

The View - How to Save the Commercial Real Estate Industry

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The commercial real estate industry is the next big shoe to drop in the U.S. economy and may push the fragile economic recovery into a double-dip recession. It is a \$5 trillion business and its health and vibrancy is critical to a strong and growing economy.

The industry has been hit by the perfect storm of the great recession, an average decline in property value of 40 percent, increase in risk aversion by investors, lack of new debt and equity capital and weakening fundamentals for rental rates, occupancies and operating costs. The industry is frozen and there are few investment, financing and leasing transactions.

Transactions are the lifeblood of the commercial real estate industry. The banking industry is faced with mounting defaults and foreclosures and many financial institutions have been in the "pray and delay" mode wherein they have not foreclosed and recycled defaulted loans into the marketplace. There is virtually no financing available except for apartments through Fannie Mae and Freddie Mac. According to Foresight Analytics, roughly half of the \$1.4 trillion in commercial mortgages maturing by 2014 are under water. If this situation continues, it will be very difficult for the economy to avoid a double-dip recession.

I believe that the commercial industry can be pulled out of this crash by Congress suspending the Passive Loss Tax Rules for 2010 and 2011. The passive loss tax rules were promulgated by the Internal Revenue Service in the Tax Reform Act of 1986 and further amended in 1994. These rules stipulate that losses from real estate and equipment rentals and investment transactions by partnerships, limited liability companies and S corporations cannot be used to offset wages and investment income unless you are a material participant.

A material participant is someone who works on a regular, continuous and substantial basis in the business. Most real estate investors are not material participants and hence cannot use real estate losses.

Some investors who are considered active participants may deduct up to \$25,000 in annual losses. However, this deduction is eliminated as the investor's adjusted gross income reaches \$150,000. Suspension of the passive loss rules will allow individual investors to deduct real estate losses, arising primarily from depreciation deductions, against wage and investment income. This will open the floodgates of new capital to the commercial real estate industry and a turnaround in the economy.

Suspending the passive loss rules for two years will help the commercial real estate industry tremendously as follows:

1. Generate substantial new capital investment into distressed and troubled projects.
2. Allow overleveraged owners to reduce their debt and increase the equity funding.
3. Help financial institutions, especially smaller community banks, restructure their troubled real estate loans.
4. Increase economic activity and jobs through the development of new projects and new investments in existing projects.
5. Help stem the value decline of commercial real estate loans and investments.
6. Provide a tax benefit to real estate investors by allowing real estate losses to offset wages and investment income.
7. Increase the disposable income of real estate investors that can be used for other spending.
8. Reduce the number and amount of distressed and troubled projects owned by financial institutions, thereby reducing the risk to taxpayers.
9. Help the economy grow out of this recession and a potential double dip.
10. Increase capital investment in low-income housing projects.

Although my proposal has many benefits, it does cost the Treasury lost revenue. However, it may be offset by increased taxes from the boom in economic activity. It also can be implemented easily by Congress, and the economic benefits will start to appear quickly.

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