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Townsend Views

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The Tax Cuts and Jobs Act of 2017:

Implications for the economy and commercial real estate markets

Current Status

On Friday, December 22nd, Donald Trump signed the tax bill legislation, a significant overhaul to the system. The final version of the bill continues to favor the commercial real estate sector over the residential sector.

Key Provisions of the Bill: Favorable to Commercial Real Estate

- **Corporate Tax Rates:** Corporate tax rates were lowered from 35% to 21%. For commercial real estate investment management firms who typically pay a relatively high corporate tax, this lower corporate tax rate will be a boon to after-tax profits. Financial institutions will benefit as well. CRE lending institutions, especially banks, will benefit from the lower corporate tax rate on their profits. In addition, the corporate alternative minimum tax has been fully repealed.

- **Global Capital Flows**: Other countries are concerned about the U.S. tax bill, most notably China. China is worried that the lower U.S. corporate tax rate, combined with higher U.S. interest rates, could lure investments to the U.S. According to WSJ, the PBOC is preparing an array of tools to slow capital flight, including higher interest rates, capital controls, and currency intervention; other U.S. trading partners may follow suit.

- **Depreciation:** The bill shortens the depreciable life of commercial property assets from 39 to 25 years. This is a very generous depreciation timetable.

- **Pass-through Deductions:** The tax bill will result in lower tax rates for corporations, partnerships, and family-owned firms. This will be a benefit to after-tax real estate cash flows, because many property investors and developers use pass-through entities, such as LLCs or partnerships (S corporations). The bill as signed results in a huge tax cuts for such pass-through entities (which don't pay income taxes at the corporate level). Previously income that was passed through such partnerships was taxed at 39.6%, the top rate. Pass-through businesses, in which landlords book profits as their income, will recieve a more favorable deduction on their income. The plan will reduce the top effective marginal tax rate for S corporations to a top rate of 29.6%. Alternatively put, the plan will set a 20% business income deduction for the first $315k in income earned through pass-through businesses. This is a boost to the commercial real estate industry and may result in a restructuring of many real estate companies into pass-through entities.

- **Other:** For the commercial real estate market, the bill maintains 1031 exchanges and commercial mortgage tax deductions; plus, carried interest still receives capital gains treatment under a 3-year hold window (previously a 1-year hold window).

- **REITs:** The bill lowers the top tax rate on income that REITs and other businesses pass through to their owners and shareholders. Again, this results in tax rates being reduced from 39.6% to a range of 25% to 31%. Moreover, individuals who borrow money to invest in a REIT will be able to deduct the interest they pay on the loan at the top individual rate.

- **Other Real Estate Income:** Real estate rental and mortgage interest income now qualifies for a lower tax rate.

- **Individual Income Tax:** The top individual tax rate will be set at 37%, lower than previous Senate and House versions. However, this lower top income tax rate will be phased out by 2025. The individual alternative minimum tax will be tweaked to exclude any individual income under $500k, or $1 million for a family.

Economic Implications: Neutral to Positive

- **Growth:** The U.S. deficit will increase by slightly less than the $1.5 trillion permitted under current law. In other words, the tax cut should provide roughly $1.46 trillion net stimulus to the U.S. economy over the next 10 years, or $146 billion annually. Given the size of the U.S. economy, this translates into a 0.2% to 0.3% boost to real GDP growth in 2018. According to the Tax Foundation, the tax bill will lower marginal tax rates and the cost of capital, which should lead to a 1.7% increase in GDP over the long-term, 1.5% higher wages, and an additional 340k full-time equivalent jobs.

- **Inflation:** This fiscal stimulus is being levied at a time when the U.S. economy is close to full employment. The labor markets are tight, and the unemployment rate is 4.1% (as of October 2017). This additional stimulus can lead to an economy that overheats with accelerating inflation pressures.

- **Interest Rates:** Market consensus expectations are for a total of three Fed rate hikes in 2018. These rate hikes are expected due to diminishing slack, especially in the labor market. We may now witness earlier and additional rate hikes, given the potential economic overheating as a result of the tax reform's fiscal stimulus. Additionally, there is potential for an overly aggressive Fed that offsets the fiscal stimulus with a more contractionary monetary policy than is currently being underwritten. The Fed's Williams (who is a hawk) tells the WSJ that the U.S. economy is entering 2018 with very good momentum. Williams said it was reasonable to assume three Fed hikes in '18, followed by two in '19.

Implications for Property Fundamentals: Modestly Positive

- Slightly stronger economic growth, additional job gains, and sharply lowered corporate rates should benefit property fundamentals across office, retail and industrial sectors. A number of commercial real estate firms are reporting increased occupier demand for office in particular, in anticipation of greater economic activity resulting from the tax bill. The retail sector was among the highest taxed businesses, and lower corporate rates should encourage domestic expansion and international retailers growing their business in the U.S. This should favor retail absorption. The elimination of the individual mandate from Obamacare may negatively impact the healthcare sector.

- Many popular itemized deductions are less generous under the new bill. This includes state and local income taxes and home mortgage interest deductions. The plan will not change mortgage interest deduction of existing homeowners. For new homes, taxpayers can deduct interest on up to $750k of mortgage debt. The latter is viewed as negatively impacting housing in the short run. Home prices are expected to fall in the near term as well, especially in high home price metros across the coasts. Since home mortgage deductibility is less of an incentive for homeownership in high home price states, this may increase demand for multifamily rental units in the near-term as well.

- The State and Local Tax deduction (**SALT**) will now be expanded beyond just property taxes to include income tax. This deduction will be capped at $10k. High-tax state legislators have been wary of losing SALT deductions, fearing widespread outmigration. For example, in Manhattan, the average SALT deduction is ~$57K and the average property deduction is ~$14K. Going forward, the deduction for both SALT and property tax will be capped at $10K. Home prices in Manhattan could fall by as much as 10% as a result of the tax changes. The fear is that workers and then jobs may gravitate towards cheaper cities.

- This fear is a bit of an overreaction. States like California and New York, high SALT states, have continued to attract jobs and people given the strength of their local economies. Positive externalities (agglomeration economies and clustering) in some of these high SALT states have continued to attract jobs and in-migrants. Most regional economists do not believe limiting SALT itemization will alter such dynamics. However, low SALT states such as Texas and Florida should see some net additional in-migration over time.

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