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SPECIAL REPORT:
TAX CUTS + JOBS ACT

Marcus & Millichap

Special Report

Tax Cuts and Jobs Act

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New Tax Law Holds Favorable Prospects for Commercial Real Estate; Potential to Boost Space Demand and Capital Flows

New tax law retains key provisions for real estate investors. The highly anticipated tax reform recently signed into law by President Trump retained numerous key commercial real estate provisions. The 1031 tax-deferred exchange, the mortgage interest deduction for investment real estate and asset depreciation had few material changes. This consistency in tax law will enable investors to move forward with most of their existing investment strategies. That said, there are many provisions in the new tax law that will have a more nuanced effect on the sector, and these more subtle adjustments could create significant new opportunities for real estate investors.

Finalization of tax rules to reduce uncertainty. Over the last year, elevated uncertainty generated by the range of potential government policy changes, including tax laws, caused many investors to move to the sidelines. A more cautious outlook pervaded the industry as investors awaited clarity on taxes, fiscal policy and a change in Federal Reserve leadership. This perspective could begin to ease as the implications of the new tax law firm up and investors better understand how the new rules will affect their investments. The new tax plan offers generous tax cuts to corporations and pass-through entities such as Limited Liability Companies (LLCs), and investors may see the new tax rules as an opportunity to reconfigure their portfolios. The new tax structure will apply to 2018 income for tax filings in 2019.

Reduced taxes on pass-through entities may boost capital flows. Perhaps more important than the modest changes to the core commercial real estate tax rules that investors have been most focused on is the reduction of taxes on pass-through entities. Owners of these types of companies will enjoy a 20 percent deduction on pass-through income, though there are several restrictions that will apply to this deduction. This favorable tax treatment will encourage investors to increasingly focus on after-tax yields when comparing their investment alternatives. On an after-tax basis, commercial real estate could offer a much stronger risk-adjusted return than options such as dividend stocks and bonds. This could entice additional passive capital to flow to the sector through syndicators, partnerships and other pass-through funds. This influx of capital, should it manifest, could place downward pressure on cap rates.

Tax-induced behavior changes will be meaningful. In addition to the direct effect the new tax law will have on commercial real estate investments, indirect effects could be equally important. The increased standard deduction and limits on local property and income tax deductions could significantly alter housing demand and behavior. At the same time, the elimination of the personal mandate of the Affordable Care Act (Obamacare) could impact long-term demand for healthcare real estate. The new rules could also spark increased consumption spending and more business investment into infrastructure.

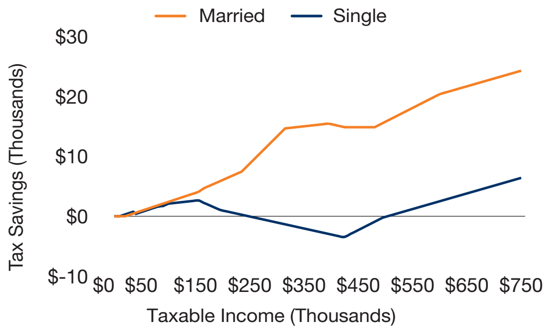
Executive Summary

- **1031 Exchange:** Tax-deferred exchanges have been retained for real estate.
- **Business Interest Deduction:** Interest on real estate loans remains deductible for real estate investments, but using this deduction will lengthen the depreciation period for real estate assets.
- **Depreciation:** Depreciation timeline remains unchanged if mortgage interest is not taken. If the mortgage interest deduction is used, then the depreciation timeline for commercial properties increases from 39 years to 40 years and for residential properties it rises from 27.5 years to 30 years.
- **Carried Interest:** The hold time of assets increases from one year to three years to treat earnings as capital gains.
- **Pass-Through Income:** Business owners receive a 20 percent deduction on qualified income generated by pass-through entities such as LLCs, but there are some restrictions. For taxpayers earning over $157,500 (single filers) and $315,000 (married couples), deduction is limited to greater of 50 percent of the taxpayer's share of aggregate W-2 wages paid by the business or 25 percent of the taxpayer's share of aggregate W-2 wages paid by the business plus 2.5 percent of the unadjusted basis of all qualified property (structures but not land).
- **Corporate Tax Rate:** Maximum tax rate reduced from 35 percent to 21 percent. Generous expensing and depreciation rules on capital expenditures over short-term.
- **Individual Tax Rate:** Significant restructuring of personal taxes. Still uses seven tax brackets, but the income span of each bracket has changed and the marginal rates have generally been lowered. Standard deduction has been increased and several deductions have been eliminated or restricted.
- **Estate Tax:** Doubles exclusion to $11 million for single filers and $22 million for married couples.

