income will the project generate? Given current market conditions and lending requirements, how large a loan will the net operating income support? And, given the estimated cost of the project, can the property be financed? Answering such questions is difficult for persons who are not real estate professionals. And even if individuals rely on the advice of professionals, their decision to invest will be much less straightforward than when it largely depended on understanding the effect of financial leverage on tax shelter and a high property appreciation rate. **Although the recast public limited partnerships currently are being sold in record amounts, the long-run investment performance of the syndications depends on the properties' underlying quality, and this has not yet been established. Until it is, the continued participation of individual investors in the investment real estate market is in doubt.** Furthermore, the expected performance of alternative investments relative to real estate will play a role; if, for example, investors expect common stocks to provide a greater return than real estate, they will prefer common stocks to real estate.

Pension Funds

Other investors such as pension funds could be attracted to the market in greater numbers than at present and could supplement the flow of investment funds to real estate. Pension funds currently invest in real estate, but their activities have been inhibited for several reasons.

> (R)eal estate investments have traditionally been structured to make maximum use of leverage and to provide sizable tax shelter benefits to taxpaying investors. Since pension funds are tax-exempt and cannot take advantage of tax shelter benefits, real estate in the 1970s appeared overpriced to them because the price reflected the capitalized tax benefits that would accrue to taxable entities. That is, pension funds expected to be outbid by taxable investors who could use real estate tax benefits to increase their after-tax return. Moreover, pension funds have generally bought properties

> on an all-cash basis; thus, they have not been able to enjoy the return-magnifying effects of positive leverage. It is important to note that there are several reasons why pension funds have tended to avoid leveraged investments: First, they had plenty of cash; second, being very conservative and risk-adverse investors, they feared the impact of negative leverage on portfolio performance; and third, until late 1980 they were subject to an unrelated business income tax on the income generated by leveraged investments (properties purchased using debt) under Section 514 of the Internal Revenue Code. With the 1980 tax law change, however, a disincentive for pension fund investors to use leverage in real estate purchases has been removed.[5]

The changes brought about by general market conditions and the 1986 Tax Reform Act could result in increased interest in income-producing real estate by pension funds. As already shown in this report, the result of the 1986 Tax Reform Act is that properties will not be attractive investments unless they produce taxable income and that before-tax returns will exceed after-tax returns. **Properties valued on the basis of before-tax returns will be more attractive to the tax-exempt pension funds than to taxable investors.** The 1986 Tax Reform Act eliminates a principal cause of the lack of interest by pension funds in real estate—**taxable investors can no longer add tax benefits to the before-tax return to outbid them for real estate.** And, as the data reported in Table 6 indicate, the unleveraged before-tax return is only slightly less than the 50 percent leveraged after-tax return. This suggests that the advantage of leverage previously possessed by the individual investor has been much reduced by the 1986 Tax Reform Act. Because pension funds prefer nonleveraged investments, they will be able to bid almost equally with individual investors who want to leverage their investments. Furthermore, individual investors may find it more difficult to obtain debt financing. In short, it appears that the tax-exempt pension funds can now compete if they wish with taxable investors. And, if before-tax returns on investment real estate increase as a result of the general oversupply of properties and because of the provisions of the 1986 Tax Reform Act, pension funds can be expected to demonstrate considerable interest in prime properties.

Foreign Investors

An article in *The Property Times*, February 1987, considers the effect of the 1986 Tax Reform Act on foreign investors in U.S. real estate:

> Those outside the U.S., however, have been at a disadvantage because of significant tax benefits only available to the U.S. citizen, developers, builders and owners. These benefits were in the form of 'deductions' lowering the 'base' income on which tax is assessed.
>
> So great were these incentives to buy or build housing or engage in other types of real estate development, that a well-planned portfolio could result in no tax liability whatsoever even to those with substantial incomes from other sources. As a result, many rental properties sold readily at a price that insured significant sums would be lost in their day-to-day operation. Thus, many properties made no economic sense to those whose income was earned or whose tax responsibilities were paid in other countries.
>
> The Tax Reform Act nearly obliterates this theory as nearly all such deductions have been eliminated.[6]

This point was echoed in a brochure advertising "The American Real Estate &

Investment Show" that was held in London during the spring of 1987. Although it mentioned a number of factors concerning the attractiveness of U.S. real estate to U.K. investors, it noted that the "New U.S. tax law reduces buying advantages for U.S. investors."[7]

The attraction of U.S. real estate to foreign investors is considerable; with the tax law change, foreign investors will find such investments even more attractive to them. They will be on an equal footing with taxable U.S. investors because, as shown in this report, the before-tax return will now exceed the after-tax: **Taxable U.S. investors can no longer add tax benefits to the before-tax return to outbid them for real estate.** If, over time, before-tax returns from real estate increase as a result of the general oversupply of commercial real estate and the provisions of the 1986 Tax Reform Act, foreign investors' interest in prime U.S. real estate may be expected to grow.

Foreign investors have a further advantage because, largely, they are professional investors. As earlier noted, the 1986 Tax Reform Act increases the need to base investment decisions on analyses of project economics. Because of the requirements of such analyses, **professional investors will have an advantage over non-professional investors.**

Conclusion

The 1986 Tax Reform Act all but eliminated the ability of income-producing real estate to provide tax shelter; furthermore, it reduced the returns from income-producing real estate. However, if market values decline and rents rise in response to the 1986 Tax Reform Act and the general oversupply of properties in many areas, the after-tax yield on investment real estate may be high enough to induce individuals to continue investing in this market despite the lack of tax shelter benefits. And to the extent that the real estate investment activities of pension funds and foreign investors have been limited because taxable investors were able to outbid them for properties, the 1986 Tax Reform Act may be expected to increase the interest of these two investor groups in investment real estate.

A note of caution is in order, however. Much of the current problem in U.S. real estate markets results from an uncontrolled real estate supply. The foregoing analysis assumes values will decline and rents will rise because developers will recognize the changed environment and act rationally and limit the supply of new space to that which is reasonably needed. In the past, this has not been the case as developers have brought buildings onto the market for reasons other than the demand for space. However, it seems probable that some of the more desirable properties will begin to reach reasonable occupancy levels and become attractive investment opportunities.

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Notes

[1] "Stanger Syndication Sales Data," *Real Estate Review*, Vol. 14, No. 1 (Spring 1984), p. 10 and Vol. 17, No. 1 (Spring 1987), p. 10.

[2] William B. Brueggeman and Thomas G. Thibodeau, "Real Estate Returns and Market Responses to 1986 Tax Reform," *Real Estate Review,* Vol. 17, No. 1 (Spring 1987), p. 69.

[3] James R. Follain, Patric H. Hendershott and David C. Ling, "The Impact of the 1986 Tax Reform Act on Real Estate," *Real Estate Review,* Vol. 17, No. 1 (Spring 1987), p. 76.

[4] *The Wall Street Journal,* June 11, 1987.

[5] Jerry D. Fisher, "Portfolio Construction: Real Estate," *Managing Investment Portfolios: A Dynamic Process* (Boston-New York: Warren, Gorham & Lamont, 1983), pp. 444-46.

[6] Donna Gilbrech, "Investment Versus Tax," *The Property Times,* February 1987.

[7] "The American Real Estate & Investment Show," Miller Marketing Network, Ltd., London.

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