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THE 1986 TAX REFORM ACT AND ITS EFFECT ON THE OFFICE BUILDING MARKET IN ST. LOUIS COUNTY

Pat P. Clark

A Culminating Project Presented to the Faculty of the Graduate School of Lindenwood College in Partial Fulfillment of the Requirements for the Degree of Master of Science

1990

COMMITTEE IN CHARGE OF CANDIDACY:

Associate Professor Richard Rickert PhD,
Chairperson and Advisor

Adjunct Professor Ernest A. Demba, MAI,
ASA, IFAS, PE

Cris Kukuk, PhD, Reader

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Abstract

Prior to the 1986 Tax Act, the real estate industry enjoyed privileged status granted by the Economic Recovery and Tax Act of 1981. Because of flagrant abuse of the provisions of the 1981 Act, Congress passed the 1986 Tax Reform Act in order to curtail certain activities in the real estate market that had become unhealthy for the economy of the United States. Therefore, it is the intent of this project to show its readers that the 1986 Tax Reform Act had a negative impact on the office building market in St. Louis County.

The following pages explore a variety of issues concerning the 1986 Tax Reform. The articles cited in this paper cover many topics that figured significantly in bringing about the need for tax reform. Data on office building permits, office construction, and vacancy rates does support this thesis that the 1986 Tax Reform Act had a negative effect on the office building market in St. Louis County.

Chapter One focuses on conditions in the real estate market and the United States economy prior to 1986. The reasons and goals behind the passage of the Economic Recovery and Tax Act of 1981 are discussed. Changes in monetary policy during this

time also played a large part in boosting investments in real estate projects, and are discussed in detail in this chapter. Chapter One deals with a period of excesses. There were excess money in the hands of lenders, excess building by real estate investors, excess tax sheltering by real estate syndicators, and excessive losses of tax revenue as a result of this tax sheltering.

Chapter Two is a discussion of specific areas of the 1986 Tax Reform Act that have particular impact of the real estate market. These areas are the altering of depreciation periods, the change in the long-term capital gains rate, the extension of at-risk rules to real estate activities, limitations on interest expense deductions, and change in the corporate tax rate. Spreadsheets are given which show how these changes collectively work to decrease the value of commercial property.

In Chapter Three details the area referred to as St. Louis County. Also, this chapter describes the types of office space that are not included in office space inventory data provided by St. Louis County's Department of Planning. Identifying the geographical areas used in this paper is very important since different reports on topics such as vacancy rates, office construction, and building trends are not uniform in their definitions of the

St. Louis County area. Some sources included the St. Charles County area as a part of the St. Louis Regional area, while others included parts of Illinois. The author has made every possible effort to use only those references that gave data on St. Louis County as it is defined in this chapter.

The emphasis of Chapter Four is on the office market in St. Louis County before the 1986 Tax Act. This examination is necessary in order to determine what impact the 1986 Tax Reform Act had on this market. Identifying office building construction trends, and establishing the motives of investors in the office market before 1986 is very important since these factors indicate to what degree investment decisions were based on tax policy, instead of demand for office product. How St. Louis County investors made investment decisions before 1986 will have a direct bearing on the office building market after implementation of the 1986 Tax Act.

Chapter Five discusses the office building market in St. Louis County in the years following the 1986 Tax Reform Act. Data on office vacancy rates, office building permits, and completion of office space is interpreted to show that the 1986 Act did indeed have a negative effect on this market. The degree of damage caused by tax changes is also examined and explanations as to why the

St. Louis County area fared better than other parts of the nation is discussed. The savings and loan crisis is also mentioned as a factor in curtailing supply of new office space.

Finally, a summation of this writing addresses the debatable issue of whether the impact of the 1986 Tax Reform Act will prove to be negative in the future. Predictions regarding the St. Louis County area that may cause investors in office buildings to view the 1986 Tax Reform Act as a positive change are discussed as a point for further research.

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Chapter One

Why Tax Reform?

Why Tax Reform?

When the contents of the proposed 1986 Tax Act hit the streets, magazines and newspapers heralded the impending death of the real estate industry. For many areas of this country, the newspapers were right. In St. Louis County, the office building market did take a downturn, though not to the extent seen in other areas of the United States.

Real estate investors did abuse tax shelters. This particular group of investors even had our government's permission to do so under the old tax code. But Congress decided to put an end tax shelter abuse by passing the Tax Reform Act of 1986.

Congress had four honorable goals in mind when they drafted the Tax Reform Act of 1986. The first three, "develop equity in the tax code, broaden the tax base, and simplify reporting procedures," produced rounds of applause and hearty hurrahs. Many said "it was about time something was done." However, when the fourth goal was revealed, "to close loopholes and tax shelters," mouths snapped shut as cold shivers traveled up the spines of investors who had become addicted to sheltering tax dollars through real estate investments (Martin 60).

This could not be the same Congress that was so accommodating during 1981 and 1982's legislative

sessions. At that time, lobbyists for the real industry lined the halls of Congress, dressed in full Armani battle gear, shaking hands, patting backs, wining and dining legislators who listened with genuine interest and concern (Martin 60). Lobbyists claimed, and the Congress agreed, that certain tax benefits would be good for the country.

At that time, the term "tax shelter" did not carry with it the negative connotation that it does today. Actually, the phrase "tax incentive" was a much better choice of words since the tax benefits that Congress eventually granted were meant as enticements to investing in real estate. Why did the Congress feel that real estate investors needed incentives, beyond those of profit and return, to invest in an already lucrative dealing?

It is the goal of Government policy to "maximize output from the use of scarce resources" (Burstein 4). The profit motive induces investors to allocate their resources among those activities that produce the greatest benefit, or return, after taxes. To produce economic equilibrium, return on investments must be taxed in a way that equates the before-tax rate of return between two investments.

It is profit that spurs an investor into allocating resources into ventures that will yield the greatest benefits, or returns, after taxes. Taxing

the profits from these ventures at the same tax rate maintains equilibrium since the size of the returns of two different investments before taxes is maintained after taxes (Burstein 4).

In 1981, both Congress and real estate lobbyists felt that the country was lacking in the areas of productivity and economic growth. If the government could stimulate real estate investments, productivity and the economy would improve. As a push in that direction, Congress implemented changes in the tax code that decreased risk, and increased the potential for profit in all areas of real estate investments.

Investors could deduct losses from real estate ventures from their ordinary income. Ordinary income could be reduced by as much as fifty percent of the loss. Depreciation, a non-cash expense, could be included in the loss amount (Martin 60). An investor could not go wrong with a tax "safety net" like that to fall into.

The stage was now set. Many new and profitable buildings would be constructed. This surge in real estate investment would increase jobs, and reduce unemployment. Hotels, restaurants, office buildings, and shopping malls would grow and thrive.

As Congress and the lobbyist had prophesied, investments increased. These investments however,

were not of the kind they had hoped for. Investors were no longer afraid to invest in risky ventures. If they did incur a loss, the resulting tax benefit was so great, they could actually come out ahead. It was now fashionable to end up "in the red," and "quick doubles, and four-to-one write-offs" became the hot topics of cocktail conversation (Moore 33).

Investments in all different types of tax shelters increased after 1981. Real estate tax shelters showed the greatest increase of money invested. The following table lists eight tax shelters and their growth rates:

TAX SHELTER CATEGORIES

(in millions of dollars)

	1981	1983	% Change
Real Estate	$1,600	$4,477	+180%
Oil and Gas	2,884	2,995	+ 4%
Equipment Leasing	200	388	+ 94%
R & D and Misc.	25	237	+848%
Film	80	141	+ 76%
Cable TV	35	71	+102%
Agriculture	21	44	+110%
Transportation	39	0	-100%
Totals	$4,884	$8,353	+ 71%

(Dentzer 59)

While money was pouring into real estate shelters, the IRS was losing money, and lots of it.

The net result of the tax law legislation of the early 80's was the spread of tax shelter abuse. In 1982, the Government lost over 3 billion dollars because of tax shelter abuse. The IRS had 16,300 cases pending in court over tax shelter abuse in 1983. These cases represented over a billion dollars of potential adjustments. At the same time, there were an additional 325,000 shelters under examination. "For these reasons, it becomes easy to see why tax reform developed into a major political issue" (Martin 60).

As seen in the above table, real estate tax shelters grew from $1.6 billion to a staggering $4.5 billion in just two years, making it the largest area of tax sheltering. There was a big increase in real estate shelters after 1981. There are many reasons for this, and to fully understand what was happening in the real estate arena, we must examine the economic, financial, and government happenings prior to 1981.

Real estate is the largest and most common form of wealth in the United States. For millions of people in the U.S., real estate is their principal asset. Because of this, what affects real estate, affects the welfare of the entire nation (Downs 1). Government is, therefore, very interested in what is happening in the real estate industry. Our government can control the real estate industry

through taxation, fiscal policy, monetary regulations, etc., and does so quite often.

Changes in monetary policy can have a great effect on real estate because it takes money to invest. Real estate investments require large sums of money, with much of this money coming from loans by financial institutions. The $3 billion increase in real estate shelters could not have happened without a great deal of help from financial institutions. These institutions apparently had a very favorable attitude toward real estate investing to have extended so much credit. This favorable attitude arose from changes in government regulation since about 1978.

The largest source of capital for real estate investing comes from savings and loans. These institutions originate and hold the majority of real estate mortgages in the United States. Commercial banks are second, and mortgage companies third (Downs 4).

These institutions obtain a majority of the money they loan from customer savings. It is the main function of real estate financial markets "to move capital from those who save it out of their current incomes, to those who will invest in real estate" (Downs 63). These savers might be households, business firms, non-profit organizations, or state and local governments.

In order to have $3 billion to loan, there had to be a large amount of money being saved. People deposit their savings in a bank or thrift institution because interest is paid on their savings, and the safety of their money. Financial institutions all over the United States compete for the savings of depositors because they, too, receive interest payments, plus other fees from their depositors. If the banks and thrift institutions can earn higher returns on their investments, higher interest rates can be paid to the depositors.

Deregulation freed financial institutions to invest in other areas previously forbidden to them in the past. After deregulation, banks and thrifts developed a bias toward investments in real estate. This bias is a result of federal benefits to investors that "make two methods of raising capital less costly to financial institutions than all others" (Downs 10). Federally insured savings deposits, and the selling of shares in real estate syndications provided significant benefits to investors, compliments of the government, and the financial institutions did not have to pay the full costs (Downs 10).

Banks and thrifts once bought their insurance from private companies at extremely high premiums. The premiums for federal deposit insurance are much

smaller. Savers reap the benefits of lower costs because institutions could pay higher interest rates to the depositors. Before deregulation, however, these benefits could not be passed on to customers due to laws limiting the amount of interest these institutions could pay. Higher interest rates drew more depositors and increased the amount of money available for real estate investing (Downs 11).

Savings accounts are not the most efficient type of investment. However, they are one the safest because federal insurance

> guarantees that savers will not lose their deposits, no matter how bad the economy or how incompetent the management of the savings institutions involved. Only the federal government can offer such a secure guarantee; no one else can tax or print money to cover liabilities if necessary.... If two institutions offer the same rates to savers but only one has federal deposit insurance, that one can attract far more funds for the same promotional cost. (Downs 91-92)

Since only banks and thrifts institutions can offer federally insured savings accounts, these companies have a huge advantage in attracting savings.

The attractiveness of federal deposit insurance became apparent between late 1982 and early 1983. In preceding years, money market funds drew billions of dollars from banks and thrifts. In 1978, total assets invested in money market funds were $20 billion, growing to $230 billion by 1982. At this

time, banks and thrifts still had limits on the amount of interest they could pay. Although they are not insured, money markets had no such ceilings and lured investors with higher rates of return (Downs 92).

The money market advantage quickly changed when the government lifted interest ceilings for banks and thrifts. In December of 1982, net new savings accounts at thrifts were $10.4 billion. By the end of the first quarter of 1983 this figure grew to $28.9 billion, and by the end of 1983 it jumped to $62.8 billion. Commercial banks faired even better, going from $22.5 billion in the first eleven months of 1982, to $238.6 billion at the end of 1983. On the other hand, money market funds dropped from $230 billion to $165 billion by the end of 1983 (Downs 92).

Banks will normally invest money from savings accounts in short-term investments, but thrifts, as a rule, will invest much of theirs in long-term uses. These long-term investments are normally real estate mortgages and equities (Downs 11). During the time deposits were modest, thrifts had been "relatively stingy about making mortgage loans or other real estate investments" (Downs 93). When new deposits began to pour in, thrifts had to put this money to work making interest. They soon became very eager to do business.

