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Potential Tax Law Changes and Income Property Values

Marvin L. Bouillon and William D. Terando

The authors examine the effect on income property values if current tax rates increase or the proposal to broaden the individual income base and lower individual income tax rates is enacted.

Over the next three years there are two potential tax law changes that could dramatically impact income property values. First, there is a possibility that the ordinary income tax rates could increase to pre-2001 levels. The Revenue Reconciliation Act of 2001 ("RRA2001") reduced the highest marginal tax rate ("MTR") for individuals from 39.6 percent to 38.5 percent.[1] The Jobs and Growth Tax Relief Reconciliation Act of 2003 ("JGTRRA2003") accelerated the scheduled RRA2001 reduction in the highest individual MTR (38.5 percent to 35 percent) from 2006 to 2003.[2] In addition, the highest preferential tax rate on capital gains (and qualifying dividends) was reduced from 20 percent to 15 percent.[3] Both RRA2001 and JGTRRA2003 include a sunset provision that reinstates the pre-2001 statutory tax rates on ordinary income for tax years beginning in 2011.

In addition, on December 14, 2006 the Joint Committee on Taxation ("JCT") released a study entitled: *Macroeconomic Analysis of a Proposal to Broaden the Individual Income Tax Base and Lower Individual Income Tax Rates*.[4] This proposal reduces ordinary tax rates on individuals by 23 percent with the highest individual MTR decreasing to 26.8 percent.[5] Revenue neutrality is achieved through the broadening of the individual tax base by eliminating of most personal exemptions, above-the-line deductions, itemized deductions, personal credits, and the alternative minimum tax.[6]

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In this article we estimate the impact of these two potential changes in ordinary tax rates on residential and non-residential income property values. We utilize the Bouillon and Karney (1990) After-Tax Cash Discount model[7] to estimate the incremental change in income property after-tax cash flows associated with each potential change in tax law. Our results suggest that residential and non-residential property values will increase if tax rates sunset in 2011 due to the increased tax savings afforded to depreciation deductions. This result is conditional, however, on whether the preferential capital gains tax rate remains at current levels. If this rate is allowed to increase to 20 percent, property values will decline because the marginal cost associated with increased capital gains taxes will exceed the marginal benefit of higher depreciation tax savings. This may provide incentive for owners to increase their holding period in their properties to maintain their value. On the other hand, our analysis shows that, despite an effort to maintain revenue neutrality, the lower tax rates under the JCT tax reduction proposal will negatively impact both residential and non-residential income property values by reducing the tax savings attributable to depreciation deductions. In contrast to the sunset provision tax law change, we show this result holds regardless of whether the preferential capital gains tax rates remain at current levels or are allowed to increase to 20 percent.

The remainder of this article is presented as follows. It next describes the Bouillon and Karney (1990) After-Tax Cash Discount model. This article then estimates the impact that the potential change in tax law has on residential and non-residential property values. A summary of the significant findings concludes the article.

Impact of Tax Law Change on Property Values

The Bouillon and Karney (1990) model defines the value of an investment in income producing properties as the sum of the present value ("PV") of annual after-tax operating cash flows ("AATCF") and the after-tax cash flows associated with the property sale ("SATCF"). AATCF accounts for the PV of after-tax operating income before the deduction for depreciation, plus the tax savings from the depreciation deduction less the cash outflow from the principal payment on the mortgage loan. SATCF is equal to the difference between the PV of the property net sales proceeds received (sales proceeds less selling costs) and the loan balance due at the time of sale, less the capital gains tax paid.[8] We utilize the following parameters to estimate the impact of the two potential tax law changes on residential/non-residential property values:

1. The property is financed by a 30 year mortgage for 80 percent of value with a seven percent interest rate.
2. The average holding period is 10 years.
3. First year net operating income before the deduction for interest and depreciation *(N)* is forecasted at $100,000.[9] This value is expected to grow at a rate of one percent per year.
4. The value of the property is anticipated to increase at a rate of two percent per annum.
5. Land represents 20 percent of the total market value.
6. Selling expenses are expected to be seven percent of the selling price.
7. The property expected yield rate is expected to be 10 percent.
8. The purchase of the property is assumed to take place in January of 2011. The property will be sold in December of 2020.

We calculate residential/non-residential property values for three scenarios as follows:

Current law: the average investor's marginal tax rate is 35 percent and capital gains tax rate is 15 percent.

Sunset Provision: the average investor's marginal tax rate is 39.6 percent and the capital gains tax rate remains at 15 percent. We also calculate the impact on property values assuming that capital gains rate increases to 20 percent.

JCT Proposal: the average investor's marginal tax rate is 26.8 percent and the capital gains tax rate remains at 15 percent. We also calculate the impact on property values assuming that capital gains rate increases to 20 percent.

