Tackling Tax Reform

How Changes to the Law Impact CRE

Marcus & Millichap

BY BRANDI SMITH

Just before Christmas, Congress offered up to President Trump what is arguably the best gift lawmakers could have presented: a major legislative victory in the form of the Tax Cuts and Jobs Act. The sweeping reform of the U.S. federal tax system will mean significant changes for individuals and businesses, including those in commercial real estate.

Some particulars of the bill are being worked out at the IRS and are expected to be clarified this month. Ahead of that, Marcus & Millichap, a national CRE brokerage firm, broke down how investors will be impacted by the changes with a forum of experts.

To dig into its impact, you must first understand the reasoning for the bill, which is building economic growth, according to John Chang, Marcus & Millichap's first vice president/national director of research services.

He says the U.S. has averaged close to 200,000 jobs a month continuously for 87 months, the longest growth cycle on record. Roughly 17 million jobs have been added in that cycle with 1.8 million more expected in 2018. In summary, the economy is booming and tax reform could add even more fuel to the fire.

"This could start to spark some wage growth and a little bit of inflationary pressure, especially with the stimulative effect of the new tax laws," says Chang.

Change can be daunting for any industry, especially something as widespread as national tax reform. As a result, many folks in CRE worried the overhaul could be disruptive. However, Matthew Berger, vice president of tax at the National Multifamily Housing Council, suggests there's no real reason to worry.

"I think most people will be very pleased to learn that the tax reform bill turned out very favorably to the commercial real estate industry," Berger says.

What follows is a summary of highlights from the Tax Cuts and Jobs Act pertaining to CRE.

LIKE KIND EXCHANGE

For real property, the bill keeps like kind exchanges, also known as 1031 exchanges, which allow for the disposal of an asset and the acquisition of a replacement asset without generating a tax liability.

"Under prior tax law, like kind exchanges were available for real property and what's known as tangible personal property," says Berger. "What's really nice is that the tax law retains like kind exchanges for structures, which is going to really help make sure that money keeps being invested in the real estate sector."

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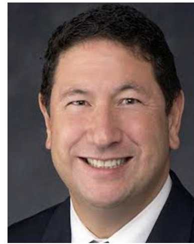
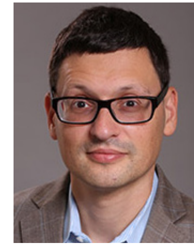

John Chang

John S. Sebree


Matthew Berger

Michael D'Onofrio

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DEDUCTIBILITY OF BUSINESS INTEREST

Real estate isn't often paid for fully in cash; property and developments are typically financed. For that reason, old tax law allowed business interest to be fully deductible. The reform bill curtails interest deductibility based on earnings before interest, taxes, depreciation and amortization, according to Berger.

"What's really great is that we were able to secure a carve out for real estate because real estate is so capital intensive and generates so much interest," he says. "The tax law will now allow real estate companies to fully deduct all their business interest."

He adds there will be a slight consequence for that, however, because it will require a slightly longer depreciation period for buildings.

To cope with that, Michael D'Onofrio, the managing director of Engineered Tax Services, suggests savvy property owners and CPAs do a cost segregation study for personal property inside a building.

"[You can] carve out of that 30 years for residential or that 40 years for non-residential investment property and get your accelerated identified five year and 15-year class size," says D'Onofrio. "There's still a great cost seg strategy, even if they elect that business interest deduction strategy."

To break it down, the old tax law regulated depreciation of residential structures at 27.5 years and non-residential structures at 39 years. If a firm abides by limits on interest deductibility, those limits still hold. If electing out of the limits on interest deductibility, firms are looking at 30 years for residential and 40 for non-residential structures. In either instance, cost seg could carve out and accelerate 5-year and 15-year property.

Because the law is written broadly, real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing or brokerage all qualify as a real property trader business.

BONUS DEPRECIATION

The new law includes provisions for bonus depreciation of capital expenditures to potentially fully expense items, says D'Onofrio. Per Section 179 of the new law, renovations or improvements to a property (value add) can be fully expensed up to $1 million.

"Take note, though, the IRS has currently identified HVAC, roofing and security systems in non-residential properties, but we do expect further guidance on that, because it's strange that lighting was left out of that topic," he says.