Commercial banks found their line of thinking regarding short-term investments quickly changing. Many "liberalized the terms on...mortgage loans and entered into more joint ventures with real estate developers" (Downs 93). With 238.6 billion dollars worth of deposits, banks were under great pressure to invest in real estate to cover the cost of the capital.

After deregulation, a trend toward real estate investment emerged because of federal benefits to investors that made two methods of raising capital less costly to financial institutions. The first, federal insurance, was discussed earlier. The selling of shares in real estate syndicates is second.

Syndicated tax shelters can be described as "financial arrangements in which the principals share investments with others who participate in the activities (at least substantially) as a result of tax benefits" (Burstein 4). Between 1981 and 1983, investment in real estate shelters grew by $3 billion. The $3 billion increase was used to build shopping malls, apartment complexes, and multitudes of office buildings.

The Economic Recovery and Tax Act of 1981 made investing in real estate very appealing to investors and financial institutions. The Tax Act of 1981

> ...shortened the period for computing depreciation on real estate investments to fifteen years. This accelerated depreciation enhanced the tax-shelter benefits of owning syndicated partnership interests in real properties, especially if these partnerships were heavily leveraged. (Downs 94)

Shortening the depreciation period provides huge returns in the initial years of the investment. In the case of highly leveraged properties, the deduction of interest, and the large depreciation expense made real estate investments hard to resist.

Congress was successful in stimulating investment in real estate by changing the tax code. The tax advantages were the main catalyst in attracting funds, but other things happening at this time also helped.

In the later part of 1982, interest rates fell sharply, and many bond market investors left for the greener pastures of real estate investments. Also, the stock market rallied in late 1982 and early 1983. Many stock market investors felt the rally had reached its peak, and bailed out before the market began to downturn. Real estate syndicators welcomed the stock market refugees with open arms (Downs 94).

To financial institutions, real estate syndication was advantageous for two reasons. First, it was a very low-cost way to raise capital. Second,

syndicators could profit from large front-end fees, and did not have to wait until the properties they invested in showed a profit. In some cases, those front-end fees amounted to twenty-five to twenty-eight percent of the initial amount of capital that was raised (Downs 95).

Real estate syndications were a low-cost way to raise capital because benefits gained by investors were not paid by the fund raisers. The high after-tax returns came from tax advantages granted by the tax code in effect at that time. Our government

> was conferring a special advantage upon a particular form of investment. This advantage permitted financial institutions using that form to raise funds at less than the full cost of providing the benefits that the investors themselves received. No other investments provided fund raising institutions with capital under such advantageous terms. (Downs 95)

The government gave syndicates an advantage over all other kinds of investment. The cost of this benefit was paid by the government through lost tax revenue.

Up to this point, everything sounds wonderful for real estate investors. The deluge of deposits in financial institutions because of the removal of interest ceilings and federal depositors insurance, provided cash for investing. The financial institutions, anxious to put these funds to work, were

extremely generous in granting loans to real estate investors. Real estate investors were eager to put this money into syndications because of tax advantages the 1981 Tax Code provided. Financial institutions saw that syndication was a quick, low-cost way to raise even more funds. The result was "a flood of cash searching for real estate equities" (Downs 96).

It is plain to see what was on the horizon for the real estate industry and the federal government. The basic concept of economics is that equilibrium in the market exists when supply equals demand. If there is a huge demand for a limited resource, the price of the resource will begin to rise. The huge demand, plus the higher price, will attract more suppliers of that resource. The increase in supply will cause the price to fall. As the price falls, some suppliers will leave the market. Supply will decrease until it equals demand, and the market is again at equilibrium.

Investors and financial institutions were in hot pursuit of real estate to invest in, hence huge demand. The sudden increase in deposits happened very quickly, almost overnight. Actually, the bulk of the increase occurred from December 1982, through early 1983 (Downs 92). During this time, there was

only a limited amount of real estate available to investors. Real estate is not built overnight. It takes considerable time to build office buildings, houses, and apartment buildings in order to keep up with the demand.

Financial institutions involved in real estate syndications had practically unlimited funds available to them, and at low cost. When vying for these very limited properties, syndicates could afford to offer higher prices and had no qualms about doing so. During 1983, "syndicators consistently out-bid traditional investors, such as insurance companies, in the competition for real estate equities" (Downs 95).

It was imperative that these institutions put all their money to work making more money. If this meant paying a higher price, it did not matter because everyone could still benefit. For the syndicators, profits come from large front-end fees, tax savings, and returns on the investments made with investors payments (Dentzer 57). Since much of their profit was received up front, the long-term returns did not need to be extremely high.

Investors in real estate syndicate shelters did not object to high front-end fees because they could be written off (Jones 160). In addition, if the investor borrowed the funds to invest in the

shelter, the interest on the loan could also be deducted. If investors realized a loss, as many made sure they did, they could use it to reduce ordinary income by as much as fifty percent (Martin 60). Low-income housing shelters offered even better benefits.

An article in Newsweek discussed how "even losers can win" since "huge tax savings at the outset can make up for any eventual loss" (Dentzer 57). The article gave this example:

> A shelter that operates an apartment building in a decaying New Jersey city. After 10 years, it still owns the property.
> Invest: $70,700 over five years
>
> Payments from shelter, including rental income: $19,200.
>
> Tax savings: $45,400.
>
> After-tax result: $15,700 loss.

The $19,200 in payments and the $45,400 tax savings can be invested elsewhere, so the investor comes out ahead while showing a loss on their tax returns.

Because of the new tax advantages received by the real estate industry,

> ...unprofitable properties became attractive for acquisition and developers began to ignore market conditions when making a decision as to whether or not a project should be built. This is clearly exhibited by the glut of office space vacant in a number of metropolitan areas across the country right now. (Martin 60)

The concept of supply and demand says that when prices rise, new suppliers will enter the market. Real estate investing "replaced baseball as a national pastime" and everyone wanted to play (Dentzer 58).

Existing real estate available to purchase became scarce, but demand was still increasing, which sent prices soaring. Examples of how syndicators helped raise prices were given in a Business Week article in October 1983. The article stated that

> one syndicator recently paid $58 million for a downtown office building in a major Western city. The seller's asking price had been $50 million. Another syndicator is investing hundreds of millions of dollars in a mixed-use development that institutional bidders figure to be worth almost one-third less than the sum paid. (Glancz 203)

Unsatisfied demand and rising prices attract new suppliers of the needed product. This is exactly what happened in the real estate industry.

Developers, seeing the great demand for real estate at any price, launched into a building frenzy. Some financial institutions decided to become developers themselves, hiring their own people and cutting out the middleman. Syndications started their own building projects. Office buildings, apartment complexes, hotels, restaurants, shopping centers, subdivisions, and practically anything else that

could be built, were built in record numbers. Everyone became developers with the same motto: Build, build, build, and the market be damned (Downs 229).

In the past, comprehensive market research was done prior to building any kind of commercial property. If a developer seeking financial backing, went to the potential investors without substantial market analysis showing a need for the building, he or she would be thrown out. Market conditions had to indicate substantial need before financial institutions would go out on a limb to loan large amounts of cash.

With the tax situation as it was, the question was no longer; Is there a need? The question was now; Can it be written off? Since syndicates and financial institutions were doing their own developing with others money, they did not have to show a need for the building since funding was already available. Institutions ignored market conditions. Sam Zell, a Chicago real estate entrepreneur warned:

> There's a growing epidemic of oversupply. Many syndicators understood raising billions of dollars through Wall Street, but they never had much understanding of real estate, which is an entrepreneurial business. It's the same mentality that led to the REIT disaster in the 70's.(Rudnitsky 110)

Builders continued to supply the real estate market

with buildings. Even when demand started to slow down, suppliers still found it profitable to build.

Dallas, Texas is "in the grips of the most devastating economic slump it has experienced in forty-five years" (Squires 50). The office-vacancy rate there is twenty-seven percent, the fifth highest in the entire United States. There is thirty-five million square feet of empty space in downtown Dallas, more than all the office space in downtown Los Angeles. The office vacancy rates throughout the United States serve as prime examples of "tax-driven" investing (Segal 143). Every major U.S. city is suffering double-digit vacancy rates.

Economists say that when prices begin to fall, some suppliers will leave the market and bring it back into equilibrium. Suppliers leave the market when the price of their product falls and/or they begin incurring losses. Suppliers are then aware that consumer tastes are changing and it is no longer profitable to supply goods that are not in such great demand.

The 1981 Tax Act made losing money very appealing. Builders kept building, even when the market was beginning to drop off. The more they lost, the more they came out ahead because of taxes. Ignoring

market conditions was paying off in after-tax rates of return, so investors did not care about losses.

Congress did care, however, and so did the IRS. The Internal Revenue Service did not share the same laissez-faire attitude about losses. There was too much sheltering going on. Syndicates were taking advantage with their "profitable" paper losses.

Mortimer B. Zuckerman, a big real estate developer, syndicator, and member of the Forbes 400, could be called the "king" of paper losses. The Washington Post reported that Mr. Zuckerman has not paid any income tax since 1980. Joel A. Kozol, his lawyer, told the newspaper that

> Mr. Zuckerman's abundance of tax losses just shows that his real estate business is booming...and due to paper losses created by Internal Revenue Service a zero tax liability is true of almost every substantial real estate developer in the country.(McIntyre 15)

Of the Forbes 400, fifty-nine of the members make real estate their primary business, while another thirty-two list real estate as their major sideline.

The ultimate insult, which many find extremely humorous, came when a partnership involved in tax sheltering "syndicated the very office building where the IRS rents its Manhattan headquarters (Dentzer 58).

The economy was a mess, and the government was lossing millions of dollars in revenue. The dream of what the 1981 Tax Act would do for the United States had turned into a nightmare. Instead of increasing productivity and economic growth, banks were failing, office buildings were fast becoming vacant, half-built condominium developments were abandoned. The 1981 Tax Act created a monster, and something had to be done to destroy it before it was too late.

The 1986 Tax Reform Act targeted the real estate industry in particular. Chapter Two will be examine those items of the 1986 Tax Act that are most damaging to the commercial real estate market.

Chapter Two

What the 1986 Tax Reform Act means to the office building market

What the 1986 Tax Reform Act means to the office building market

There are often solid reasons for changes in the tax code, but the nightmare that happened as a result of the 1981 Act should have been foreseen, or at least considered. The resulting chaos stemmed from several things, not strictly from the Tax Act. Bank deregulation, federally funded depositors insurance, conditions of the stock and bond markets, improper appraisals, as well as fraud and mismanagement of savings and loan institutions all worked in combination to create a crisis for the government and the real estate industry.

The successful lobbying effort by the real estate industry prior to 1981 did succeed in securing lucrative tax benefits for their investors. One industry leader said, "Not only did we get it, but we chose to flaunt it as an industry by hyping tax shelters, and tax free income" (Martin 60). The IRS will not listen to claims of "tax free income," and "profitable losses of tax shelters" for long.

Those involved in all segments of real estate investing became very flagrant in their promotions of tax evasion. The equality and equilibrium conditions that were forecast did not happen. By March of 1985, vacancy rates were over twenty percent in

some cities, and above fifteen percent in the downtown areas of thirty-one of the largest metropolitan areas (Downs 103).

There were many not so subtle hints of what was to come. Congress did not lower the axe on the real estate industry in 1986 without some warning. There were tax changes in 1984 that began to curtail real estate investment activities. Although complicated, the 1984 Tax Act "nickeled and dimed investors by raising small increments of tax revenue" (Jones 160). The changes in this act produced more headaches than fear for the real estate industry.

Under the 1981 Tax Code, aggressive investors could take huge deductions for accrued interest, even though interest would not be paid until the underlying mortgage was paid off. The 1984 Act " clamps down on the treatment of accrued interest" (Jones 160).

Another tactic mentioned on page eleven of Chapter 1, large front-end fees paid by investors for services and expenses not yet performed, were disallowed in the 1984 Code because out-of-pocket expenses can only be deducted after they have actually been paid out of the pockets of syndicators that demand the fees (Jones 160).

Damage to the real estate industry from these changes were minor. According to Kenneth Leventhal & Company:

> the return on a representative real estate tax shelter investment held for 10 years drops about two percentage points--from 31% to 29%--under the 1984 rules. In general, a deal that would have generated a $2 write-off for every $1 invested will now give you a $1.50 write-off. (Jones 160)

As long as investors could deduct more than they invested, their bottom line figures still looked good.

One change in the law that affected everyone, not only real estate investors, was the altering of depreciation periods. Income-producing properties, such as office buildings, would now be depreciated over 18 years, instead of the 15 years provided by the 1981 Tax Act.