A summary of the tax rules that affect residential and non-residential income properties currently, after 2010 if sunset occurs, and under the proposed JCT rules are presented in Table 1. Table 2 presents the applicable yearly depreciation rates for residential/non-residential real property.

Estimated Property Values

The potential effects of these changes can be shown by separately estimating the market value of residential and nonresidential income properties under the current and proposed tax regimes. Using the Bouillon/Karney model, estimated values for the residential income property under different scenarios was found by imputing the appropriate parameters.[10] Table 3 provides these estimated values assuming that the current tax rates sunset after 2010. We estimate these values using a capital gains rate of 15 and 20 percent. Table 4 provides these estimated values assuming that the JCT proposal becomes law. Again, we calculate values using a capital gains rate of 15 and 20 percent.

Table 3 shows that the model estimates the current value of our hypothetical residential income property under the current law at $1,535,700. When the parameters are changed to reflect the increased ordinary tax rates under the sunset provision, the property value increases to $1,561,400 (1.67 percent increase). This increase is attributable to the larger tax savings received for depreciation deductions due to the higher tax rates. When the preferential capital gains tax rate is increased to 20 percent, we find that property values decrease to $1,511,500 (1.58 percent decrease).[11] These results suggest that the marginal cost of increasing capital gains taxes from 15 percent to 20 percent exceed the marginal tax savings afforded to depreciation deductions under the sunset provision. The same basic story applies if non-residential income properties are considered. Under the sunset provision rules, the value of our hypothetical non-residential income property increases from $1,463,300 to $1,467,700 (0.30 percent increase) under a 15 percent capital gains scenario, and declines to $1,432,200 (2.13 percent decline) under a 20 percent capital gains scenario.[12] The percentage increase (decrease) in property values is lower than similar percentages for residential income property due to the lower annual depreciation rates assigned to non-residential real estate by the taxing authorities.

The incremental impacts on the value of our hypothetical residential/non-residential property under the JCT proposal are presented in Table 4. Assuming the 15 percent capital gains rate is in effect, we estimate that residential property values will decline to $1,499,400 (2.36 percent decline). This is primarily due to the reduce tax savings afforded to depreciation deductions as a result of the lower tax rates under the proposed rules.[13] These values further decline to $1,461,300 (4.84 percent decline) assuming a capital gains tax rate of 20 percent. Similar results are obtained if we assume the property is non-residential, as its value declines to $1,457,000 (0.43 percent decline) and

$1,428,000 (2.41 percent decline) when the capital gains rates are 15 percent and 20 percent, respectively.[14] Again, these percentage declines are less than their residential property counterparts due to the lower depreciation rates assigned to non-residential property by the taxing authorities.

Conclusions

In summary, this analysis illustrates that the impact on residential and non-residential property values of the potential changes in tax law that may occur in the next three years depends upon whether ordinary tax rates are allowed to increase (sunset provision) or decrease (JCT provisions). If current tax rates are allowed to sunset and expire in 2011, this may benefit holders of income producing property due to the increased tax savings afforded to depreciation deductions. On the other hand, our analysis shows that an across the board reduction in ordinary tax rates under the JCT proposal will have a negative impact on residential/non-residential property values due to the lower tax benefit afforded to depreciation deductions. In any event, property values will decline if capital gains rates are allowed to increase to 20 percent, however, because the marginal tax cost of increasing capital gains taxes exceeds any marginal benefit afforded to depreciation deductions. This may influence owners to hold on to their properties for longer time periods to maintain their value. Another factor that will put downward pressure on the non-income producing property values under the JCT proposal will be the fact that the personal mortgage interest and property tax deductions would be repealed as itemized deductions for personal residences.[15]

Table 1
SUMMARY OF TAX RULES THAT AFFECT INCOME PROPERTIES

Current Tax Law:		
	Residential	*Nonresidential*
Depreciation Method	Straight-line	Straight-line
Depreciation Life	27.5 years	39.0 years
Maximum Capital Gain Rate	15.0 percent	15.0 percent
Maximum Marginal Tax Rates for Individuals	35.0 percent	35.0 percent
Tax Law After 2010 if Sunset Occurs:		
	Residential	*Nonresidential*
Depreciation Method	Straight-line	Straight-line
Depreciation Life	27.5 years	39.0 years
Maximum Capital Gain Rate	15.0 percent or 20.0 percent	15.0 percent or 20.0 percent
Maximum Marginal Tax Rates for Individuals	39.6 percent	39.6 percent
JCT Proposal:		
	Residential	*Nonresidential*
Depreciation Method	Straight-line	Straight-line
Depreciation Life	27.5 years	39.0 years
Maximum Capital Gain Rate	15.0 percent	15.0 percent
Maximum Marginal Tax Rates for Individuals	26.8 percent	26.8 percent

Table 2
THE APPLICABLE PERCENTAGE FOR DEPRECIATION

When Life is 27.5 Years[16]

Years	*Percentage**
1	3.485
2-9, 11, 13, . . . , 27	3.636
10, 12, 14, . . . , 26	3.637
28	1.970

When Life is 39.0 Years[17]

Years	*Percentage**
1	2.461
39	2.564
40	.107

* These percentages are for straight-line depreciation for real property assuming mid-month convention.

