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INVESTMENT MANAGEMENT

Implications of Tax Reform on the Commercial Real Estate Industry

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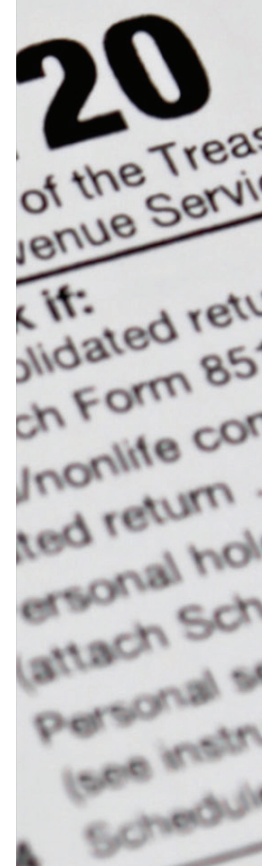
AUTHORS

REAL ASSETS RESEARCH & STRATEGY TEAM

U.S. President Trump signed the new Tax Cuts and Jobs Bill on December 22, 2017 (the "Tax Bill"), effectively putting the final seal of approval on some of the most substantive tax law changes seen in the U.S. over the last 30 years. We believe the general view is that the new provisions may yield a net positive impact on commercial real estate, but that the impacts will differ by market and sector. The tax changes that could potentially have the greatest impact on the commercial real estate sector include:

- Drop in corporate tax rate from 35% to 21%
- Cap on deductions for mortgage interest ($750,000) and state and local income taxes ("SALT") ($10,000), elimination of interest deductions for home equity loans, partially offset by the doubling of the standard deduction for married filers
- Personal tax rates reduced, e.g., 39.6% to 37% for the top tax bracket. These expire in 2025
- Owners of pass-through entities eligible to claim 20% deduction for business-related income
- Preservation of 1031 tax-deferred exchange rules, excluding the value of any personal property
- Limitation on the deduction of net business interest expense to 30% of adjusted taxable income (for real estate businesses that do not elect out of the rule)



- Immediate expensing of the cost of certain depreciable property (e.g., most improvements to non-residential property)[1]
- Lowering of effective tax rate on dividends for REIT shareholders from 39.6% to 29.6%
- FIRPTA withholding tax reduced from 35% to 21%

While it is impossible to know specifically the full extent of the impact of the tax reforms on the commercial real estate industry, set out below are certain potential macro and real estate considerations garnered from various internal and third party sources.[2]

Broad Macroeconomic Impacts

- Tax cuts may have the potential to fuel economic growth and job growth, in the short to medium term that may drive incremental demand for commercial real estate. Morgan Stanley Research has increased its GDP forecasts from 2.5% to 2.7% in 2018 and from 1.9% to 2.1% in 2019. The increase in 2018 was largely due to earlier than anticipated approval and larger overall size of the Tax Bill.[3]
- Positive impacts to growth are expected to come from higher consumer spending (+90bps in 1Q'18 and 2Q'18, then +40bps through YE'19) emanating from individual tax cuts and higher equity markets (Barclays has estimated that 2018 earnings per share will be raised by an average of 6.3%) as well as greater business investment (+40bps per quarter through 2019) from the reduction in the corporate tax rate[4] and immediate expensing provisions, which is expected to save US companies $32.5 billion in 2018.[5]
- Over the longer term, the new tax bill could add approximately $1.5T to the budget deficit over the next ten years, with 30% of the increase incurred within the first two years. With the tax cuts financed through additional government borrowing, interest rates are likely to rise due to additional supply of debt in the financial markets. Additionally, there are some fears that stimulus provided at this point in the economic cycle may spur inflation which could also raise interest rates,[6] which in turn could slow growth in the long run and negatively impact investments, including real estate.

Regional Macroeconomic Impacts

- There may be increased economic pressure on markets adversely impacted by the deduction caps as individuals in New York, California and other high-income states could potentially have less disposable income which could trickle through to lower income growth and weaker real estate fundamentals in certain geographies.[7]
- May also lead to migration of high income earners out of high-tax jurisdictions (i.e. Illinois, New York, New Jersey & California) into low tax states (i.e. Texas, Nevada, Florida & Washington). Goldman Sachs Group Inc. estimated that New York City could lose as much as 4% of its top earners.[8]
- This may be offset by the lower corporate rate, which will likely benefit the "ultra-wealthy", a group that tends to live in higher-tax states.
- Over the long term, companies will face complex decisions on whether to change domiciles, weighing the sizable increase in taxes faced by their high-income earners (i.e., the executives) against the disruption associated with relocating the business/workforce.[9]
- Several states vulnerable to major changes to the SALT deduction have raised income taxes this decade. These increases have generally coincided with an out-migration of high-income earners. California is an outlier, perhaps due to its unique lifestyle, but a tech boom also played a role in limiting the out-migration.[10]
- Per Green Street, low-tax markets that are expected to benefit the most include: Seattle, Las Vegas, Texas, Nashville and Florida.