Deductions of depreciation reduce investor's current tax liability. Under the 1984 law, "available depreciation is decreased by one percentage point for each of the first four years of ownership" (Jones 160). Because the allure of big deductions in the first few years of ownership is the benefit of accelerated depreciation, the 1984 Tax Code did slightly reduce this benefit.

Another change that reduces initial-year deductions concerns leasing activities that involve payments greater than $250,000 a year. The tax code now says that

> No longer can a lower initial rent schedule be offset by a higher future rent schedule to achieve a back-loading of income with a corresponding reduction of taxable income.... Initial-year deductions are reduced, increasing the effective investment and lowering the rate of return. (Jones 161)

Anything that reduces initial-year returns hurts the tax shelter industry, and in turn, the real estate market, since this is their most attractive benefit.

These changes were implemented to curb abuses and fraud, and increase the Treasury's purse. The reforms also served as a warning to those in real estate to become "less shelter-oriented and more profit-oriented" for their own sake, as well as that of the economy (Walbert 86).

For those real estate investors that were already economic-growth-oriented, the impact of the 1984 Act was fairly positive. Although property values were expected to drop, this could still mean profit. Some new construction was delayed because of the changes, but in the already over-built industry, that meant less supply, higher rents, and in turn, higher profits (Jones 164).

Before the ink was dry on the 1984 Tax Act, there were hints of bigger changes down the road. As they had done countless times before, the real

estate industry had re-grouped, and was handling the fallout from 1984 fairly well. The industry's concern was now shifting to the future. Jerry Reinsdorf of Balcor/American Express, a leading real estate syndicator, sums up their fear of the unknown: "Our concern in the real estate business is uncertainty. We could live with almost anything as long as we know what it is" (Jones 164).

By late 1985, Senator Robert Packwood was getting much attention. Senator Packwood, Chairman of the Senate Finance Committee, was proposing changes to the tax law that would deal a fatal blow to real estate investors. News of what was happening on Capital Hill filled newspapers and television news programs. Panic was wide-spread, and "lobbyist were incensed about the threatened repeal of the 1981 provisions" (Cullen 24).

By early 1986, lobbyists descended on Washington by the thousands. The usual lobbying campaigns were not working. To make matters worse, the TV cameras portrayed lobbyist as the bad guys. Even Senator Packwood, who himself had received $6 million in campaign contributions from special interest lobbyist, warned against the increasing numbers of "high-priced lobbyist" (Cullen 24). In desperation, the lobbyist turned to allies in the bank lobby and building-trade unions, but found no open support.

By summer, the real estate industry had resigned itself to the fact that tax reform would "eliminate much of commercial real estate's privileged status" (Novack 73). On October 22, 1986, President Reagan signed the dreaded Tax Reform Act of 1986, and that 1984 page document "ripped apart tax shelters like a tornado racing through a trailer park" (Petre 27).

Even before the Act was signed, real estate investors were feeling its affects. The rumors of impending doom caused some of the previously reckless investors to become very cautious. For wise investors, the idea of losing money was quickly losing it's appeal.

The reason that the 1986 Tax Reform Act is so damaging to real estate investors is that it "eliminates most investments that are primarily tax oriented with little or no true economic benefits" (Snyder 15). The limitations on tax shelters were needed to offset the revenue loss from tax rate reductions granted by the Act. With the United States deficit problem, a tax reduction could not have been possible unless tax loop holes were closed.

The new Accelerated Cost Recovery System is an area of the 1986 Reform Act that really hurts the real estate industry. The 1981 Tax Code assigned a

recovery period of fifteen years for all forms of real estate. At various times since then, Congress lengthened the recovery period until it reached its pre-1986 length of nineteen years.

The new ACRS of 1986 applies to all tangible business property put in service after December 31, 1986. Real estate is now divided into two classifications. The first is residential rental property, which will now have a recovery period of 27.5 years. The second is nonresidential real property, such as office buildings, which now has a recovery period of 31.5 years. The straight-line method of depreciation must now be used for both classes, as opposed to the 175 percent declining balance method previously used.

Large deductions in first years of ownership were big incentives for investing in big-ticket properties, such as office buildings. The 1981 ACRS method fully returned the taxpayer's cost in only fifteen years, but the new method returns less than half the original investment at the end of fifteen years.

There is solid reasoning for lengthening the recovery period. It is unrealistic to depreciate a building in fifteen years when its actual life can be three or four times that. Also, real estate usually appreciates over time, making huge deductions for depreciation contradictory.

The following example shows the impact of the 1986 Tax Reform Act on annual deductions for depreciation on a $1,000,000 investment.

Year	1981 Act (15-Year ACRS, 175% Declining Balance)	1986 Act (31.5 Year ACRS Straight-Line)
1	$120,000	$31,746
2	100,000	31,746
3	90,000	31,746
4	80,000	31,746
5	70,000	31,746
6	60,000	31,746
7	60,000	31,746
8	60,000	31,746
9	60,000	31,746
10	50,000	31,746
11	50,000	31,746
12	50,000	31,746
13	50,000	31,746
14	50,000	31,746
15	50,000	31,746
Total	$1,000,000	$476,190

(Schwartz 30)

Going from a first year deduction of $120,000 to $31,746 certainly subtracts from the attractiveness of real estate investing.

The 1981 Tax Act allowed investors to deduct sixty percent of their net long-term capital gains each year. This deduction limited their tax liability to forty percent of ordinary income rate. The maximum ordinary income rate was fifty percent, so the capital gain rate was capped at twenty percent. The new Act equalizes rates on capital gains and ordinary income. The top rate on net capital gains is now twenty-eight percent, and thirty-four percent for corporations (Schwartz 31).

Another blow to investors is the extension of at-risk rules to real estate activities. The at-risk rule was established to prevent taxpayers from deducting losses greater than the amount actually at risk, or invested, in the activity. This limitation did not apply to real estate holdings. The amount at risk was the sum of the following taxpayer contributions to the activity:

> 1. His cash contributions to the activity.
> 2. The adjusted basis of other property that he contributed to the activity; and
> 3. Amounts that he borrowed for use in the activity for which he has personal liability or for which he has pledged, as security for repayment, property not used in the activity. (Schwartz 32)

This sum was normally increased each year by the taxpayer's share of income from the property, and was decreased by losses and withdrawals.

The 1986 Act limits the deductible losses from real estate activities to the amount of at-risk investment, including personal liability on mortgages. The taxpayer cannot deduct losses that "reflect the full cost of real property if a portion of the cost is financed by nonrecourse indebtedness" (Schwartz 32).

A somewhat complicated feature of the 1986 Tax Act concerns passive loss rules. The new rules say

that deductions from passive activities cannot exceed income from passive activities. This addition discourages investments in tax shelters because it "limits the ability of taxpayers to use deductions from passive activities as an offset against other income" (Stretch 37).

Income is now classified as either active, passive, or portfolio. The definitions for these three kinds of income are

> Active income--wages, salaries, and any income or loss from a trade or business activity in which an individual owns at least a 10% interest or participates directly in management decisions.
> Passive income--income or loss from an activity in which an individual does not materially participate, and any rental income.
> Portfolio income--interest, dividends, royalties, and gains or losses on stocks, bonds, and other securities. (Moore 36)

The passive loss rules do not completely disallow losses and credits from passive activities, but do govern how and when they can be used.

The question of whether an activity is passive must be considered on an individual taxpayer basis. A trade or business might be a passive activity for one owner, but not for another. It is each particular owner's level of activity that determines the kind of income it will be for tax purposes.

An exception to this is a limited partnership. The Act establishes a "conclusive presumption that a taxpayer holding a limited partnership interest in an activity does not materially participate in the activity" (Stretch 38). Also, any losses incurred by a limited partnership are always considered passive and subject to the limitation.

All rental activities are also considered passive without regard to whether the taxpayer materially participates in the activity. Rental income and losses are limited under the new rules. There is one exception that involves losses up to $25,000 from rentals of real estate in which the owner actively participated.

For tax purposes, a taxpayer actively participates in the management of real estate by

> making management decisions or arranging for other to provide services (such as repair) in a significant sense. Relevant management decisions would include approving new tenants, determining rental terms, approving capital or repair expenditures and other similar decisions. (Stretch 38)

Such an individual can offset up to $25,000 of nonpassive income annually with losses and credits (to the extent they exceed net income from all passive activities) from rental activities that he actively participates in.

Portfolio income is not considered passive, so any passive losses or credits may not be applied to offset it. Portfolio income from a passive activity must be seperated from other income or expenses produced by such activity. In the case of limited partnerships, dividends earned must be separately stated and not included in the limited partner's share of passive income or loss from the activity (Stretch 38).

Passive loss limitation rules are phased in and became effective after December 31, 1986. These rules apply to all losses incurred after that date without regard to when the activity was entered into. Rules regarding passive activity credits apply to all properties placed in service after December 31, 1986.

For passive activities entered into prior to the date of enactment, the losses and credits from these activitites are allowed against nonpassive income according to the following percentages:

Taxable Years Beginning In	Percentage Allowed
1987	65%
1988	40%
1989	20%
1990	10%
1991	0%

Passive losses disallowed during the transitional period must be carried forward to the succeeding year (Stretch 40).

Interest deductions are also limited by the 1986 Act. An investor may deduct investment interest up to the amount of net investment income. Net investment income is investment income over investment expense. Congress has expanded the current definition of investment income to include

> the taxable gain from the disposition of investment property, income from investments and investment interest. Investment expense is the amount of depreciation and depletion the taxpayer actually utilizes for tax purposes. (Stretch 42)

In cases of net lease properties, some deductible expenditures in excess of rental income are allowed.

The phase-in period for these new interest expense limitations is five years. In 1987, sixty-five percent of the otherwise disallowed interest is deductible, forty percent in 1988, twenty percent in 1989, and ten percent in 1990. Interest can be carried forward from this phase-in period, but is only deductible to the extent that investment income exceeds investment interest paid (Stretch 44).

Real estate investment trusts came out ahead by the Tax Act of 1986. Rules governing REITs are relaxed to provide them with greater flexibility. REITs were created to

> provide a vehicle for numerous small investors to invest in a diversified real estate portfolio with the benefit of professional management. In order to provide the investors with benefits similar to direct ownership, the portion of income distributed by a REIT to investors is generally taxed to the investors without being subject to tax at the REIT level. (Eisenstadt 25)

A REIT may be in the form of a corporation, trust, or association. However the REIT is structured, it must specialize in investments in real estate, real estate mortgages, or a combination of both.

Some of the strict requirements of qualification previously imposed on REIT's have been eased with the 1986 Tax Code. There are still numerous restrictions designed to assure that REIT's investment activities are passive nature, but according to the Senate Finance committee Report

> many of the prior law provisions were overly restrictive; therefore, changes were enacted to enable REITs to enter into transactions, or otherwise structure their affairs, in a manner consistent with prevailing market conditions. (Galler 178)

The changes in the 1986 Tax Reform Act will enable newly created entities to qualify for REIT status more easily and let existing REITs compete more effectively with other real estate investments.

The old law required seventy-five percent of the REIT's income to be derived from real estate transactions or investments. The new rules relax this qualification by allowing income from stock and debt instruments purchased by REIT's to be treated as qualifying income for the seventy-five percent income test.

At least ninety-five percent of REITs income must come from sources qualifying for the seventy-five percent test or from other interest, dividends or gains from the sale or disposition of stock or securities. This income test has not been changed by the 1986 Act, but rents from real property can now be applied towards the seventy-five and ninety-five percent income tests.

The old law disallowed use of income from the rental of real property if the REIT rendered any services to tenants, or managed the property, unless the services or management was provided by an independent contractor. This exclusion is intended to ensure that the REIT remained a passive entity.

Under the new law, income received by a REIT from rental property is no longer disqualified just because the REIT performs certain services without the use of an independent contractor. Tenant payments are considered rents from real property when "services provided in connection with the rental of space are...customarily rendered in connection with

the rental..." (Galler 180). For example

> amounts attributable to maid services would not be considered rent because such services exceed those required for mere occupancy, while amounts attributable to the furnishing of heat and light, cleaning of public areas and trash collecting would constitute rents from real property. (Galler 180)

The services provided must be of the kind usually provided to rental space, and not just for the convenience of the occupant.

The 1981 Tax Act obviously gave real estate investors preferential treatment. Because the real estate industry abused these benefits, the 1986 Tax Reform Act removed many of the 1981 benefits. Although much of the new act affects real estate investors in a negative way, the government was not seeking to destroy the industry. Congress saw that by ignoring market conditions, the real estate industry would destroy itself if something was not done to stop them.

The 1986 Act drastically reduces the benefits of tax shelters and forces investors to change their approach to investment decisions. Many real estate syndications have gone under since the enactment of the 1986 laws, but they probably would have done so anyway. Investment decisions based on losing money will eventually topple even the strongest companies.

