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CONCRETE THOUGHTS

It's the Fundamentals, Stupid!

In flashback to tax law changes made during Clinton administration, investment sales surged in 2012 thanks to the threat of escalating costs

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Economics 101 teaches us that the more expensive it is to do something, the less it happens. Conversely, the less expensive doing something is, the more of that activity occurs. The 2012 investment sales market very clearly illustrates this cornerstone of economic theory.

In the case of New York's sales market last year, it was more the threat that selling would be more expensive in 2013 that drove hundreds of sellers into the marketplace. At the time of this writing, I am unable to provide the actual statistics, as the Massey Knakal year-end press conference, where the figures will be revealed, is happening this morning. But I can say that, last year, the number of properties sold in the Manhattan submarket reached an all-time high going back to at least 1984. This is not a big surprise, as a surge was anticipated for quite a while.

In my column in these pages, this avalanche of sales was predicted in early January of 2012. Its not that I have any magical insight; I simply looked at history (and remembered my Econ 101 fundamentals).

Before recapping what history has taught us, a rather straightforward axiom first: the only thing sellers care about is how much money they are left with after the costs of selling. Taxes, and specifically capital gains taxes, profoundly impact after-selling-costs proceeds.

With the Bush tax cuts set to expire at the end of 2010, much of the rhetoric during the midterm election campaigning revolved around taxes, and the threat of capital gains tax increases caused an increase in selling, particularly in the fourth quarter of 2010, as sellers wanted to beat an anticipated increase.

In 2012, this threat appeared much more likely in the minds of investors, so the selling began early in the year and hit a crescendo in December, when pandemonium wreaked havoc with holiday vacation schedules for anyone involved in the transactional side of the sales market. In a typical month, Massey Knakal closes 30 or 40 transactions. In December, that number was 100.

The 2012 turnover percentage (the number of properties sold out of the total stock of properties) in the Manhattan submarket reached record levels, based upon the impact this externality had on the market. The years 2010 and 2012 were not the only times these dynamics were at work.

There was a spike in sales activity decades ago caused by the Tax Reform Act of 1986 (which went into effect on January 1, 1987). Changes included linking capital gains rates to ordinary income rates and the virtual elimination of passive losses and tax shelters. Before 1986, real estate investment was done primarily by passive investors. It was common for syndicates of investors to pool their resources in order to invest in commercial or residential property. They would then hire management companies to run the operation. TRA 86 reduced the value of these investments by limiting the extent to which losses associated with them could be deducted from the investor's gross income. Almost overnight, wealthy syndicators that were providing investors with 2 to 1, or even 3 to 1, tax write-offs were not only out of business, they were bankrupt. This encouraged the holders of loss-generating properties (losses were intentional, as two or three, or even four, mortgages were placed on assets to create the losses) to try to sell them, which contributed to sinking real estate values. This turmoil and repositioning in real estate markets was caused not by changes in underlying fundamentals or market conditions. The result of this, coupled with sellers wanting to beat an increase in capital gains taxes, was a sharp rise in the number of properties sold in 1986.

Prior to 2012, the previous record year for turnover was 1998, when 3.9 percent of the properties in the market traded (2.6 percent is the long-term average). What sparked this surge? The Clinton administration passed tax law changes in 1997 that reduced capital gains taxes from 28 percent to 20 percent. Sellers threw properties on the market left and right.

With history as our guide, the results observed in 2012 should not have surprised anyone. It's Economics 101 folks, simply Economics 101.

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