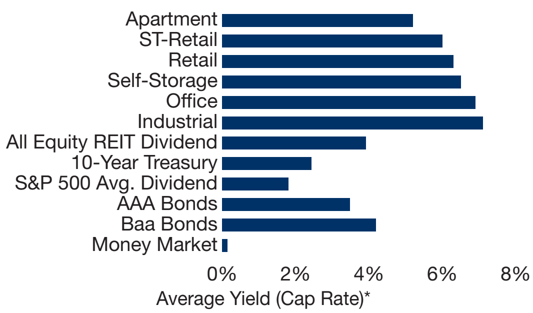
This report is not intended and should not be considered tax or investment advice. It provides an interpretation of the potential effects of the new tax law on the commercial real estate market. A tax accountant should be consulted for guidance on specific tax rules.

Tax Law Changes to Reshape Behavior, Hold Implications for Investment Real Estate

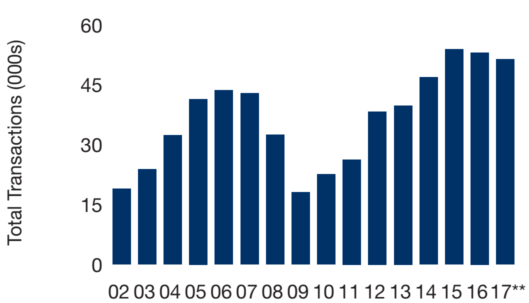
New Tax Law Savings



New Tax Law Makes Real Estate Yields Even More Compelling



U.S. Commercial Real Estate Investment Trends



* As of December 28, 2017
** Trailing 12-months through 3Q

Apartment demand likely to rise. The previous tax rules created an economic incentive to purchase a home through itemized deductions. If the mortgage interest and property taxes exceeded the old standard deduction of $12,700 for married couples ($6,350 for individuals) then taxpayers received a reduction to their taxable income that effectively offset a portion of the housing payment. The threshold home price to receive this benefit naturally depended on interest rates and local property tax rates but was in the $200,000 range for married couples. Under the new tax law, the standard deduction has been raised to $24,000 for married couples ($12,000 for individuals), and as a result the threshold home price to benefit from itemized deductions has increased to the $400,000 range for married couples. Because the threshold has increased well above the median home price in most metros, there will likely be a modest reduction of first-time homebuyers, lifting apartment demand.

Long-term prospects of healthcare real estate soften. The elimination of the personal mandate, a provision of the Affordable Care Act that required people to have health insurance, will reduce the total number of insured by 13 million people over the next 10 years. As a result, about 5 percent fewer people will have health insurance compared with the number that would have been insured if the personal mandate were retained. This will modestly reduce the future demand for healthcare, implying a slight downshift in demand for healthcare real estate compared with projections with the personal mandate. Nonetheless, the aging population will still increase demand for healthcare services over the next 10 years, just not as much as would have occurred with the personal mandate in place.