There has been much debate about the impact of the 1986 Tax Reform Act on the market value of real estate investment properties such as office buildings. All of the changes provided by this Act have an effect on the office building market in one way or another, but mostly in a negative way.

There are "three major provisions of the 1986 Act which collectively work to decrease the value of an investment property" (Turley Martin 1). The provisions include:

> A. The change in the allowable depreciation rate, from 19 to 31.5 years.
>
> B. The change in the long-term capital gains tax rate, from 20% to 28%; and
>
> C. The change in the corporate tax rate, from 50% to 28%. (Turley Martin 1)

In a flyer put out by the Turley Martin Company, two spreadsheets were compiled to show taxable income and cash flow under the old tax law, and under the 1986 Tax Act. Comparison of the two spreadsheets will show a decrease in value of over 7 percent due to the provisions of the 1986 Tax Reform Act.

The following data and spreadsheets are taken from Turley Martin's "Realty Asset Dynamics" flyer. Spreadsheet A (Table 1) displays the calculation of taxable income and net cash flows of a commercial property under the tax law prior to the passage of the 1986 Act. Spreadsheet B (Table 2) illustrates

Table 1

Spreadsheet A
TAXABLE INCOME AND CASH FLOW-UNDER THE OLD TAX LAW

TAXABLE INCOME	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996
Net Opr.Income	212737	223374	234543	246270	258583	271512	285088	299342	314310	330025
Less Int. Expns.	187103	185200	183107	180805	178273	175488	172424	169053	165346	161268
Less Dep. Expns.	118170	118170	118170	118170	118170	118170	118170	118170	118170	118170
Taxable Income	-92536	-79996	-66734	-52705	-37860	-22146	- 5506	12119	30794	50587
Income Tax	-46268	-39998	-33367	-26353	-18930	-11073	- 2753	6059	15397	25294

NET CASH FLOW	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996
Net Opr. Income	212737	223374	234543	246270	258583	271512	285088	299342	314310	330025
Less Debt Serv.	206127	206127	206127	206127	206127	206127	206127	206127	206127	206127
Bef. Tax Csh Flow	6610	17247	28416	40143	52456	65385	78961	93215	108183	123898
Less Tax	-46268	-39998	-33367	-26353	-18930	-11073	- 2753	6059	15397	25294
Aftr Tax Csh Flow	52878	57245	61783	66495	71386	76458	81714	87155	92786	98604
+Sales Price										+3567839
-Cost of Sale										-178392
-Loan Balance										-1567820
-Capital Gain Tax										-415289
Net Cash Flow	52878	57245	61783	66495	71386	76458	81714	87155	92786	1504942

Purchase Price	Int. Rate	Dep. Yrs.	IRR.	Eqty Invstd	Amor. Yrs.	Inc. Tax
$2,494,700	10%	19	.16675	$623,675	25	50%

Amount of Loan	Annual Payment	Capital Gains Tax Rate
$1,871,025	$206,127	20%

(Turley Martin 1)

Table 2

Spreadsheet B
TAXABLE INCOME AND CASH FLOW-UNDER THE 1986 TAX ACT

TAXABLE INCOME	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996
Net Opr.Income	212737	223374	234543	246270	258583	271512	285088	299342	314310	330025
Less Int. Expns.	172500	170746	168817	166694	164360	161792	158967	155860	152442	148682
Less Dep. Expns.	65714	65714	65714	65714	65714	65714	65714	65714	65714	65714
Taxable Income	-25477	-13086	12	13861	28509	44006	60407	77768	96154	115629
Income Tax	-7134	-3664	3	3881	7983	12322	16914	21775	26923	32376

NET CASH FLOW	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996
Net Opr. Income	212737	223374	234543	246270	258583	271512	285088	299342	314310	330025
Less Debt Serv.	190040	190040	190040	190040	190040	190040	190040	190040	190040	190040
Bef. Tax Csh Flow	22697	33334	44503	56230	68543	81472	95048	109302	124270	139985
Less Tax	-7134	-3664	3	3881	7983	12322	16914	21775	26923	32376
Aftr Tax Csh Flow	29831	36998	44500	52349	60561	69150	78134	87527	97347	107609
+Sales Price										+3567839
-Cost of Sale										-178392
-Loan Balance										-1445459
-Capital Gain Tax										-489045
Net Cash Flow	29831	36998	44500	52349	60561	69150	78134	87527	97347	1562552

Purchase Price	Int. Rate	Dep. Yrs.	IRR.	Eqty Invstd	Amor. Yrs.	Inc. Tax
$2,300,000	10%	31.5	.16675	$575,000	25	28%

Amount of Loan	Annual Payment	Capital Gains Tax Rate
$1,725,000	$190,040	28%

(Turley Martin 2)

taxable income and net cash flows under provisions of the 1986 Tax Act.

It is assumed that seventy-five percent of the January, 1987 purchase price of over $2.4 million is financed at ten percent interest for a twenty-five year period. This is a standard loan-to-value ratio. This analysis makes no unusual assumptions about the investment. This property is sold at the end of 1996 for $3,567,839.

The internal rate of return on this investment is 16.675 percent. With the changes under the 1986 Act regarding depreciation, corporate income, and capital gains tax, however, this property could not sell for more than $2.3 million if it is to generate the same internal rate of return. This represents a decrease in value of over seven percent--from $2,494,700 to $2,300,000.

In addition to the decreased market value of the investment property, there is a significant decrease in cash flow to the investors. Under the old tax laws, total net cash flow during the ten year period of 1987 through 1996 was $2,118,949. The total after tax cash flow for this same period is $746,504. However, under the provisions of the 1986 Tax Act, net cash flow is reduced by $64,711, to $2,054,238, or approximately 3.2 percent. Also, the after tax cash flow is reduced by $82,498, to

$664,006. This decrease signifies an 11.1 percent reduction in returns to the investor.

The reduced cash flows are attributed to the the increase in the depreciation period, which in turn causes taxable income to be increased. Even though the corporate tax rate is decreased from 50 percent to 28 percent, the increase in taxable income is so great that taxes actually paid at the 28 percent level are $122,177 for the ten year period. Under the old law, taxes actually paid amounted to only $46,750, or 38.3 percent of the post 1986 Tax Act amount.

What happened to those seductive catch phrases used by real estate syndicators? As mentioned in Chapter 1, in 1981 it was fashionable to end up "in the red," and "quick doubles, and four-to-one write offs" were the hot topics of cocktail conversation (Moore 33). What happened to those profitable losses lauded by syndicators? Spreadsheets A and B provide the answer to that question.

As shown in Spreadsheet A (Table 1), this investment generated those "profitable losses" allowed under the old tax law. This investment produced losses in seven out of ten years shown. In 1987, the taxable income amounted to $-92,536. With a tax rate of 50 percent, the tax savings would then total

$46,268. Total taxable income losses in the first seven years amounted to $357,483. Consequently, the tax savings amounts to 50 percent of $357,483, or $178,741.

In Spreadsheet B (Table 2), the same investment generated losses in the first two years only. The total loss in taxable income for the two years was $-38,563. The 1986 Act reduced the tax rate to 28 percent, so tax savings on $-38,563 is only $10,798, as opposed to a savings of $178,741 under the old law. The 1986 Tax Act definitely took the profit out of losing money on real estate investments.

Chapter Three will define the area referred to as St. Louis County in this paper. Each area and its associated subareas will be discussed. This identification is necessary because some sources on the St. Louis County office market include other areas such as St. Charles County and some counties in Illinois. In order to see what affect the 1986 Tax Act had on the St. Louis County office market, only that data concerning St. Louis County, as defined by this paper, has been used.

Chapter Three

A Geographical Description of the St. Louis County Office Market

A Geographical Description of the St. Louis County Office Market

The following data on St. Louis County office space was taken from the Office Space Inventory publications of 1986, 1987, 1988, and 1989 prepared by the St. Louis County Department of Planning. The following types of office space are not included in this data:

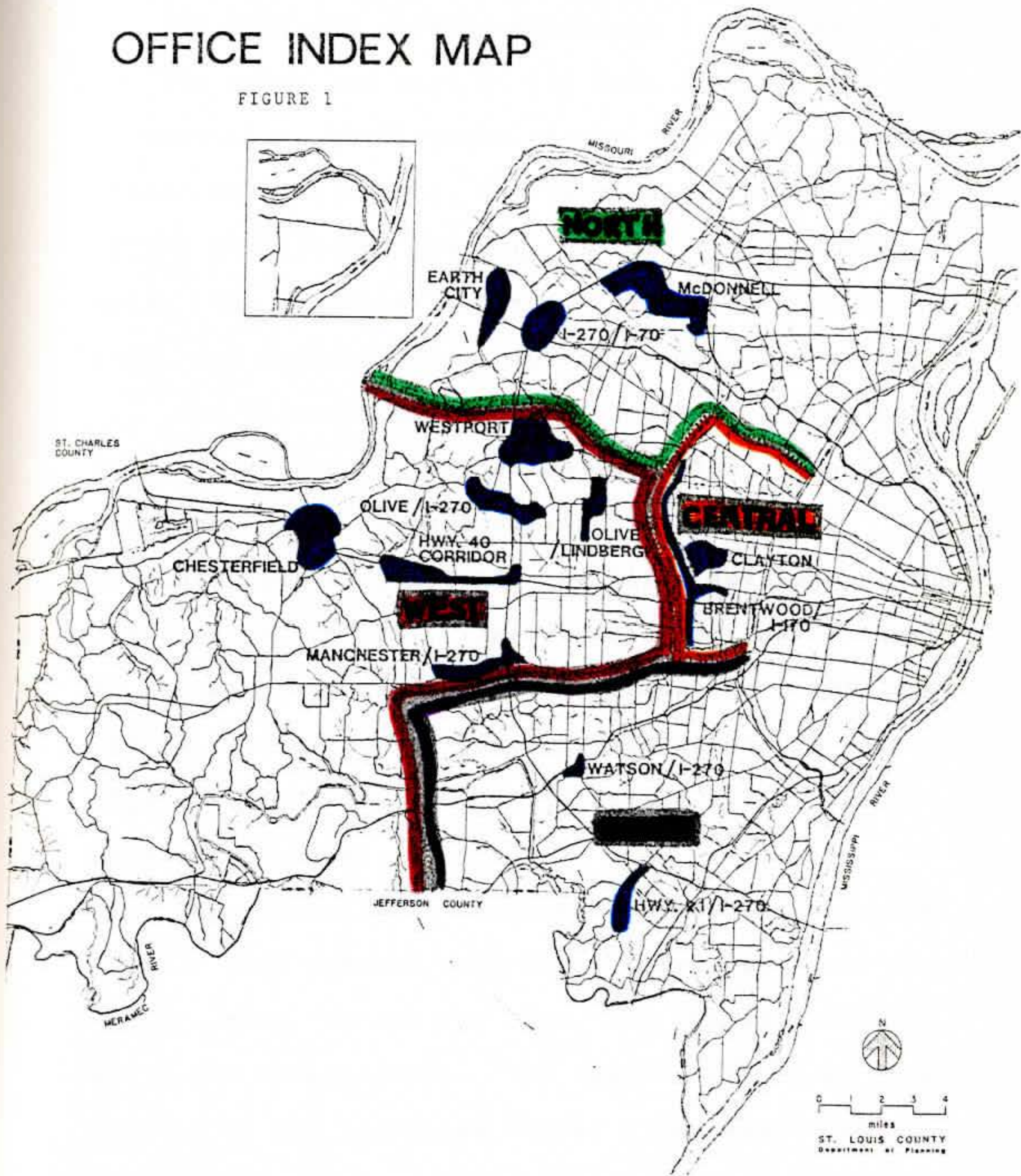
1. Office buildings of 10,000 gross square feet or less.
2. Publicly owned and occupied buildings (such as the County Government Center).
3. Utility owned and operated buildings.

Also, in the case of office/warehouse and office/retail space, only the square footage of the actual office portion is included.

The St. Louis County Office Market consists of four main geographic areas; West, South, North, and Central. These areas are further broken down into subareas based on concentrations of office developments. (Figure 1)

WEST AREA

Most development during the 1980's has been in the West area. This area grew 62 percent, from 6.6 million to 17.5 million net square feet in the past



OFFICE INDEX MAP

FIGURE 1

decade. The West area consists of seven subareas: Westport, Olive/Lindbergh, Olive/I-270, Manchester/ I-270, Hwy. 40 Corridor, Chesterfield, and Other.

