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By Donald Greenhalgh - Economic and tax uncertainty is paralyzing the commercial real estate market

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The word "may" best defines the current commercial real estate market. As in, the U.S. Congress may close tax loopholes. It may increase income taxes including capital gains taxes. It may cut spending. It may renew expiring tax provisions.

It may. Or it may not. And there's the rub.

Unfortunately, the word "may" causes industry-wide paralysis. When a developer plans a multi-million dollar investment in a real estate project, but does not know with any degree of certainty what the tax implications will be, nothing happens.

On top of tax uncertainty, there is plenty of economic uncertainty. The stock market is not reaching new highs, but the volatility index is. Growth is so slow, we may be entering a double-dip recession, and the federal debt looms as an ongoing challenge.

Any business that is moving or expanding into new space today is making a bold business decision, yet that risk may not pay off. That risk is shared by builders of office or retail space, who will find it more difficult than ever not only to fill space, but to keep tenants long-term.

Uncertainty for Years?

In a business climate like this one, uncertainty over taxes becomes even more problematic. And there's a good chance that uncertainty will continue for years.

Currently, one party wants to raise taxes and the other wants to cut spending. In reality, neither action will be enough to balance the budget, never mind reduce the federal debt. Given the scale of American debt, the logical approach would be to cut spending and raise taxes before the U.S. becomes a much larger version of Greece.

However, both parties have shown little willingness to compromise, as making the other party look bad seems to trump doing what's best for the country. If neither party budges, automatic across-the-board spending cuts will take place on Dec. 1, 2011. If that happens, expect each party to blame the other for failing to take action.

Inertia is likely to continue through the next budget cycle, as the fiscal year will end on Sept. 30, 2012, just before the next Presidential election. No one is in a hurry to either cut spending or raise taxes, as either will create dissatisfaction with some voters.

After the election, of course, it will still take some time for Congress to decide on a course of action. Even when action is taken, any changes to the tax code will likely be phased in over the course of years. Eliminating tax deductions or credits immediately would likely crater the market.

While no one knows what action will be taken, a consensus may build for closing tax loopholes and eliminating some deductions. If that happens, the real estate industry is likely to be affected. While some question the feasibility of continuing deductions for residential mortgages, eliminating that deduction would be politically unpopular, especially at a time when homeowners have lost much of the equity in their homes.

Conversely, Congress is unlikely to be as sympathetic to commercial property owners. At a time when Congress is looking everywhere for tax revenues, how, for example, will it view the deductions allowed for property financed with qualified non-recourse debt? Currently, the tax code allows the property owner to receive a tax benefit that may be up to 10 times the capital investment. Will those deductions continue to be allowed? What impact will eliminating it have on the industry?

No one invests in a question mark, but for owners of real estate, one thing is even worse than uncertainty. When Congress finally does take action, it may remove incentives to invest in real estate and make many real estate projects financially less attractive.

The real estate industry should carefully track Congressional action, while trade associations and lobbyists should be prepared to make a strong case for continuing favorable tax treatment.

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