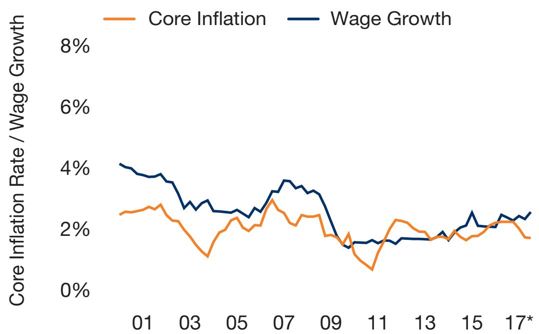
Market liquidity could rise; net-leased properties positioned favorably. The newly introduced 20 percent deduction on income from pass-through entities could invigorate investment in real estate. On an after-tax basis, the yields offered by the sector will be even more compelling than under the previous tax structures. New capital could enter commercial real estate through syndicators and investment funds that are structured to capitalize on the pass-through advantages, but some new investors will enter the market with direct acquisitions. The additional capital will undoubtedly flow across a variety of property types including apartments, self-storage facilities, and retail, office and industrial buildings, but a segment that could attract a disproportionate share of the investment is single-tenant net-lease properties. These assets, often occupied by high-credit tenants on long leases, afford passive investors compelling yields that could be structured to benefit from the new pass-through tax rules. In addition, because these types of properties generally require minimal management and are available in a wide range of price points, they are well positioned for passive investors.

Expanded expensing rules benefit niche real estate. Changes to the Section 179 depreciation rules will favor several niche real estate investments. Under the revisions, business owners will be able to fully expense up to $1 million of depreciable tangible personal property used to furnish lodgings. This change will allow investors with investments such as hospitality, student housing and seniors housing to deduct the full cost of furniture placed in service at their properties rather than depreciating them over multiple years. The rules also extend to roofs, heating, ventilation and security systems in non-residential property. This provision is largely targeted toward small businesses, so the deduction phases out as business investment purchases exceed $2.5 million.

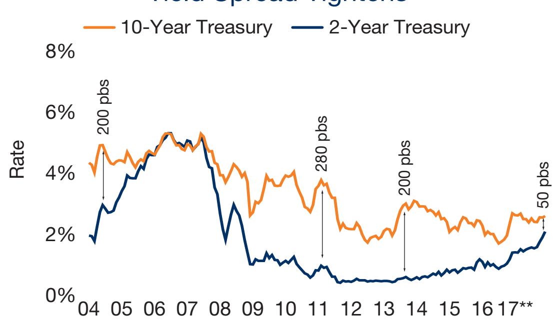
TAX REFORM: 2017 TAX LAW vs. 2018 TAX CUTS AND JOBS ACT

Provision	Old Tax Law (2017)	Tax Cuts and Jobs Act (provisions effective beginning 2018)
Like-Kind Exchanges	Available under current law for property held for investment	Retained for real property only (real estate).
Business Interest Deductibility	Fully deductible for all businesses	Fully deductible for real estate businesses with some exceptions. Limits on interest deductibility apply to firms outside of real estate with exception for businesses with average annual gross receipts of less than $25 million over past three years.
Depreciation of Buildings	Residential 27.5 years, nonresidential 39 years	If the mortgage interest deduction is used, then the depreciation timeline for commercial properties increases to 40 years and for residential properties it rises to 30 years.
Carried Interest	Taxed at capital gains rates if held at least a year	Taxed at capital gains rates if held at least three years.
Business Tax Rates	Flow-through entity: Maximum rate of 39.6% REIT dividend maximum rate of 39.6% Corporation: Maximum Rate of 35%	Flow-through entity: 20 percent deduction available for qualified pass-through income with some exceptions. REIT dividends eligible for 20 percent deduction. Corporation: Maximum rate of 21 percent. Flow-through entity deduction sunset after 2025. Corporate rate cut permanent.
Active Losses	Fully deductible against active income	Deduction of net active pass-through losses against wage or portfolio income limited to $500,000 (married filers) and $250,000 (single filers). Disallowed losses may be carried forward as part of a taxpayer's net operating loss. Provision effective through 2025.
Individual Tax Rates	Seven brackets ranging from 10 percent to 39.6 percent; highest rate effective at $418,400 (single filers)/$470,700 (married filers).	Seven tax brackets ranging from 10 percent to 37 percent. Highest rate effective at $500,000 (single filers)/$600,000 (married filers). Rate structure expires after 2025.
Standard Deduction	Single: $6,350, Married: $12,700	Single: $12,000, Married: $24,000.
State and Local Taxes (SALT)	State and Local Taxes (SALT) deductible. Available deduction declines for income above $266,700 (single), $320,000 (married).	$10,000 limit on deduction of state and local taxes including property tax and either income tax or sales tax.
Mortgage Interest Deduction (personal)	Deduct interest for primary or secondary residence up to $500,000 (single) or $1,000,000 (married). Home Equity Line of Credit deductible up to $100,000	Deduct interest for primary or secondary residence up to $750,000. Home Equity Line of Credit no longer deductible. Loans prior to Dec. 16, 2017, grandfathered.
Estate Tax	$5.49 million ($10.98 million per couple) exclusion, 40 percent rate, and stepped-up basis for inherited assets	Exclusion doubled. Stepped-up basis retained. Provision after 2025 and tax reverts to current law exemption amount indexed for inflation.