The Westport subarea comprises 2.7 square miles to the north and east of the Page Avenue/I-270 intersection. Development of the Westport subarea began in the 1960's, and continued throughout the 1970's and 1980's. General office space predominates the Westport subarea, but office/warehouse, bank, and medical office space is also present.

The Olive/Lindbergh subarea covers approximately 2.5 square miles, extending along Lindbergh Boulevard from Baur Boulevard to Ladue Road. The Monsanto Company completed the first development in this subarea in 1957. The majority of development in this area was completed during the 1960's and 1970's. This subarea is comprised of mostly general office space, with only a few office/warehouse, and bank developments.

The Olive/I-270 subarea covers 2.7 square miles. This subarea runs along Olive Boulevard from Mosley Road to Fee Fee Road, and its mid-point is the I-270 intersection. The largest office in this subarea is the Insurance Center Plaza completed in 1980. Most development occurred during the 1980's, with 1982 being the peak year. General office space dominates with just a few bank and medical office developments.

The Manchester/I-270 subarea is a 3-mile corridor that runs westward along Manchester Road from Ballas Road to Weidmann Road. The largest office development here is the Community Federal Center completed in 1978. This development, which contains 239,000 net square feet, is the largest bank development in St. Louis County. The corridor developed largely during the 1980's, and is predominately general office, with some bank, medical and office-warehouse space.

The Hwy. 40 Corridor extends 4.6 miles towards the west from Ballas Road to Woods Mill Road along Hwy. 40. There are only two types of office space in this subarea; general and medical, with general office space being the largest. The first development completion was in 1972, however, most office development has occurred during the 1980's. The Hwy. 40 Corridor's peak year was 1986.

The Chesterfield subarea runs from the intersection of Highway 40 and Olive Boulevard to Wild Horse Creek Road. Over 90% of the office development in this area occured during the 1980's. The Monsanto Company's Chesterfield Village Parkway development is the largest office building group, and was completed in 1984. General office space is dominant, with some bank, office/warehouse, and office/retail space.

The remaining sections not a part of the subareas mentioned above are included in the West Other subarea. The first office development in this subarea, the Alvey Building, was completed in 1950. Development continued through the 1960's and 1970's, with the most development occurring in the 1980's. The main types of office space in order of size are general, office/warehouse, and medical, with a small amount of bank and office/retail space.

SOUTH AREA

The South area has experienced a 54 percent increase in office space over the last decade. The South area is divided into three subareas; Hwy. 21/I-270, Watson/I-270, and Other South.

The Hwy 21/I-270 subarea covers a 2.4 mile corridor along Tesson Ferry Road, south of the I-270 intersection. General office space predominates, but medical office space is a significant part of this subarea. Development has occurred throughout the 1970's and 1980's. The largest office is the General American Life Assurance Building, which was completed in 1976.

The Watson/I-270 subarea is only .2 square mile in size. This subarea is located along Watson Road immediately east of the intersection of I-270, and includes some development along I-44. The largest

and first built development is the Safeco Office Park, completed in 1972. There is only one medical and one bank office development. General office space predominates.

The South Other subarea comprises the South area not included in the two subareas above. Most of the developments included here are concentrated along the I-270 and I-44 corridors. South Other is a mixed subarea of general, office/warehouse, office/retail, bank and medical office space. The largest development here is Maritz Headquarters, which was completed in 1971.

NORTH AREA

The North area has experienced an increase in office space of 52 percent in the last decade. This area consists of four subareas; McDonnell Douglas, Earth City, I-270/I-70, and North Other.

The Earth City subarea is a 1.3 square mile corridor centered along the Earth City Expressway from St. Charles Rock Road to the Riverport Area south of I-70. The Earth City development began in the early 1970's and has grown rapidly during the 1980's, with it's peak year in 1987. Earth City has a higher proportion of office/warehouse developments than in any other subarea, but general office space is still the dominate office type.

The I-270/I-70 subarea covers 1.2 square miles surrounding the intersection of I-270 and I-70, and extends to the northeast. Development in this area began in the 1970's and continued into the mid-1980's. The largest development is the Regional Headquarters of Maryland Casualty Insurance Company, completed in 1985. General office space dominates, but medical office space has a relatively high proportion of footage in the subarea. DePaul Medical Center, built in 1976, is the largest medical office development.

The McDonnell subarea covers 2.8 square miles southeast of I-270 and north of Lambert Airport. Office development in this area began during the 1950's and has continued into the 1980's, with it's peak year being in 1985. This subarea is home to the largest company in St. Louis County, McDonnell-Douglas, which comprises the majority of space in this area. Over 95% of office floor space here is in general office developments, and a very small portion is in office/warehouses.

The North Other subarea consists of the North area excluding the subareas mentioned above. Office space here is concentrated along the I-70 and I-270 corridors. Development has grown steadily since the 1960's. The largest development in this subarea is the Northwest Plaza Tower, completed in 1968. This

area contains mainly general office space, but medical office space is also important.

CENTRAL AREA

The Central area contains the largest single concentration of office space in St. Louis County. In the past decade, this area has increased office space by 40 percent. Central Area is broken into three subareas: I-170/Brentwood, Clayton, and Central Other.

The I-170/Brentwood subarea is a 6.4 mile corridor along Brentwood Boulevard/I-170, bounded by Manchester on the south and Page to the north. Office development in this area began in the 1950's, and has continued through the 1980's. The completion of Interstate I-70 contributed to the large development in the 1980's. The largest office is the University Club Tower, completed in 1975. General offices dominate this subarea, followed by bank offices. There has been considerable office/ warehouse development in the 1980's around the intersection of Page Avenue and I-170.

The Clayton subarea boasts the largest single concentration of office space in St. Louis County. This subarea consists of 1.1 square miles north of Hwy. 40, east of I-170, and south of Delmar. The Clayton subarea has developed steadily since the

1950's, with the peak year in 1986. General office space predominates, but there is also bank, medical, and office/retail space.

The Central Other subarea consists of those remaining offices in the Central Area not included in the above mentioned subareas. Development of the Central Other subarea began prior to 1950, and has continued to develop through the 1960's and 1970's. Almost half of the office development in this small, dispersed subarea occurred during the 1980's. The largest office development, Purina Mills Inc., was completed in 1985. Most of the office space here is general with a significant amount of medical and a small amount of bank office space.

The next chapter will examine the St. Louis County office market prior to 1986 to see if investors were reacting to demand for office product, or responding to tax policy when making decisions to build. How investors made these decisions will have some bearing on how greatly the market will be affected by tax changes in 1986.

Chapter Four

The St. Louis County Office Market

Before the 1986 Tax Act

The St. Louis County Office Market Before the 1986 Tax Act

To determine how great of an effect the 1986 Tax Act had on the St. Louis Office Market, we must examine this market prior to the passage of the Act. As discussed earlier, many things happened prior to the 1986 Tax Reform Act that affected real estate.

Between 1978 and 1982 there were many things happening in the financial arena that had a direct impact on the real estate industry. Deregulation of financial institutions was underway which freed banks and thrifts to invest in areas previously forbidden to them. One area was the selling of shares in real estate syndicates (Downs 10).

Prior to deregulation, banks and thrifts were limited to the amount of interest they could pay to depositors. Federal deposit insurance lowered cost for these institutions, but until deregulation, the savings could not be passed on to customers by way of interest. Once this limitation was lifted, they could compete with other forms of investing for investment dollars (Downs 10).

By December of 1982, net new savings accounts at thrifts were $10.4 billion, and $22.5 billion at commercial banks. On the other hand, money market fund investments dropped from $230 billion to $165

billion (Downs 92). A flood of cash was pouring in to banks and thrifts. Once known for their stinginess towards real estate loans, financial institutions were now desperately searching for real estate equities (Downs 96).

In 1981, Congress passed the Economic Recovery and Tax Act which further increased the demand for real estate investments, particularly real estate syndicates. The 1981 Act shortened the depreciation period to 15 years, and allowed losses from real estate investments to reduce ordinary income by up to fifty percent, producing a safety net not found in other forms of investing (Martin 60).

In addition, interest rates fell sharply in the later part of 1982 causing investors in the bond market to leave for the greener pastures of the real estate syndicates. In late 1982, the stock market rallied and investors felt the rally had reached its peak, and bailed out before the market took a downturn, turning to real estate syndicates (Downs 94).

All these factors together created a frenzy for real estate. All over the United States office buildings, as well as other forms of real estate, were being built in record numbers.

In St. Louis County prior to 1978, there were 14,760,148 net square feet of existing office space. In the four year period of 1978 through 1982, net

square footage grew by 7,783,582 square feet, or 52.7 percent. Sixty-four percent of the 7,783,582 square foot increase occurred in the West Area of the county (St. Louis County Department of Planning 1986 [SLCDP86] 8). The frenzy for real estate investing and building occurring across the nation had obviously caught on in St. Louis County as well.

It was earlier discussed that many real estate investors became so enamored with profitable losses created by the 1981 Tax Act that they actually made investment decisions based upon the properties loss potential. However, such is not wholly the case when discussing real estate investments during the time period of 1978 through 1982.

In 1974, the national office vacancy rate was over 14 percent. By 1978, however, absorption was soaring, and vacancy rates fell sharply to below five percent on a national average (Caldwell Banker Commerical 1990 [CBC90] 3). The St. Louis Metropolitan area vacancy rate dropped to 4.3 percent during this time. This increased demand was forcing rents to rise higher than the overall inflation rate "which itself was setting new records" (CBC90 3).

To suggest that the upshot in office building construction during this time was due strictly to real estate investors responding to an increase in

demand for office space would be naive. To say the decision to build was strictly tax-driven would not be completely true either. Perhaps it was merely a coincidence, or a combination of these things. No matter what the underlying factors were, one could safely say that the situation during this time was exactly what the government had hoped for with the passage of the 1981 Tax Act, and the deregulation of savings institutions.

As stated in Chapter 1, Congress and the real estate lobbyists felt that the country was lacking in the areas of productivity and economic growth. By stimulating investments in real estate, productivity and the economy would improve. Need for growth was evident when vacancy rates dropped below five percent and office rents began to rise. How could new companies get started without office space to operate out of?

Deregulation provided the money for investing in these much needed office buildings, and the 1981 Tax Act provided incentive for investors to use the money for building office buildings. Congress was striving for the economic goal of equalibrium, where supply is increased to meet demand. Although perfect equalibrium in a market can seldom, if ever, be achieved, the period of 1978 through 1982 was perhaps Congress' finest hour.

It does appear, however, that the surge in new office buildings in St. Louis County during this period was made on the grounds of potential for profit, and not loss. First, St. Louis City found its tax base dwindling as city based companies headed for the county. Also, only one-fifth of the total St. Louis population were city residents.

St. Louis County was capturing much of the cities population and business refugees. The towns and unincorporated areas of the county accounted for a large percentage of residential and construction activity (Clayton-Fillmore Ltd. [CFL] 12). The large businesses and corporations that desire office space look for locations with readily available housing for their employees, and the county filled this need. By 1981, "roughly one-fourth of the city's housing stock had been either abandoned or demolished" (CFL 12).

With vacancy rates at 4.3 percent, population on the rise, and business desiring to relocate to the county, there was a definite need for vast amounts of office space in St. Louis County. Pair this with the increased supply of cash to loan, and real estate syndicates searching for real estate equities and you have a sound reason for increasing office space in the county.

As further proof, St. Louis' most affluent communites--Frontenac, Ladue, Clayton, Chesterfield and others--are located in the West Area along the Highway 40 corridor (CFL 12). These areas are primarily made up of white-collar and professional workers who normally work in office settings. The West Area was also experiencing population growth. Sixty-four percent, or 4,984,510 square feet, of the total office space build in St. Louis County during 1978 through 1982 occurred in the West Area, further proving that investors had done their homework before launching into building projects.

By 1983, it had become obvious that the once healthy real estate market was becoming over-built. At the end of the third quarter of 1983, the office vacancy rate for the nation was a dangerously high 18.7 percent (Table 3). The St. Louis County office vacancy rate had jumped to 12.0 percent with no signs of it stopping there.

