OPINION

Democrats' Tax Plan Would Sink Real Estate

By Dan Palmer
And David Williams

The most lasting effects of government policies are often the unintended consequences. Americans learned this lesson the hard way in the aftermath of the 1986 Tax Reform Act. The tax proposals in the Democrats' $3.5 trillion budget-reconciliation bill have the potential to kick off economy-crippling events similar to the savings-and-loan crisis of the late 1980s.

We've seen it before. The 1986 reform led to the savings-and-loan crisis and the 1990-91 recession.

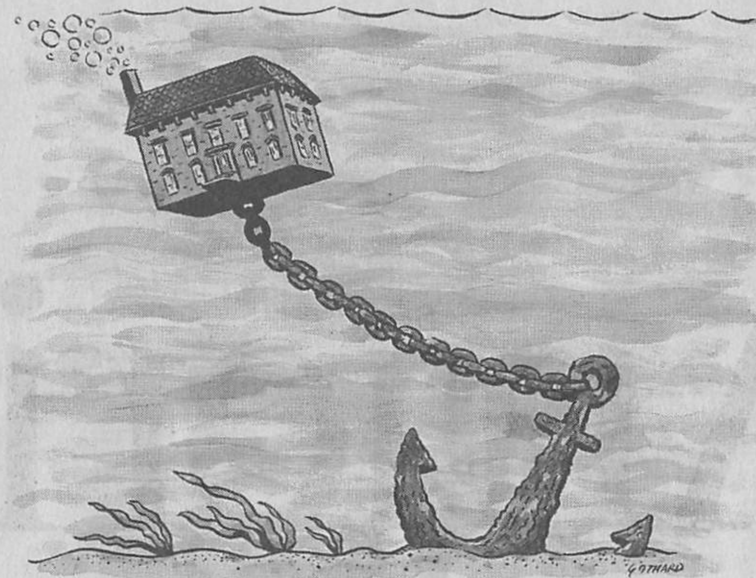
The landmark 1986 Tax Reform Act reduced the top personal income-tax rate from 50% to 28%. The politically divided Congress paid for these cuts, in part, by raising the rate on capital gains from 20% to 28% and limiting the deductibility of real estate losses for passive investors. The unintended consequences were many and profound.

As the new rules were phased in, investment capital dried up and asset values collapsed. Rents rose as landlords refused to pay their mortgage interest with nondeductible cash. Many other landlords "mailed back the keys" to the S&L associations holding their mortgages. The lack of investment capital, sharply lower valuations, and the resulting flood of foreclosures and "deeds in lieu" took down the S&L industry.

Before the 1986 act, the S&Ls were the primary source of loan capital for local property owners, developers and builders. After 1986, 747 institutions with assets of more than $394 billion (about $1 trillion in today's dollars) collapsed into the federal Resolution Trust Corp. When the S&Ls failed, community-based lending and much of the local home-building industry vanished. The fallout was ultimately felt up and down Main Street during the recession of 1990-91.

Even before the 1990-91 recession, Congress knew it had blundered, and reinstated real-estate tax benefits for genuine professionals only. Those benefits still don't apply to a casual investor who buys a small apartment block or enters a real-estate partnership. The lesson? The capital-gains tax rate has a larger effect on real-estate investment than limiting deductions does, but increasing rates and limiting deductions at the same time is deadly.

Wall Street was the big winner, filling the void left by the S&Ls with commercial mortgage-backed securities, or CMBS. Today, most commercial and multifamily real-estate funding is done by CMBS loans. All major financial institutions—including banks, insurance companies and pension funds—participate heavily in CMBS markets. Consequently, we are all in this together. When the CMBS market collapsed in 2008, it plunged the global economy into the Great Recession. Taxpayers funded huge bailouts.



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Real estate is a long-term, risky and labor-intensive investment compared with stocks and bonds. Without tax incentives, real estate can't compete with other investments for essential capital. Currently, real-estate professionals get depreciation deductions against taxable income, and long-term capital-gains rates when they sell. When an owner dies, his heirs get a free step-up in tax basis—that is, they don't pay taxes on appreciation during the decedent's lifetime.

Under the House bill, taxation of real-estate operating profit would soar from 29.6% (37% less 20% business deduction) to nearly 46.4% (39.6% basic maximum plus 3.8% investment tax plus 3% surtax for some, with no business deduction), and real estate capital gains would spike from 20% to 31.8% (25% basic capital gains maximum plus 3.8% investment tax plus 3% surtax for some). For a successful investor, that's an extra 16.8% tax on operations and an extra 11.8% tax on capital gains. At the same time, new limitations are phasing in to reduce mortgage-interest deductions and depreciation. Increasing rates while limiting deductible losses is the same deadly recipe as in 1986.

Adding to the toxic brew, President Biden proposes a radical change to the way real-estate assets are treated when an owner dies. He proposes to tax the step-up in basis on death that has been a tax-code constant for a century. It is a foundational reason why families make multigenerational, long-term property investments. Taking away the free step-up in basis creates a disincentive to invest for the long term and ensures even less capital flowing to real estate.

Whether a generational property transfer is taxed at death at the proposed 31.8% capital-gains rate or the higher proposed ordinary-income rate of 46.4%, it may also face a proposed 45% death tax. And that is before state taxes. The huge aggregate tax bill on death will force estates to sell properties to cover what they owe. As 1986 and 2008 proved, forced selling in real-property markets creates havoc in financial markets.

What Congress did in 1986 to real-estate tax shelters was deliberate. What it did to S&Ls, community lending, investors, capital markets and Main Street was unintended. This time, it's much the same, but the effect will be broader. Everyone is directly or indirectly exposed to the CMBS market, and sharply declining real-estate values are highly disruptive. Total CMBS loans today are approaching $4 trillion.

If passed, the Democrats' real-estate tax proposals will tank property values. This sudden, broad decline will be recessionary. Recessions hit all Americans, not the few that Congress and the president are targeting with this legislation. Washington is at serious risk of replaying a historic economic blunder.

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