The Tax Deal and Commercial Real Estate

With Congressional approval looming, reasons for the industry to applaud Obama's move to the middle

EXECUTIVE SUMMARY:

- The recently struck tax deal is a generally positive thing for the investment-sales market.
- The tax deal has benefits for commercial property owners, including shorter periods for build-out write-offs and cost recovery for certain leasehold improvements.
- Most importantly: The capital gains rate stays at 15 percent for two years.
- Good for REITs, especially: The dividends tax rate stays at 15 percent instead of almost tripling.
- Still, with fresh expirations looming in 2012, tax policy uncertainty will return.

If you're a regular reader of my column, you know that I often discuss the relationship between the relative level of employment and the health of the underlying fundamentals of real estate. During this past recession, our economy lost approximately 8.4 million jobs, which had a significant negative impact on our real estate market. Since the recession officially ended, job creation has been lackluster, and this disappointing performance has been blamed significantly upon the tremendous uncertainty that exists within our economy.

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This uncertainty has been based primarily on a lack of clear tax policy; no transparency or understanding of the true financial impact of the national health care program; and the yet-to-be-determined impact of the new financial regulation package. While the latter two impacts may take years to fully understand, last week we got a little closer to understanding what our tax picture might look like for the next two years.

This week, following likely Congressional approval, we should see President Obama sign a new tax package that demonstrates his ability to work with Congressional Republicans. Since the shellacking taken by Democrats in the midterm elections, the country has been waiting to see what tack the president was going to take with regard to his governing approach. Would he remain ideological and stay on the left, as Jimmy Carter did, or would he move more toward the center and get things done, the approach taken by Bill Clinton? So far, it appears he is somewhere in the middle.

Last Monday, the president reached agreement with Republican leaders in Congress on a far-reaching tax package that would allow present income tax rates to stay in effect for another two years, even for those in the highest tax bracket. The deal would reduce worker payroll taxes by 2 percent for one year; would provide incentive for business investment through favorable tax treatment; and would reinstate the estate tax, but at the 35 percent level with a $5 million exclusion, as opposed to a 55 percent level with a $1 million exclusion, as would be the case in the absence of an agreement. These were items high on the agenda for Republicans. In exchange, an extension of jobless benefits for 13 months was provided for the long-term unemployed.

Having the president endorse and agree to this deal is significant from both an economic and political perspective. The political ramifications have been profound, as the president's position has caused significant upheaval within the Democratic Party. During his first year in office, his almost singular focus on health care, at the expense of any tangible focus on job creation or the economy, caused him to lose support from the center that elected him. This was evidenced by the historical swing in the midterm elections, where independent voters shifted an amazing 24 percent, from 18 percent pro-Democrat in the 2008 election to 6 percent pro-Republican in the midterms. Never before had a swing of this magnitude been observed.

During his second year in office, President Obama lost support from some of his base, which has been disappointed with the lack of follow-through on many of his campaign promises and his perceived abandonment of his ideological keystones. His liberal base is upset that (1) he did not fight harder for the public option in health care reform; (2) Guantánamo Bay is still open; (3) the nearly $900 billion stimulus package was too modest; (4) he appeared too deferential to Wall Street in his financial reform package; and (5) we are still involved in wars in the Middle East and South Asia. The present tax deal proposal has Democrats, particularly in the House, revolting against the president.

In his news conference, when the president, trying to substantiate his position on the matter, said, "My job is to do whatever I can to get this economy moving," it was as if he were saying that tax rates matter to economic growth. This was seen as blasphemy from his liberal base. Astonishingly, it appears that he simply negotiated this deal with Senate Republicans without any pre-selling of the idea to his own party. It is inexplicable to Democratic political professionals that he either didn't know how to, or could not, win support within his own party (at least to this point).

Clearly, this was not a compromise the president could have been happy about. A major theme for Mr. Obama while on the campaign trail in 2008 was ending the Bush-era tax cuts for the wealthiest 2 percent of Americans. But, in the words of Bill Clinton, "Sometimes you have to do what you have to do."