If the smart real estate investors of the 1978 through 1982 building period were still looking at need as a factor in building, then it would follow that office building permits would decline in response to decreased demand. Unfortunately, permits rose in all areas of the nation, as well as in the once profit oriented St. Louis County area. It now appeared that real estate investors had been seduced

Table 3

St. Louis County Office Vacancy Rates
Versus National Vacancy Rates

Quarter	St. Louis County	National
July-Sept. 1983	12.0	18.7
Oct.-Dec. 1983	13.7	18.7
Jan.-Mar. 1984	13.6	18.4
Apr.-June 1984	14.2	18.1
July-Sept. 1984	14.4	17.9
Oct.-Dec. 1984	14.1	18.2
Jan.-Mar. 1985	11.8	18.9
Apr.-June 1985	9.6	19.7
July-Sept. 1985	9.7	21.2
Oct.-Dec. 1985	9.9	22.0
Jan.-Mar. 1986	12.1	22.5
Apr.-June 1986	11.7	23.3
July-Sept. 1986	15.4	23.8
Oct.-Dec. 1986	15.4	23.8
Jan.-Mar. 1987	14.7	23.9
Apr.-June 1987	14.2	22.7
July-Sept. 1987	15.0	23.0
Oct.-Dec. 1987	14.2	22.8
Jan.-Mar. 1988	14.0	22.3
Apr.-June 1988	12.4	21.5
July-Sept. 1988	12.7	21.4
Oct.-Dec 1988	13.8	21.4
Jan.-Mar. 1989	14.2	21.2
Apr.-June 1989	15.8	21.4
July-Sept. 1989	14.3	21.3
Oct.-Dec. 1989	13.7	21.4

(Coldwell Banker Commercial Office Vacancy Indexes 1988 and 1989.)

by the "profitable loss theory" preached by syndicators. Congress' dream of a healthy economy was now rapidly dying, and they again sat down to work out a solution.

Congress issued a warning to the real estate industry by passing the 1984 Tax Reform Act, which created more headaches than concern. The 1984 Act nickeled and dimed investors by increasing the depreciation period to 18 years on income producing properties, resulting in an available depreciation decrease of one percentage point for each of the first four years of ownership (Jones 160).

This act also clamped down on the treatment of accrued interest by disallowing the deduction of out-of-pocket expenses unless they have actually been paid out of the pockets of the syndicators demanding the large front-end fees (Jones 160).

As discussed in Chapter One, the 1984 Act was aimed mainly at real estate syndications, the group most guilty of tax shelter abuse. The allure of big deductions in the first years of ownership was the majoring selling point of shares in real estate syndications. The 1984 Tax Code did slightly reduce this benefit, but investors could still deduct more than they invested, and their bottom line figure still looked good.

Congress was sending a message to those in the real estate market to become "less shelter-oriented and more profit-oriented" for their own sake,as well as that of the economy (Walbert 86). For the most part, the message fell upon deaf ears.

By the end of 1985, the national vacancy rate had reached an ominous twenty-two percent. Office buildings were standing uncompleted or empty in many of the nations leading cities. In Denver, the vacancy problem was so great that auctions were held to try and fill vacant office space, with leases going to the highest bidders.

Although St. Louis County did experience high vacancy rates in 1984, these rates began to decline in 1985, reaching a fairly acceptable 9.9 percent by the end of that year. Had real estate investors here perhaps heeded Congress' warning?

The largest increase in completed office space in St. Louis County occurred in the period of 1981 through 1985 (Table 4). Over one-third of the total office space existing in St. Louis County was built in this four year period. Of course, it does take considerable time to plan, secure financing, and build an office building. Michael Gibson, the Director of Information Services for Follman Properties, says that as an average there is a two year time lag between issuance of the building permit,

Table 4

SUMMARY OF ST. LOUIS COUNTY OFFICE SPACE BY YEAR OF CONSTRUCTION AND AREA BEFORE 1986
(In Square Feet)

NORTH AREA

1976-77	1978-80	1981-82	1983-85	Total Existing
509,850	228,820	965,977	843,243	5,363,780

SOUTH AREA

1976-77	1978-80	1981-82	1983-85	Total Existing
468,800	413,620	680,995	569,665	3,459,930

WEST AREA

1976-77	1978-80	1981-82	1983-85	Total Existing
654,355	2,121,655	2,862,855	2,203,775	12,516,650

CENTRAL AREA

1976-77	1978-80	1981-82	1983-85	Total Existing
-129,157	275,247	234,413	988,497	5,808,550

TOTALS

1976-77	1978-80	1981-82	1983-85	Total Existing
1,503,848	3,039,342	4,744,240	4,605,180	27,148,910
5.5%	11.2%	17.5%	17.0%	100%

(The above figures were taken from the Office Space Inventory Reports from years 1986, 1987, 1988, and 1989 published by the St. Louis County Department of Planning.)

and the completion of an office building (Michael Gibson, personal communication, February 21, 1990). This two year average is only an estimate, or guideline, not an exact figure.

Keeping in mind this two year time lag, a look at Table 5 will give some insight to the question: Have St. Louis County real estate investors responded more to market conditions, or to tax policy when making investment decisions regarding office space? This is an important question when determining what effect the 1986 Tax Act had on the St. Louis County office market because investments that were merely tax-driven were seriously hurt when the once lucrative tax policies were changed.

In 1982, the years average vacancy rate in St. Louis County was 11.7 percent. During the year thirty-three permits for office buildings were issued (Table 5). Total square feet of office space completed in 1984 (using the two year time lag) was 2,172,850.

In 1983, vacancy rates in St. Louis County were on the rise, going from 12.0 percent at the end of the third quarter, up to 13.7 percent at the close of the year (Table 6 gives the average of 12.9). During 1983, thirty-six permits were issued for office buildings, three more than the previous year

Table 5

St. Louis County Office Vacancy Rates
And Building Permits

Quarter	Vacancy Rates	Permits
Average of 1982	11.7	33
July-Sept. 1983	12.0	
Oct.-Dec. 1983	13.7	36
Jan.-Mar. 1984	13.6	
Apr.-June 1984	14.2	
July-Sept. 1984	14.4	
Oct.-Dec. 1984	14.1	42
Jan.-Mar. 1985	11.8	
Apr.-June 1985	9.6	
July-Sept. 1985	9.7	
Oct.-Dec. 1985	9.9	70
Jan.-Mar. 1986	12.1	
Apr.-June 1986	11.7	
July-Sept. 1986	15.4	
Oct.-Dec. 1986	15.4	77
Jan.-Mar. 1987	14.7	
Apr.-June 1987	14.2	
July-Sept. 1987	15.0	
Oct.-Dec. 1987	14.2	34
Jan.-Mar. 1988	14.0	
Apr.-June 1988	12.4	
July-Sept. 1988	12.7	
Oct.-Dec 1988	13.8	59
Jan.-Mar. 1989	14.2	
Apr.-June 1989	15.8	
July-Sept. 1989	14.3	
Oct.-Dec. 1989	13.7	43
Jan. 1990		3

Vacancy Rate Data--(Coldwell Banker Commercial Office Vacancy Indexes 1988 and 1989.)

Building Permit Data--(Department of Public Works Construction Reports 1982 - 1990.)

Table 6

St. Louis County Office Vacancy Rates and Office Construction

Year	Vacancy Rate	Construction (Square Feet)
1983	12.9	1,356,350
1984	14.1	2,172,850
1985	10.3	1,784,888
1986	13.7	3,977,848
1987	14.5	1,883,689
1988	13.2	1,124,700
1989	14.5	1,729,796
(Jan.) 1990	14.5	1,800,150

Vacancy Rate Data--(Coldwell Banker Commercial Office Vacancy Index 1989 [CBCOVI89] 15)

Vacancy Rate Data for Jan. 1990--(St. Louis Post Dispatch 18BP)

Construction Data 1983-1988--(St. Louis County Department of Planning 1988 [SLCDP88] 6)

Construction Data 1989--(St. Louis County Department of Planning 1989 [SLCDP89] 5)

Construction Data 1990--(Personal Communication SLCDP February 21, 1990)

(Table 5), or an increase of ten percent. Total square feet of office space completed in 1985 (using the two year time lag) was 1,784,888, a decrease of 17.9 percent.

In 1984, vacancy rates continued to climb, and averaged 14.1 percent for the year, an increase of 9.2 percent over 1983's vacancy rate. Although vacancy rates were increasing, permits for office buildings were still increasing. Forty-two permits were issued in 1984, six more than 1983, or an increase of 16.6 percent. The total square footage completed two years later in 1986 was 3,977,848, representing a 222 percent increase.

It would seem from this data that investors were not paying a great deal of attention to the demand for office space when making decisions about building more office space. To increase office space by 222 percent when less space is being demanded does not make sense. However, if investors could still profit, even if the property produced a loss, increasing vacancy rates would not be a deterrent, and this seems to be the case in St. Louis County, as well as the rest of the nation.

By late 1985, Senator Packwood was becoming a media darling. On May 7, 1986, Senator Packwood disclosed the contents of his tax reform bill, and

sent shockwaves through the real estate industry. By early 1986, real estate investors had resigned themselves to the fact that the safety net Congress provided in 1981, was going to be taken away. How did real estate investors react to this knowledge that profitable losses might soon become only a warm memory?

The national office vacancy rate for the first quarter of 1985 was 18.9 percent, and steadily increased until it reached 22.0 percent in December. St. Louis County ended it's first quarter of 1985 with a vacancy rate of 11.8 percent, and ended the year at 9.9 percent with an average of 10.3 for the year (Table 3). Office vacancy rates had decreased slightly, 27.0 percent from the 1984 figure of 14.1 percent. Total square feet of construction completed two years later was only 1,883,689, which represents a substantial decrease of 47 percent.

On the surface, it would appear that St. Louis County investors and developers were indeed taking demand into account, and decreasing their supply of a product in response to the market's decrease in demand. The first clue that perhaps this was not the case is the number of building permits issued in 1985. However, seventy permits for new office buildings were obtained in 1985, an increase of 66.6 percent! An increase of 66.6 percent in new

building permits, and a decrease of 47 percent in completed office space two years later? And yet in 1984, building permits increased by a much smaller 16.6 percent, while office space completions jumped by a whopping 222 percent! There was something definitly amiss.

Earlier, the two-year lag between issuance of permits and actual completion of the buildings was mentioned, noting that two years was just a guideline and not the law. An exception must be made when discussing the office market during 1985.

According to Michael Gibson of Follman Properties (personal communication, February 21, 1990), there is a very good reason for deviating from the two-year guideline when looking at data from 1984 and 1985. Real estate investors knew in early 1985 that their tax safety net would be taken away. In order to take advantage of the 1981 Tax Act before it was gone forever, investors had to act fast.

A flurry of building activity soon commenced all over the United States. Office buildings were completed in record time in order to produce those soon-to-be-gone profitable losses. It did not matter that large amounts of overtime had to be paid to construction workers. Overtime would push up costs, decreasing taxable income, and increasing returns.

If office buildings were constructed in less than two years during this time, than the entire 3,977,848 square feet of completed office space for 1986 cannot be attributed to just the 42 building permits issued in 1984 (Tables 5 and 6). Although there is no data available stating exactly how many of 1985's seventy building permits resulted in completions in the following year, one might assume that it was probably quite a few.

If this theory is correct, then investors in St. Louis County were not as sensitive to changes in vacancy rates as previously thought. However, it would appear that they were very sensitive to tax policy, which would mean trouble for the office market in St. Louis County after 1986.

In Chapter Five, data on vacancy rates and office construction after 1986 will be examined to see how the provisions of the 1986 Tax Reform Act affected the St. Louis County office market.

Chapter Five

The St. Louis County Office Market After 1986

The St. Louis County Office Market after 1986

Although real estate lobbyists did their best to retain "commercial real estate's privileged status" (Novak 73), President Reagen signed the dreaded Tax Reform Act of 1986 on October 22, 1986.

Those areas of the 1986 Act that are damaging to the real estate industry were previously detailed in Chapter Two. This Act succeeded in greatly reducing the returns on commercial properties, and therefore reducing market values of these commercial properties (Tables 1 and 2), which ultimately eliminated "most investments that were principally tax oriented with little or no true economic benefits" (Snyder 15).

Many real estate investments made before 1986 were principally tax oriented. High vacancy rates, empty office buildings, condominium developments abandoned before completion, failed savings and loan institutions, and plunging market values in many major cities support this statement. Although not as seriously effected as some cities, St. Louis has also experienced some of the fallout from the 1986 Tax Act.

