Marcus & Millichap

Special Report

New Tax Plan

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New Tax Laws Subtly Affect Commercial Real Estate; Could Alter Capital Flows, Business Structures and Portfolio Strategies

New tax laws hold modest change for investment real estate. The highly anticipated tax reform legislation making its way through Congress could be signed into law by President Trump this month. For real estate investors, the final versions appear relatively benign, with only modest changes to key provisions such as the 1031 tax-deferred exchange, mortgage interest deductibility and asset depreciation. The two versions, one from the House of Representatives and one from the Senate, have yet to be reconciled, but neither version holds any significant changes that will radically impact real estate investment.

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 laws firm up and investors better understand how the new rules will affect their investments. With both versions of the tax plan offering generous tax cuts for corporations and pass-through entities such as Limited Liability Companies (LLCs), investors may see the new tax laws 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 spark activity. Both versions of the tax proposal make only modest changes to the current tax provisions for commercial real estate. Personal tax rates and tax brackets vary significantly between the House and Senate versions but generally go down for most top-tier income segments. However, changes to the tax structure for pass-through entities that allow tax rates as low as 25 percent may create significant benefits for private investors to move assets held as personal holdings into a pass-through entity. In addition, this favorable treatment could entice additional capital to enter the commercial real estate space. Both versions of the tax reform proposals preserve the 1031 tax-deferred exchange for real estate and make only minor modifications of the interest expense deduction for loans on commercial real estate and the depreciation of real estate assets.

Some changes to come, but tax law likely final this month. The tax proposals will continue to morph as they go through reconciliation at conference between the House and Senate. Moderate differences between the House and Senate versions could take time to align with sticking points arising over the deductibility of state and local taxes (SALT) and the cap on mortgage interest deductions for owner-occupied housing. However, Congress appears committed to finalizing the new tax code and delivering it to the president for his signature before the end of the year.

Executive Summary

- **1031 Exchange:** Tax-deferred exchange unchanged for real estate. Both the House and Senate versions make no changes to the real estate portion of tax-deferred exchange rules.
- **Business Interest Deduction:** Under the House version, the deduction of interest on real estate would be unchanged for real estate businesses. The Senate version also allows full deduction but extends depreciation timelines if the deduction is used.
- **Depreciation:** Real estate continues to be depreciable. The House version retains current 27.5-year depreciation term. The Senate version increases the time of depreciation term to 30 years if interest deductibility is used but offers a 25-year depreciation period if no interest deduction is taken.
- **Carried Interest:** Under both versions, the hold time of assets is increased from one year to three years to treat earnings as capital gains.
- **Pass-Through Income:** Reduces taxes on income generated by pass-through entities such as LLCs, but there are many nuances in both the House and Senate versions. The House version could reduce tax rates on this income from personal rates as high as 39.6 percent to as low as 25 percent depending on whether the earnings are active or passive. The Senate version grants a 23 percent deduction on qualified pass-through income with some restrictions.
- **Corporate Tax Rate:** Maximum tax rate reduced from 35 percent to 20 percent under both the House and Senate versions.
- **Individual Tax Rate:** Significant variance between the House and Senate versions. House creates four tax brackets; Senate version uses seven tax brackets.
- **Estate Tax:** Doubles exclusion under both plans to $11 million for single filers and $22 million for married couples filing jointly. House version repeals estate tax by 2025.

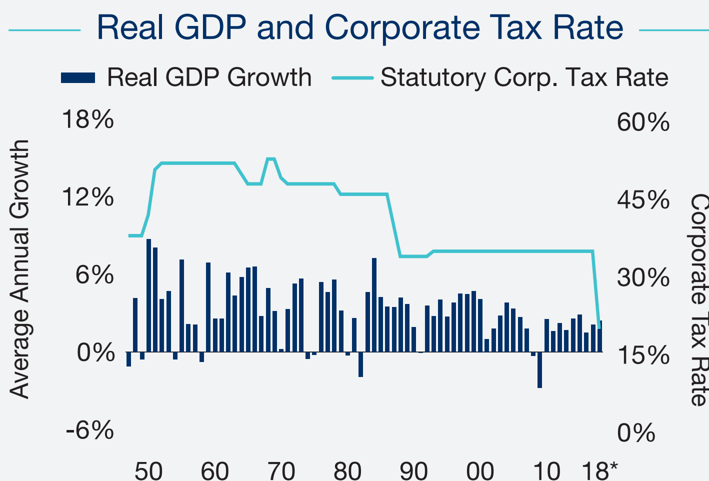
Implications of Tax Law Changes

Clarity on taxes empowers investor decisions. For the commercial real estate sector, one of the greatest benefits of the new tax law could simply be its finalization, as this will reduce uncertainty. With new tax rules in place, some of the caution that emerged over the last year could abate, reinvigorating investors who moved to the sidelines over the last year. The new tax laws could also inspire investors to reevaluate how they structure their real estate holdings, particularly private investors who hold their properties personally rather than through a pass-through entity. There may be sufficient tax benefits for these investors to reposition their portfolios into an LLC, sparking some investment decision that had been put on hold.

Tax rules could favor rental housing. A byproduct of the new tax laws could be a boost in demand for apartment living. The doubling of the standard deduction, the establishment of a $10,000 cap on the deduction of property taxes and changes to the ability to deduct mortgage interest would reduce some of the tax incentives of homeownership and could thereby increase demand for apartments. This holds particularly true in states with high home prices and tax rates such as California and the Northeast, which would face the most significant loss of the tax-sheltering benefits of homeownership under the new rules. Demand for upper-tier rental units that have historically faced the most competition from homeownership could see the most benefit from the new tax rules.

Tax laws may modestly dampen student housing demand. The House version of the plan would begin taxing graduate student tuition reductions as income. Some graduate students work at their university and receive tuition reductions instead of pay, and the new tax laws would effectively raise costs for students pursuing advanced degrees. In addition, the House plan repeals the deduction of up to $2,500 per year of interest paid on federal student loans. A resulting erosion of student housing demand would likely be nominal.

Healthcare real estate could see ripples from new tax rules. Two provisions could impact healthcare-related real estate such as medical office buildings and seniors housing. The potential elimination of tax-free Private Activity Bonds (PABs) that are used to fund development of public interest projects like public seniors housing facilities could reduce construction of healthcare real estate. Another factor emerges under the Senate version: the elimination of the personal mandate. The elimination of this provision of the Affordable Care Act could reduce the number of insured by an estimated 13 million people by 2027. This change could reduce demand for medical services and seniors housing by as much as 5 percent over the next 10 years, though the direct effect on real estate performance may be minimal.



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Sources: Marcus & Millichap Research Services; NMHC, U.S. House of Representatives, U.S. Senate, U.S. Internal Revenue Service, U.S. Bureau of Economic Analysis, policyuncertainty.com.