Last week could have been an opportunity for the president to finally embrace the bipartisanship he campaigned on. Having problems with the far left for not being liberal enough, and never being able to win over the far right, perhaps he thought this tax deal would make him more attractive to the center. Unfortunately, his position would have been better received had he appeared to believe that this centrist position was correct. He portrayed the deal as something that he truly believed was awful, but something that he had to do. There is no winning the center with this approach and, more importantly, particularly from the perspective of real estate, this means that this tax issue will be put on the table as a central theme in the 2012 election.

The implications of this tax deal on the commercial real estate market are not insignificant. Tax benefits for certain real estate developments will remain intact, as the bill extends for two years the special 15-year cost recovery for certain leasehold improvements, restaurant building and improvements and retail improvements. Being able to write off the cost of tenant build-outs over 15 years rather than 39 years is particularly important to commercial property owners who may have negative equity positions. Property devaluation, as well as increased demand for concessions from tenants looking for space, has created a negative feedback loop, where owners can't afford to build out space, keeping vacancy rates high, which exerts further downward pressure on value. This cost-recovery provision will help owners fighting this negative loop.

The proposed deal also calls for a two-year extension of the provision allowing favorable expensing treatment of costs associated with the cleanup of moderately contaminated brownfield sites. These sites can be significantly more expensive to develop than other sites. New York City has been particularly active in trying to create access to public funds and incentives for developers to clean up these contaminated sites, but help on the federal level is more than welcome.

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The proposed deal also calls for a two-year extension of bonus depreciation to incentivize capital investment from business. Through the end of 2011, 100 percent deductibility will be allowed and in 2012, the amount will be 50 percent.

The most important impact on the real estate market is that the capital gains rate, under this proposal, would remain at 15 percent for the next two years. History has shown us that when a particular activity becomes more expensive, less of that activity occurs. An increase in the capital gains tax would have reduced building sales volume by a tangible amount. Ironically, the building sales market has been helped by the anticipation of an increase in the capital gains tax rate, as many sellers have decided to sell in 2010, to take advantage of this year's low rate. The process of selling a property is not something that can be done in a matter of hours or days, so many of the sellers motivated to take advantage of the present capital gains rates elected to place properties on the market in the summer or in the early fall. Many of these properties have already closed or are under contract for sale without an escape clause in the event that capital gains rates do not rise. This externality has provided the marketplace with a shot of adrenaline at a time when it needed one.

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Another impact this proposed deal has on the real estate market is that it will keep dividend taxes at a 15 percent rate rather than the 39.6 percent one they were scheduled to reach in the absence of an agreement. This is a very positive development for real estate investment trusts looking to continue to access massive amounts of capital from the public markets. As expected, REITs have been among the most active buyers in New York City based upon their ability to access this public capital, and the lower proposed dividends tax rates bode well for the flow of capital into equities.

One issue affecting mechanisms within the commercial real estate market that has not been addressed in anything reported about the tax proposal is how taxes on carried interests will be treated. Throughout 2010, there was much talk about changing the tax treatment for carried interests from the capital gains rate to an ordinary income rate. This would have significant implications for the way syndication and, particularly, development transactions are structured.

From the perspective of New Yorkers, two things are noteworthy about this tax proposal. The first is that New Yorkers would get a two-year extension of Liberty Zone tax incentives for state bonds and deductions for mass transit expenses for commuters. The second is that Senator Charles Schumer has been conspicuously silent on this proposal. He had been trying to engender support from legislators to stand firm on allowing present tax rates to sunset for those earning more than $1 million per year. As has been the case for the past year or so, he's had his eye on Harry Reid's position as majority leader, and so he has not taken any transparent position against the administration, regardless of the impact on New York.

The bottom line is that this proposed tax deal, if approved by Congress, will be a very good thing for the commercial real estate investment sales market. Keeping the costs of transacting business from rising encourages more activity. This is true whether we're talking about building out space for tenants or selling investment properties. Let's hope that the adoption of this proposal will occur.

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