D'Onofrio calls Section 179 "amazing," adding that bonus depreciation applies not only to improvements and new assets that are constructed into a building, but also purchases of existing buildings as well.

"A huge amount of the investment property trades that happen are purchases of existing buildings," he adds.

It should be noted that this bonus depreciation applies retroactively to September 2017.

"That seems like a tremendous benefit to people who own investment real estate," says John S. Sebree, Marcus & Millichap's first vice president/national director of the national multi-housing group. "Not only is that going to improve the real estate, that's something that's going to stimulate construction. It is going to create jobs. It's going to stimulate the economy."

PERSONAL TAX CHANGES & THEIR POTENTIAL IMPACT ON CRE

As individuals start to feel the effects of the reform bill, Sebree notes that could signal a change in housing behavior. Itemizing home ownership is more difficult under the new law, perhaps reducing the number of first-time home buyers since they will not be able to write off the interest on the house, as they have in the past. As a result, they may choose to stay in a rental a bit longer. That means upper-tier rentals that historically face competition from home ownership could see an advantage instead.

Sebree adds that the removal of the personal mandate of the Affordable Care Act will result in an estimated 13 million fewer people with insurance in the next decade. That, he says, could trigger a dip in demand for healthcare and medical-related real estate demands.

"We don't anticipate these to have a huge effect on the supply and demand of commercial real estate," says Sebree. "I'm simply noting them as areas where you may see small behavior shifts that could affect performance of these assets over the longer term."

PASS-THROUGH TAX

A brand new provision in the law is what Chang calls "extraordinarily beneficial" to the pass-throughs that dominate real estate, specifically LLCs, S Corps, partnerships and sole proprietors. The issue stems from the delta between the individual tax rate of 37 percent and the corporate income tax of 21 percent.

"The advocacy community encouraged Congress to provide pass-throughs with a real tax cut on their business income," says Chang.

He says the provision is very complicated, which means it will take several months for the IRS to write regulations so it works as intended. In the end, though, Chang believes it will reduce the tax rates on taxable income for pass-throughs. Here's how it will work, according to Chang. For taxpayers earning more than $157,500 (single filers) and $315,000 (couples), the deduction is limited to the greater of either 50 percent of the taxpayer's share of aggregate W-2 wages paid by the business or 25 percent of that share PLUS 2.5 percent of the unadjusted basis, immediately after acquisition, of all qualified property.

As an example, Chang offers up a scenario in which a multifamily firm buys an apartment building for $20 million, $14 million of which is attributable to the structure and $6 million to the land. Annual rental income generated is $1.25 million.

The maximum deduction on income is 20 percent, adding up to $250,000. Adding in the deduction limitation (2.5 percent of the structure's $14 million value), that works out to $350,000.

In this example, Change says, the firm's deduction is not limited at all.

"This person is going to get the $250,000 deduction straight up. What's really nice about this is that we were able to get that provision in there at the end of the process, which allows for very capital-intensive industries, including real estate, to qualify," he says.

SUMMARY

Throughout the forum, the experts repeatedly pointed out that "the devil is in the details." Though Congress clearly laid out its goals and intentions in the bill, it's up to the IRS to translate that into tax code. That could result in some edits in the law as we move forward into 2018.

"This tax code is unfortunately quite complicated and very dynamic, so it certainly pays to look at all facets of it and not get caught up in one particular provision," says Berger. "It really does all work together."

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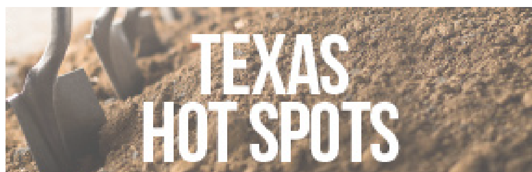

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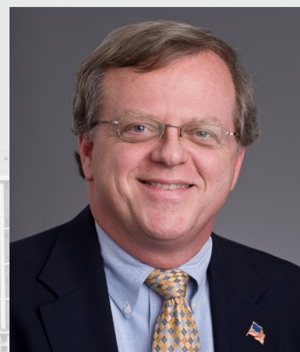

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