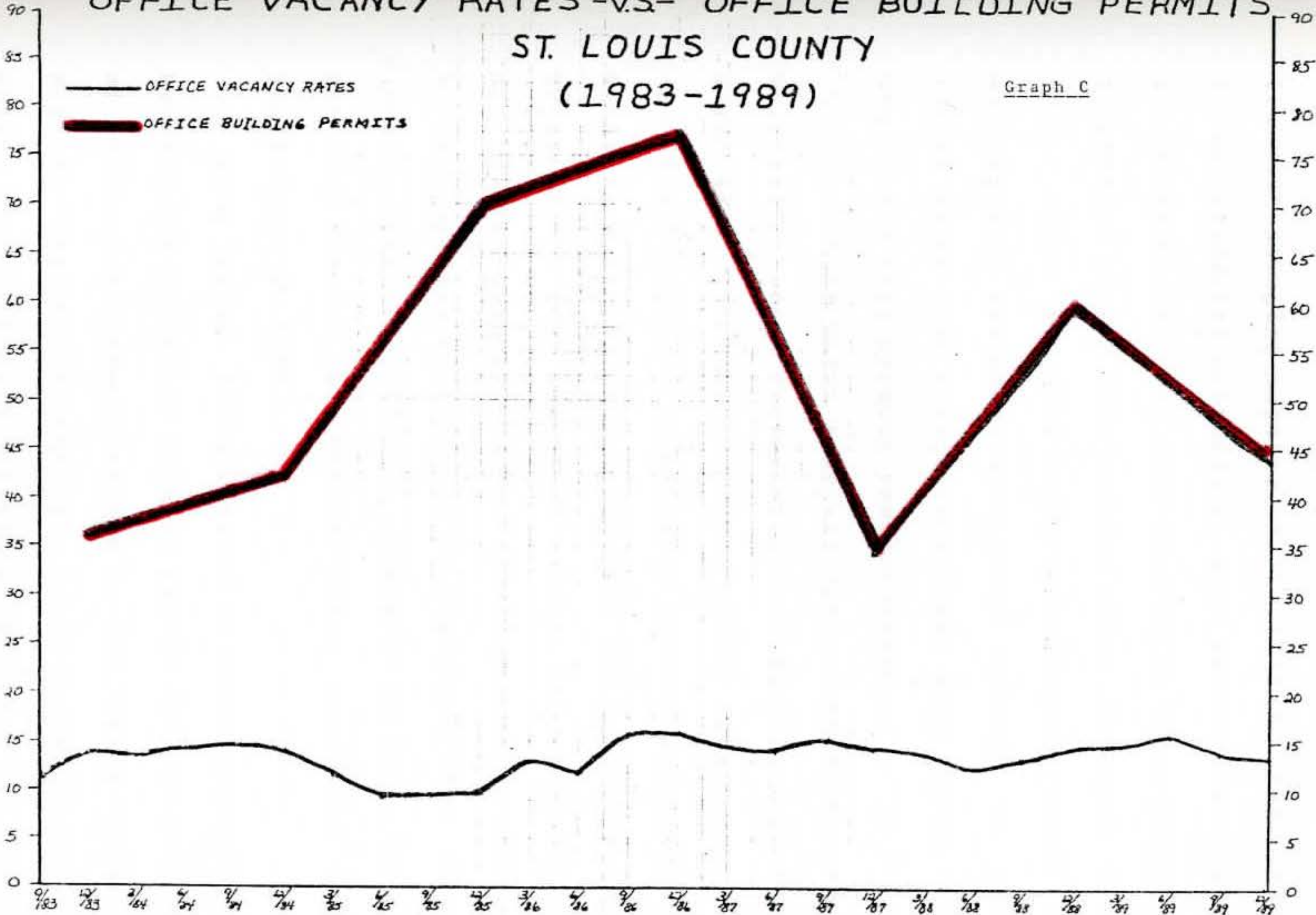
Last quarter of 1985 showed an office vacancy rate of 9.9 percent in St. Louis County while the national rate was up to 22.0 percent. Three months

later the vacancy rate in St. Louis County was 12.1 percent, and the national rate was 22.5 percent (Table 3).

If many of those seventy building permits that were issued in 1985 resulted in faster than normal completions as discussed in Chapter 4, then vacancy rates in 1986 would probably begin to rise. If the increase in building was due largely to proposed changes in tax policy, and not to demand, vacancy rates would probably increase substantially. This is exactly what was happening in St. Louis County.

By December, 1986, office vacancy rates in the St. Louis County increased to 15.4 percent from the 9.9 percent rate in December, 1985 (Table 3). This represents a 64.0 percent increase in just one year. This fact gives some credibility to the theory that investors in St. Louis County did respond to tax policy, more so than demand for office space, and that office buildings were completed in faster than normal intervals due to upcoming changes in the tax policy.

Although vacancy and supply rates of office space had reached an all time high for the county, building permits again increased in 1986 to seventy-seven (Table 5 and Graph C). In the same year that the office vacancy rate increased by sixty percent, permits for new buildings increased by ten percent.



Graph C

The provisions of the 1986 Tax Reform Act pertains to new investments in real estate after 1986. The most damaging aspects of the 1986 Act regarding income-producing properties, such as lengthening of depreciation periods, only applies to those business properties placed into service after December 31, 1986. Since projects begun in 1986 could still be written off, investors were still willing to put their money into office buildings, even though the demand for this product was decreasing.

One thing which suggests that investors were exercising some restraint in building is that the total square footage of office space completed in the following year (applicable if some accelerated building occurred) was 1,883,689, and 1,124,700 two years later. The amount of space being provided did decrease considerably. The decrease in office space completed in 1987 was 52.6 percent less than 1986's high of 3,977,848. Compared to 1986, there was 71.7 percent less office space completed two years later in 1988.

Here again there appears to some discrepancy between the number of permits issued and the amount of office space completed one to two years later. Michael Duncan of the St. Louis County Planning Office (personal communications, February 27, 1990) stated that a number of office buildings for which

permits were issued in 1986 were either postponed or canceled. Data on the exact number of permits that were postponed or canceled is not available.

Mr. Duncan said that there were probably many different reasons for the difference in building permits issued and actual projects completed. Some possible reasons are change in investment direction due to changes in tax policy, tightening of loans due to increasing savings and loan failures, some response to increasing vacancy rates, and the lack of funds provided by real estate syndications which were increasingly less popular due to the 1986 Tax Reform Act.

Vacancy rates continued to increase in 1987 to 14.5 percent, up 5.5 percent over 1986's figure of 13.7 percent. The national vacancy rate for 1987 was 23.1 percent (Table 3). Office space completed two years later in 1989, also went up. There were 1,729,796 square feet of new office space completed in 1989 (Table 6), representing a 53.8 percent increase over the 1988 figure. However, permits for office buildings had decreased to only thirty-four from 1986's high of seventy-seven, representing a decrease of 55.8 percent (Table 5). This data does appear to be rather confusing, and deserves further discussion.

It is curious that while issuance of building permits decreased by 55.8 percent, total square footage of office space completed two years later increased by 53.8 percent. This can be partially explained by referring back the discussion with Mr. Duncan on February 27, 1990, when he said that some of the seventy-seven building permits issued in 1986 resulted in postponements or cancellations of the projects. Completed office space in 1989 could very well include some of those projects that were postponed after the 1986 Tax Reform Act took effect, making the 1,729,796 square feet figure attributed to 1987's permits somewhat overblown.

Vacancy rates went down in 1988 to 13.2 percent in St. Louis County. The relatively small amount of office space completed in 1988, 1,124,700 square feet, is surely a factor in this decline (Table 6). The national vacancy rate also went down slightly, from an average of 23.1 percent in 1987, to 21.7 percent in 1988 (Table 3). By this time, office construction was on the decline all over the United States due to changes in tax policy, severe over-building, and to the savings and loan crisis.

The savings and loan crisis caused financial institutions to greatly change their once generous policy regarding real estate loans. No longer would loans be granted on office building projects unless

the investor wanting the loan could show need and produce tenants. With the national vacancy rate so high, it would be hard to convince financial institutions that there was a need for more office space.

A nine percent decrease in vacancy rates in St. Louis County was met with a seventy-four percent increase in office building permits. Permits increased from thirty-four in 1987, to fifty-nine in 1988 (Table 5). Even though the purpose of the 1986 Act was to discourage investments with little or no true economic value, this Act doesn't seem to have had much of a deterrent affect on investors in St. Louis County. Of course, if the projects being built in St. Louis County did have economic value, then changes in the 1986 Act would not discourage these investors.

Completed office space in just the first three months of 1990 was a substantial 1,800,150 square feet. There was only 1,729,796 completed in the entire year of 1989 (Table 6). Again, no data is available to tell us if some of these completions can be contributed to those postponed projects discussed earlier. Even so, it appears that 1990 will show another increase in office space construction over 1989. There were only three permits issued in the first quarter of 1990 for new office space.

St. Louis County has consistently maintained much lower vacancy rates than the national average.

In the third quarter of 1989, St. Louis County reached its highest vacancy rate, 15.8 percent. Even at this high rate, it was still 26.1 percent less than the national vacancy rate. In the first quarter of 1987 the national vacancy rate reached its highest point of 23.9 percent, but St. Louis County had a much lower 14.7 percent, 38.5 percent below the national average (Table 3 and Graph A).

The Follman Properties Office Report 1990 says that "the decade of the eighties will long be remembered in St. Louis as an area of unparalled construction growth and office development throughout the St. Louis metropolitan area" (Follman Properties Company 1990 [FPC90] 5). The growth and development discussed in this report is viewed as the result of the "increasing evolution of St. Louis' strong manufacturing base to service oriented business...." (FPC90 5).

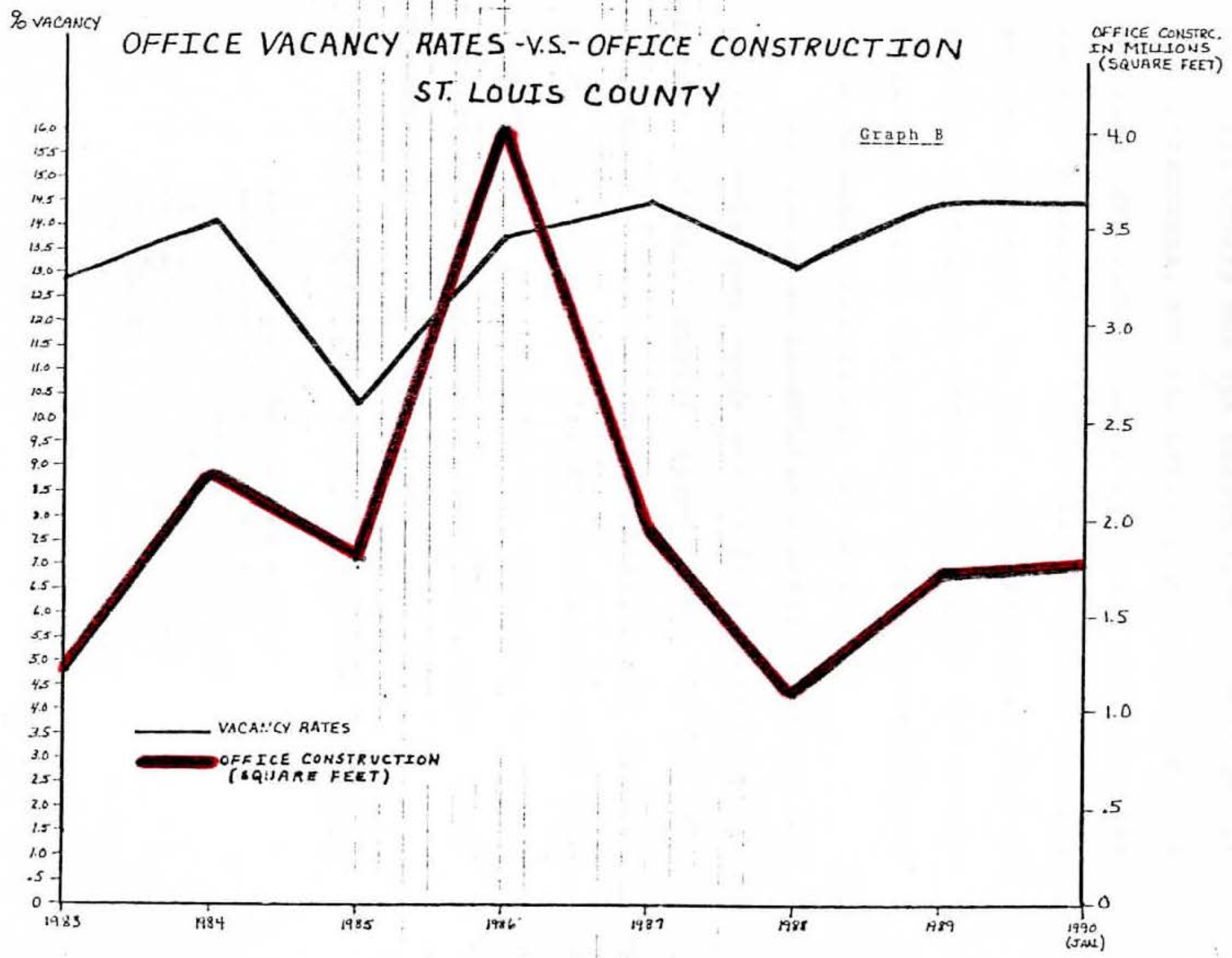
The same report says that at the beginning of this decade, there was a need for construction due to the lack of quality office product, and this need "precipitated a building boom of unparalleled magnitude that in one decade changed the face of St. Louis" (FPC90 2). Today the "surplus inventory and high vacancy rates have forced investors into acquiring properties already developed where value added opportunities exist" (FPC90 2).

