JAMES A. GRAASKAMP COLLECTION OF TEACHING MATERIALS

V. INDUSTRY SEMINARS AND SPEECHES - SHORT TERM

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3. "1981 Economic Tax Recovery Seminar", presented to the Illinois Mortgage Bankers Association, Chicago, IL, April 22, 1982

ILLINOIS MORTGAGE BANKERS
ASSOCIATION

1981 ECONOMIC TAX RECOVERY SEMINAR

Thursday, April 22, 1982

Union League Club, Chicago, Ill.

I. The Tax Act of 1981 is certainly reflective of Reagan Economics--think old, think small, think short-term, think middle class, and think rosey. Most of all, think of life as a series of short runs. All of that is true for a 71 year old President educated as a jock and an actor.

   A. The promised tax relief in the 1981 Act may be the shortest run of all. No matter whose estimate of next year's deficit you believe, Congress will perceive the need to raise taxes to reduce the deficit.

   B. The percentage of taxes paid by corporate business as compared to the percentage paid by individuals is expected to tilt to a point where business pays 24% of the income tax and individuals 76%. True there are many more individuals than businesses and many businesses aren't making any money anyway, but Congress will nevertheless need to review the burden of taxation, particularly the estate tax liberalization.

   C. Yenkelovich, White, and Roberts indicate that a major and rapidly rising issue is going to be the inequity of access to capital. Why should U.S. Steel be able to borrow money to buy Marathon Oil, a nonproductive transaction by relatively incompetent management, when the average individual can't borrow money to buy a home. Big tax credits for home buyers seems more equitable than interest deductions for inefficient corporate users of capital.

   D. Granted the changes in the tax law will provide some incentive for churning in order that property owners can restructure the tax character of their portfolio, I think the Tax Act is greatly overestimated in terms of lasting significance, with the possible exception of the emphasis placed on improving the existing stock of space at the expense of building new.

II. The broad purpose of real estate's role in an investment decision and the strategic risks inherent in any investment should put taxes at the bottom of the list in terms of the game plan.

   A. For the 1980's real estate may be seen as:

      1. Housing an activity as part of a larger system or process.

      2. Captive customer for services.

      3. Bond surrogate (portfolio theory).

      4. Long term commodity straddle.

      5. Small business investment with warrants.

      6. Tax shelter leverage for estate accumulation and distribution (estate tax gains will be more important than income tax for aging investors who made it in the 70's).

B. For the 1980's the strategic considerations in order of priority will be:

   1. Acceptability of political risk

   2. Degree of channelled demand

   3. Degree of management intensiveness

   4. Size and character of capital pool available to exploit opportunity and opportunity cost of liquidity investments (money funds).

   5. Sensitivity to taxes

C. Where we are going from here depends on two broad markets, housing and commercial-retail, and the ultimate source of capital--bank money or savings pools.

III. Many objective analysts are beginning to doubt the conventional wisdom of mortgage bankers and builders that housing demand is pent up, (rather it is dreamed-up) and awaits only a drop in interest rates to expand once again. However, neither demographics nor the outlook for the cost of money favor this arguement.

A. The demographic impetus behind housing's glory days of 10 years ago, namely a 50% surge in average net household price between the mid 1960's and the early 1970's was extraordinary and no longer the case.

   1. Whereas the 25-35 age group added nearly 12 million individuals to its number in the 1970's, only 5 million will join up in the coming decade. The number of people aged 18 to 24, who comprise nearly 1/4 of all initial home buyers, will actually shrink by a similar 5 million.

   2. In short, George Rickert, an economist with Siff, Oakley, and Marks, Inc., points out that the 18-35 age group which represents 80% of all first time home buyers and the largest part of new household formations will be only slightly larger in 1990 than it is today. Thus household formation rates will not be propelled upward in the 80's as they were in the 70's by the sheer weight of population trends.

   3. Indeed they may be pulled downward by the slow growth economic scene. In the 70's households unbundled as young people sought to live alone, as the result of divorce or older folks staying on in their home, or apartments for the elderly.

   4. Rising rents, home prices and home maintance costs as well as other costs makes unbundling much less feasible. Indeed rebundling has already begun.

   5. If housing demand will not have the demographic and economic push of the 70's, and mortgage funds remain somewhat limited and expensive, can home prices continue their 10% rate of increase? Probably not. 82 and 83 will continue to offer stagnation in list price and real declines in effective selling price.

B. Harry Schwartz, formally chief economist for FMNA, points out that forecasters of pent up demand depended almost entirely on population factors, assuming little significantchange in other factors. However, four conditions which pushed home ownership and home construction to high levels during the 1970's have sharply deteriorated.

1. Home prices have jumped from 2.5 times income 10 years ago to 3.5 times income in 1981.

2. Monthly payments have moved from under 25% of income to more than 40% of mean income.

3. Home prices in the 70's rose faster than inflation making it a good investment and a stimulus for purchase, that now is unlikely.

4. Strong home buying activity depends on favorable expectations on the part of the consumer about economic prospects for the next 3 to 5 years. And now consumers are more pessimistic than any time since the end of World War II.

5. Even if interest rates were to fall sharply, 12% seems a reasonable floor only if deficit spending is curtailed and thats not likely.

C. Only a substantial investment tax credit for the first time home buyer to match the one time capital gain exemption for the older couple will probably induce young people to buy if they are granted a substantial carry forward of the tax credit.

D. One play is building condos or detached homes for rent and converting when government provides special financing. Pension funds provide money as general partner while the developer tags along as limited partner for shelter and management.

IV. Commercial property already has a major tool favoring rehabilitation of existing properties in the form of investment tax credit of 15, 20, or 25% of the value added to older buildings. Unfortunately the demand for additional commercial-retail space is very doubtful except where institutional or geographic road blocks create short term monopolies.

A. Office demand tied to energy related economic base is now suspect in Denver, Houston, Long Beach, and New Orleans. Indeed the overbuilding has prompted some of the major institutions to change buying standards when estimating proforma income. Instead of 5 or 8 percent annual increase when rolling over leases, they are assuming no change to avoid a protracted vacancy.

B. Consider the existing supply of vacant industrial space in the Chicago market, where some estimate somewhere over 1/2 million feet. Pension fund investors not only want a tenant but are now evaluating the vulnerability of the tenant to recession and are now requiring a master lease.

C. The shared appreciation mortgage in commercial development may make no more sense than it does in residential lending. Competitive vacancies will force renegotiation of escalators, renewal at existing rates, or demands that the landlord invest in making his building energy efficient.

D. However, the tax law will bring back the sale and lease back instead of the mortgage loan. GE recently switched a loan on a refrigerated warehouse at 17% interest to a lease of 14½ since they estimated the depreciation to be worth slightly over 400 basis points. Thus the warehouse man dropped his debt service while having it all converted to rent and GE improved the yield. There may be more opportunities for recasting the finance than for origination of new projects.

E. The tax law also creates more incentive for professional service tenants to own their own space which may imply:

1. Partial conversions of existing high rise to condo floor and rental floors.

2. Very competitive low rise construction in the suburbs

3. Tough bargaining on renewals