Table 3
ESTIMATED INCOME PROPERTY VALUES ASSUMING THE CURRENT INCOME TAX RATES SUNSET IN 2010

	Current Statutory Tax Rates (Present Law) A	Sunset Tax Rates After 2010 (15 percent Cap. Gains) B	Sunset Tax Rates After 2010 (20 percent Cap. Gains) C	Percent Change if Rates Sunset (15 percent Cap. Gains) ((B-A)/A)	Percent Change If Rates Sunset (20 percent Cap. Gains) ((C-A)/A)
Residential	$1,535,700	$1,561,400	$1,511,500	1.67	(1.58)
Nonresidential	$1,463,300	$1,467,700	$1,432,200	0.30	(2.13)

Table 4
ESTIMATED INCOME PROPERTY VALUES ASSUMING THE PROPOSED STATUTORY TAX RATE (JOINT COMMITTEE ON TAXATION)

	Current Statutory Tax Rates (Present Law) A	JCT Tax Rates (Capital Gain Rate of 15 percent) B	JCT Tax Rates (Capital Gain Rate of 20 percent) C	Percent Change if Rates Change (15 percent Cap. Gains) ((B-A)/A)	Percent Change if Rates Change (20 percent Cap. Gains) ((C-A)/A)
Residential	$1,535,700	$1,499,400	$1,461,300	(2.36)	(4.84)
Nonresidential	$1,463,300	$1,457,000	$1,428,000	(0.43)	(2.41)

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[1] Prior to RRA2001 the tax rate schedules contained rates of 15 percent, 28 percent, 31 percent, 36 percent and 39.6 percent for taxable income within pre-specified levels. RRA2001 changed these rates to 10 percent, 15 percent, 27 percent, 30 percent, 35 percent and 38.5 percent.

[2] JGTRRA2003 further reduced the four next highest bracket amounts to 25 percent, 28 percent, 33 percent, and 35 percent. The 10 percent and 15 percent brackets remained unchanged.

[3] Qualifying dividends include dividends paid by either domestic or certain qualified foreign corporations. The shares on which the dividend is paid must have been held for more than 60 days during the 121-day period beginning 60 days

before the ex-dividend date. This preferential tax rate is set to expire after 2008.

[4] Joint Committee on Taxation, "Macroeconomic Analysis of a Proposal to Broaden the Individual Income Tax Base and Lower Individual Income Tax Rates, (JCX-53-06), December 14, 2006.

[5] More specifically, the proposal will reduce tax bracket rates to 7.55 percent, 11.5 percent, 19.1 percent, 21.4 percent, 25.2 percent and 26.8 percent.

[6] Retirement savings deductions, the deduction for self employment taxes, and the Earned Income Credit would not be repealed under the JCT proposal.

[7] Bouillon, M. L. and D. F. Karney, "The Ellwood Valuation Model Using After-Tax Cash Flows," *Real Estate Finance*, Vol. 7, No. 1 (Spring 1990), pp. 84-90.

[8] For a more detailed description of the model, see Bouillon and Karney (1990), page 87.

[9] We assume there will be no change in a taxpayers' ability to deduct operating expenses, interest, taxes, or depreciation related to their properties under each alternative tax regime.

[10] A spreadsheet that was used to calculate the values is discussed in Bouillon, M. L., "A Spreadsheet for Estimating the Value of Residential Income Property," *Real Estate Finance*, Vol. 8, No. 1 (Spring 1991), pp. 49-53.

[11] The estimated residential income property values would be $1,343,400 (12.52 percent decline) if the preferential capital gains rate is eliminated and the gain is taxed at the ordinary tax rate of 39.6 percent.

[12] The estimated nonresidential income property values would be $1,308,300 (10.59 percent decline) if the preferential capital gains rate is eliminated and the gain is taxed at the ordinary tax rate of 39.6 percent.

[13] The estimated residential income property values would be $1,412,300 (8.04 percent decline) if the preferential capital gains rate is eliminated and the gain is taxed at the ordinary tax rate of 26.8 percent.

[14] The estimated nonresidential income property values would be $1,390,400 (4.98 percent decline) if the preferential capital gains rate is eliminated and the gain is taxed at the ordinary tax rate of 26.8 percent.

[15] See Joint Committee on Taxation, 2006.

[16] IRS Publication 946, "How to Depreciate Property," for use in preparing 2005 returns, Department of Treasury, Washington, D.C., 1006, Table A-6, p. 71.

[17] IRS Publication 946, "How to Depreciate Property," for use in preparing 2005 returns, Department of Treasury, Washington, D.C., 1006, Table A-7a, p. 72.