ST. LOUIS COUNTY-V.S-NATIONAL OFFICE VACANCY RATES
(1983-1989)
Graph A
ST. LOUIS COUNTY
NATIONAL

Since 1987, construction in St. Louis County has slowed down, even though vacancy rates seem to have leveled off (Table 6 and Graph B)). The office market in the county is still considered "soft" even though St. Louis County has faired much better than many parts of the United States.

Demand for office space across the nation has fallen, however, new supply is not matching the reduction although office completions are down sixty percent from the boom level of the early eighties (CBC 1). 1986 was the biggest year for office completions in the St. Louis County area. Since then, supply has fallen 56.5 percent, slightly less than the national average of sixty percent.

A look at Table 3 and Graph A shows that the county of St. Louis has consistently shown much lower vacancy rates than the national average. The movement of the two graph lines are somewhat opposite for the years prior to 1986. St. Louis County show a steep increase in 1983, compared to a level rate for the nation. Vacancy rates continued to rise in St. Louis County through 1984, while the nation was experiencing a slight decline. In 1985, the nation's vacancy rates begins to increase, but St. Louis County shows a dramatic decrease in its vacancy rate.


% VACANCY
OFFICE VACANCY RATES -V.S.- OFFICE CONSTRUCTION
ST. LOUIS COUNTY
OFFICE CONSTRC. IN MILLIONS (SQUARE FEET)
Graph B
16.0
15.5
15.0
14.5
14.0
13.5
13.0
12.5
12.0
11.5
11.0
10.5
10.0
9.5
9.0
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1.5
1.0
.5
0
4.0
3.5
3.0
2.5
2.0
1.5
1.0
.5
0
1983
1984
1985
1986
1987
1988
1989
1990 (JAN)
VACANCY RATES
OFFICE CONSTRUCTION (SQUARE FEET)

After 1986, however, vacancy rates for both St. Louis County and the nation tend to move in the same directions, but St. Louis County continues to to keep its vacancy rates way below those for the nation. Although St. Louis County investors were seduced somewhat by the profitable-loss line of thinking that became popular after 1981, the county never experienced the severely over-built conditions found in many cites across the nation.

What could be considered a negative aspect of the St. Louis area turns out to be a godsend to the office building market after 1986. It was once said that the "neo-industrial" boom in the Midwest failed to happen for the St. Louis area (CFL 12). "The spirit is willing, but its progress is weak," and although the St. Louis area has shown sound fundamentals, its growth is weak (CFL 12).

The Robert Fuller Real Estate Report says that

> in a market that grows slowly and undramatically, as does St. Louis, severe overbuilding is uncommon; developers lack the confidence to build ahead of demand, a trend more typical for boom markets. (CFL 14)

Although growth in St. Louis County has been steady, and construction during the 1980's did increase, it cannot be called a boom area, and because of this, never attracted those over-zealous developers that Houston and Denver unfortunately did.

Another aspect of St. Louis County that must be considered is the attitudes of those people involved in the lending of funds for office building projects. The Follman News says that

> Missouri is the Show-Me State, and that is what lenders say to St. Louis developers before they commit funds for speculative office development--Show me your tenants! (Follman Properties Company 1989 [FPC89] 4)

Those over-zealous developers would find the somewhat conservative attitude of St. Louis lenders to be an obstacle when attempting to secure financing for office building projects that had little true economic value.

Houston and Dallas are two cities that suffered greatly from overbuilding, and it is no coincidence that there were also a substantial number of savings and loan closings in those areas in the last few years. Lenders in those areas had a more adventurous attitude towards lending money for projects that were highly speculative, and the result was vacancy rates as high as twenty-seven percent (Squires 50). St. Louis County never experienced this degree of overbuilding, and those conservative lenders deserve some of the credit.

Even though St. Louis County has faired much better than other areas of the nation, the 1986 Tax

Reform did have an impact on the office building market here. At the present, the 1986 Tax Reform Act has shown to have had a negative impact on the office building market in St. Louis County.

The first area that shows a negative impact is in the market value of real estate investment properties such as office buildings. Referring again to Tables 1 and 2, the provisions of the 1986 Act have "collectively worked to decrease the value of an investment property (Turley Martin 1). Turley Martin's example shows that an income-producing property that sold for $2,494,700 under the old tax laws, cannot sell for more than $2.3 million under the 1986 laws if it is to produce the same internal rate of return. This represents a decrease in value of over seven percent.

The value of an income-producing property is made up of many factors. If market conditions were right, an investor might be willing to pay the full $2,494,700 for the building and simply settle for a lower internal rate of return. However, when the market is experiencing over-built conditions, it is not likely that the investor would be willing to pay the full price. In either case, the 1986 Tax Act would have produced a negative impact on the office market by either lowering value or by lowering the internal rate of return to its investors.

Another area that shows the negative impact of the 1986 Tax Act is the decrease in office building construction that has occurred since 1986. A look at Table 6 and Graph B shows that after 1986's high of 3,977,848 square feet of completed office space, constructed declined, averaging 1,579,395 square feet for the years 1987, 1988, and 1989. Also, a look across the bottom of Tables 4 and 7 gives what percentage of the total existing office space in St. Louis County was completed in each year.

Of the 37,026,843 square feet of office space existing at the close of 1989, 73.4 percent of this amount was completed prior to 1986. Of this 73.4 percent, 34.5 percent was completed between 1981 and 1985. Nearly one-half of all the office space built in St. Louis County before 1986 was completed in this short four year period. In 1986, 11.5 percent of the total was completed, followed by 6.5 percent in 1987, 3.9 percent in 1988, and 4.7 percent in 1989. Only 26.6 percent of total office space existing in St. Louis County was completed in the period between 1986 and 1989.

A point that must be addressed is that some of the office space completed in 1986 and 1987 were actually begun prior to 1986, and therefore subject to the old tax laws. The 1986 Tax Act pertained to only those projects begun after 1986, so it is more

Table 7

SUMMARY OF ST. LOUIS COUNTY OFFICE SPACE BY YEAR OF CONSTRUCTION AND AREA 1986 THRU 1989
(In square feet)

NORTH AREA

1986	1987	1988	1989	Total Existing
845,130	723,865	446,490	212,596	7,591,861

SOUTH AREA

1986	1987	1988	1989	Total Existing
575,566	321,532	280,252	133,310	4,770,590

WEST AREA

1986	1987	1988	1989	Total Existing
2,090,590	1,340,999	591,572	955,780	17,495,591

CENTRAL AREA

1986	1987	1988	1989	Total Existing
764,760	32,231	135,150	428,110	7,168,801

TOTALS

1986	1987	1988	1989	Total Existing
4,276,046	2,418,627	1,453,464	1,729,796	37,026,843
11.5%	6.5%	3.9%	4.7%	100%

(The above figures were taken from the Office Space Inventory Reports from years 1986, 1987, 1988, and 1989 published by the St. Louis County Department of Planning.)

than probable that some of the office buildings completed in 1986 and 1987 were subject to the more lucrative provisions of the old tax laws. As can be seen in Table 7, the percentage of total office space completed in 1986 was 11.5 percent, but drops sharply in 1987 and 1988, and reflects the negative impact of the 1986 Tax Reform Act on the amount of office space completed.

So faced with soaring vacancy rates, big losses in tax revenue from real estate shelter deals, and conditions of severe over-building in many cities across the United States, the government stepped in to halt the dangerous trend in real estate that was snowballing across the nation.

The intent of the 1986 Tax Reform Act was to reduce returns on commercial properties, therefore reducing the market values of these properties, which ultimately eliminated "most investments that were principally tax oriented with little or no true economic benefits" (Snyder 15). In short, the Tax Reform Act of 1986 was meant to have a negative impact on commercial real estate investments, and was successful in doing so. It is no surprise then that investments in office buildings in St. Louis County have suffered as a result of the 1986 Tax Reform Act.

Summary

Summary

Congress sent a clear message to those in the real estate market via the 1986 Tax Act to become less shelter-oriented and more profit-oriented for their own sake, as well as that of the economy. To discourage investments in real estate projects that were principally tax-oriented with little or no true economic benefits, tax laws were changed so that returns on commercial properties were significantly reduced, and market values of such properties were also reduced.

The negative impact of the 1986 Tax Act is seen by reduced investment in new office product, and lower market values for these projects. In the Turley Martin spreadsheet analysis introduced in Chapter Two (Tables 1 and 2), market value of a particular investment in a commercial property was reduced by seven percent under the provisions of the 1986 Act. Since 1986, new supply of office space in St. Louis County is down by 56.5 percent, and the national average is down by sixty percent. The 1986 Tax Act succeeded in greatly curtailing tax-driven investments in commercial real estate.

For this short period between 1986 and 1989, and based on the two factors of reduced market values and reduced construction, the 1986 Tax Act

produced a negative effect on the office building market in St. Louis County. However, this conclusion deserves further comment.

This paper discussed how St. Louis County did not experience the extremely high vacancy rates as seen in other areas of the United States. Several reasons were cited for this, including the conservative nature of lenders in Missouri, and the lack of a real boom in the St. Louis Metropolitan area. Also, investors were building a majority of office building projects in the West Area of St. Louis County, an area with a good potential for growth.

Although data comparing changes in vacancy rates to completions of office space indicated that decisions to build were at least partially based on tax policy and not completely on demand, the conditions of severe over-building found in many areas of the United States did not occur here. It cannot be said, however, that these conditions would not have occurred here if the 1986 Tax Act had not been passed.

Vacancy rates in St. Louis County went up to 15.4 percent by the close of 1986, and although building declined, vacancy rates hovered between 12.4 and 15.8 percent between 1987 and 1990. The high vacancy rate signified a decrease in demand for office space. If the 1986 Tax Reform Act had

not happened vacancy rates may very well have gone as high the national average because of possible changes down the road for St. Louis County.

In Chapter Four a discussion of population trends in St. Louis County was given. First, the city of St. Louis found its tax base dwindling due to companies moving into the county. One-fourth of the city's housing stock had been abandoned or demolished by 1981. Large businesses and corporations found St. Louis County more desirable since housing was readily available to their employees. However, there is one thing on the horizon that could turn this trend around.

A good location and adequate housing, while always important, will be less critical with the arrival of the Metro Link. The Metro Link will carry workers from the county into the city, and will eliminate parking and traffic problems that had been deterrents to working in the city in the past. For this reason many developers feel that downtown St. Louis is a sleeper market and that as the light rail begins to service more areas in the county, downtown will once again draw those large corporations back into the city.

Another reason that St. Louis County could lose business to the city is that right now there is an overabundance of office space immediately

available for lease in the city. At the end of 1989, office vacancy rates in St. Louis City stood at 23.7 percent. Because of this high rate of vacancy, concessions are being made to tenants, and there are some very good deals available to renters. This is important since there will not be the financing that was available in the '70's and '80's when bankers worked hard to put deals together. It is the people that now own those buildings financed during that time who will be working hard to put together deals.

Paired with the Metro Link, businesses that are presently located in the county may find much greener pastures downtown. This is certainly an issue for those businesses wishing to expand. Due to the huge amount of office building construction in the West Area in recent years, there now exists the problem of a lack of available land for expansion. However, there is plenty of office space readily available to businesses and corporations wishing to relocate and expand in the city.

Besides the light rail system, St. Louis also includes the possibility of the domed stadium, not to mention existing assets such as the convention center, the arena, Union Station and the St. Louis Centre. These things are being "hyped" by marketing teams hired by the city to promote this area.

Also, the Regional Commerce and Growth Association has been promoting the city of St. Louis with its "Sold On St. Louis" campaign. The mayor, as well as other city managers are striving to keep their tenants happy.

With all these factors looming on St. Louis County's horizon, the decrease in construction of new office product attributed to the 1986 Tax Act could possibly end up having a positive effect on the St. Louis County office market. If the 1986 Tax Reform Act had not been passed, and investors continued to build office space based on tax-driven motives, then St. Louis County would be headed for real trouble if these predictions come true.

Vacancy rates have leveled off in St. Louis County since the 1986 Tax Reform Act was put into affect, and this is a positive aspect. Construction is down dramatically, and this is a reason why the 1986 Act is currently viewed in a negative light. However, this view could change down the road if St. Louis City does come back to life as predicted above. Investors in St. Louis County's office market may someday be thankful for the 1986 Tax Reform Act which succeeded in dampening their desire to build more office space.

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