U.S. Core Inflation vs. Wage Growth



10-Year Treasury vs. 2-Year Treasury Yield Spread Tightens



* Through 3Q
** Through December 29

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New Tax Law Offers Prospects of Economic Lift

Economy starts 2018 with formidable tailwind. The U.S. economy closed 2017 in a particularly strong position, having added jobs continuously for a record 86 months. Unemployment has settled in the low-4 percent range, supporting stronger wage growth, and there are a near-record 6.0 million job openings awaiting qualified workers. Consumer and business confidence continue to hover near decade-high levels, invigorating retail sales growth and corporate investment into infrastructure. The new tax rules could reinforce many of these trends through the many tax incentives that were created.

Corporate tax reductions likely to boost economy. Although there is considerable debate regarding how much of the corporate tax savings will filter through to workers and the broader economy, several provisions of the new tax law should spark increased corporate investment. Accelerated depreciation and expensing rules should encourage companies to increase investments into plants and equipment, while reduced tax rates on the repatriation of overseas holdings should spark an influx of capital coming back into the U.S.. Though much of this capital may be used for stock buybacks and dividends, the increased liquidity should spark consumption and support economic growth. The natural risk created by the inflow of so much capital will be rising inflationary pressure.

Lower personal tax rates should boost consumption. The actual tax savings that flow through to individual tax payers will naturally vary depending on a wide range of variables, but the consensus is that most people will see at least a modest reduction in taxes. This will increase discretionary income that should translate to increased retail sales. This will take time, as most workers will see only a modest change in their tax withholding in each paycheck, but in aggregate, it should boost consumption, the primary driver of economic growth in the U.S.

Housing market slowdown could offset growth. The restructuring of the tax rules will likely weigh on the owner-occupied housing market, particularly in states with elevated home prices and property taxes. The new tax law affects home sales in several ways: The increased standard deduction will modestly restrain first-time homebuyers, while limitations on the deduction of state and local property taxes will weigh on upper echelon housing, particularly in California and states in the Northeast. The introduction of a lower limit on mortgage interest deductibility, now $750,000 instead of $1 million, will also weigh on higher-priced home sales. Since the recession, the housing market has contributed about 3 percent to economic growth, about half of the sector's contribution levels of the early 2000s. Under the new tax law, housing's contribution will likely weaken.

Fed to keep a watchful eye. The increased liquidity and consumption levels created by the new tax law have the potential to raise inflationary pressure. The Federal Reserve raised its benchmark rate three times last year and most anticipate an additional three rate increases in 2018. The Fed will also likely continue its efforts to reduce its balance sheet by allowing assets acquired during its quantitative easing efforts to mature. Through this process, the Fed will make an effort to put upward pressure on long-term interest rates. The central bank will vigilantly watch for liquidity-sparked inflation.

Sources: Marcus & Millichap Research Services; BLS, CoStar Group, Inc., Federal Reserve, Moody's Investors Service, NMHC, Real Capital Analytics, Standard & Poor's, U.S. House of Representatives, U.S. Senate, U.S. Internal Revenue Service, U.S. Bureau of Economic Analysis, policyuncertainty.com