Commercial Real Estate Sector Impacts

HOUSING

- Limits on mortgage deductibility to $750,000 (down from $1,000,000) and SALT deductions may negatively impact the for-sale market in expensive housing states including New York, Connecticut and California. An analysis by Moody's Analytics predicted that housing prices in Manhattan could fall by 10.4%.[11]
- The broader national housing market may be less impacted as it continues to benefit from tailwinds

[1] Real estate businesses that elect out of the new interest expense limitations are ineligible for immediate expensing.

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[3] Morgan Stanley Research, 2018 Economic Outlook, December 2017

[4] Ibid.

[5] Congress's Joint Committee on taxation

[6] Ibid.

[7] The Real Deal, January 2018

[8] Greenstreet

[9] Ibid.

[10] Ibid.

[11] The Real Deal, January 2018

from demographics (demand) and historically tight supply unlikely to be derailed by the tax reform. Additionally, less than 7% of home sales in 2017 were priced above $750,000 and between 2013 and 2015, only 1.9% of mortgages were valued over $750,000. Of those, California accounted for nearly 46% of them, and New York had just over 7%.[12]

- The apartment sector may see a positive impact on demand in the near term. Renting over buying will be most attractive in high cost metros, although this may be partially offset by some households who choose to relocate to lower cost areas.
- The immediate expensing of capex may have a positive impact on multifamily value-add/repositioning strategies.
- On the affordable side, the drop in the corporate tax rate may provide less incentive to build affordable housing. In addition, newly imposed taxes on foreign-owned corporations (and U.S. corporations with substantial non-U.S. operations) prevent those subject to this tax from realizing the full value of Low Income Housing Tax Credits. Advocates suggest new affordable units could drop by 235,000 over the next ten years.[13]

RETAIL

- The retail sector is expected to benefit the most from the reduction in the corporate tax rate, given it currently pays the highest effective corporate tax rate of any sector of the U.S. economy.
- A lower corporate tax rate might also encourage foreign retailers to invest more in their U.S. operations attracting additional customers and sales.
- Changes to the individual tax code plus stronger equity markets could also benefit the retail sector through an increase in consumer spending.
- Luxury retailers may benefit due to stronger equity markets.

OFFICE

- Lower corporate taxes may benefit companies who occupy office space (corporations are likely to see a net tax cut of $400 billion over 10 years),[14] but it remains unclear how much of that incremental profit will be used to hire more people (given labor shortages) or expand their footprint, versus returning the profits to shareholders through dividends and buybacks or pay-down debt.
- The lower corporate tax rate could reduce relocation risk for multinationals, which may boost office demand.
- Medical office – there may be slightly lower medical services spending from the loss of 13 million people from healthcare insurance coverage (losses primarily due to lower income households losing coverage).[15] This could be offset by a pick-up in discretionary doctors' visits emanating from a stronger economy and the continued aging of the population driving up overall healthcare spend.

INDUSTRIAL

- Higher consumer spending tends to support demand as both e-commerce and traditional retailers benefit from higher spending.
- Lower corporate tax will help increase the global competitiveness of US manufacturers which could lead to incremental industrial demand. Additionally, higher levels of corporate capex could also support industrial demand.

INVESTMENT AND CAPITAL MARKETS

- The majority of direct U.S. CRE investment, 61%, is held by pass-through entities—only 9% is held by corporations. Another 29% is held via direct or indirect tax-exempt entities. Passive investors in pass-through entities are likely to benefit from lower rates.[16]
- The immediate expensing and accelerated depreciation of assets is expected to encourage investment and may also provide businesses with an increased incentive to own their buildings instead of renting which could in turn lead to more tenants opting to build/buy their own facilities. Additionally, capex spending may increase and ground leases might become more popular.
- Reduction in FIRPTA withholding tax to 21% may increase foreign investment. However this may be offset for certain funds with offshore blocker structures where leverage may be capped.

Conclusion

Overall, we believe tax reform is likely to be a seen as a net positive for the commercial real estate sector and more capital could flow into real estate as the asset class on-a-whole is expected to become more tax-efficient relative to other asset classes, particularly with the maintenance of 1031 exchanges, the ability to elect out of the regime imposing a cap on leverage, and favorable rates for income from pass-through entities. The impacts will differ by sector and market with the high income tax states suffering, while the no/low income tax states should benefit. The apartment sector should benefit at the expense of for-sale housing, and the retail, industrial and office sectors are also likely to benefit, to varying degrees.

[12] Bisnow, January 7, 2018

[13] Ibid.

[14] Cushman and Wakefield, December 2017

[15] Source: http://fortune.com/2017/11/29/gop-tax-plan-obamacare-cbo/

[16] Cushman and Wakefield, December 2017

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