REIS

The Tax Cuts and Jobs Act:

REIS Looks at its Impact on Commercial Real Estate

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What Can We Expect for the Commercial Real Estate Market?

December 2017

The Tax Cuts and Jobs Act is upon us. There are a number of provisions that will impact the commercial real estate industry. Below, we outline what is most germane for commercial real estate with the caveat that the details laid out here are preliminary assessments.

We also rank the top 82 U.S. metros by the ratio of tax filers that itemize deductions along with other apartment market statistics to highlight the metros that are likely to face the greatest risk of home value declines as well as the highest increase in apartment demand as people choose to delay buying a home and move to locations with reasonable rents and sought after amenities. In short, suburban markets in the Northeast U.S. are likely to see higher apartment demand and lower home values in the coming years.

Impact on Individuals

Doubling the Standard Deduction: Bad for Current Homeowners, Good (in the Short Run) for Multifamily

The plan raises the standard deduction to $24,000 for married couples who file jointly and $12,000 for single filers. This amounts to almost a doubling of the current rate, from today's standard deduction of $12,700 for married couples and $6,350 for singles. This will reduce the number of filers who itemize their deductions, including many that deduct mortgage interest.

This provision removes a significant incentive for buying and owning a home. Studies have been released estimating that home prices may decline by 10% as a result of this[1] – but there are winners and losers here. It is a definite negative for *current* homeowners whose mortgage interest and other deductions are lower than the standard deduction. It will, however, likely have positive benefits for the multifamily rental market as would-be home buyers will pause before they make commitments to assess price fluctuations in specific markets.

As for the mortgage interest deduction, the new act preserves the deduction on existing mortgage debt as is, letting homeowners claim a deduction for the interest paid up to $1 million. All new mortgages on first or second homes are allowed interest deductions on debt up to $750,000, down from $1 million today.

The bill, however, no longer allows a deduction for the interest on home equity loans. Previously, interest on home equity loans up to $100,000 was deductible.

[1] "Impact of Tax Reform Options on Owner-Occupied Housing," prepared by PriceWaterhouseCoopers for the National Association of Realtors. Downloadable via this link: http://narfocus.com/billdatabase/clientfiles/172/21/2888.pdf

Capping the Deduction of State and Local Taxes (SALT) as well as Property Taxes at $10,000: Bad for High Tax Markets

Individuals in high-tax states and cities will no longer be able to deduct state and local income taxes (SALT) or property taxes above $10,000. The direct impact is a higher tax bill for residents of high tax areas; the indirect impact is to dampen demand for housing in markets where the cost/benefit ratio has changed for the worse.

This will hurt property values directly and will impact most single family, co-op and condominium transaction values in all locales. Again, this needs to be weighed against what homeowners are buying through their property taxes: the Millburn township of New Jersey, boasting some of the state's best primary and secondary schools, may not be affected as much as other townships that have comparatively high property taxes, but without similar benefits.

It is not as simple as a straightforward comparison of high versus low tax states. State taxes in Connecticut are lower than in New York, and Pennsylvania is lower than New Jersey, which is on par with New York. Employment prospects and the quality of service and amenities are also different across these states, potentially reflecting the willingness of residents to pay higher taxes to obtain higher benefits.

That said, there is less likelihood for large-scale movements across states than there is within states, impacting the push and pull between urban and suburban locations (which has been in constant flux for the last few decades). High-tax urban locations that do not have the amenities to justify the high cost of living – made even higher by the inability of residents to deduct city taxes – will lose more people to the suburbs. Northern New Jersey and Westchester may see an increased influx of people from New York City if households and individuals now feel that the agglomeration of arts, culture, restaurants and other things "that make New York City what it is" are no longer justified in their cost/benefit calculation. The net outflow of people will hurt multifamily and commercial real estate properties in high-tax cities that cannot deliver on desirable amenities. California, New York and New Jersey stand out as high-tax states that will likely experience these population shifts within – and potentially across – their boundaries. However, the tax change should only factor into the decision making of those who itemize their taxes and/or who are considering a move or the purchase of a home.

How might this play out for multifamily markets? Holding all else equal - if population movements cause a net decline in demand for apartment rentals, the markets that will be most at risk are those with a high number of new properties coming online in the near term. High supply growth combined with weakening demand will cause vacancies to spike and rent growth to slow.

However, in metros where few residents itemize their deductions, the changes in the tax code will have a far lower impact. The tables on pages 6 through 8 look at the metros ranked by the percentage of filers that itemize deductions. This data, from the IRS, shows that the suburban metros in the Northeast have the highest share of residents that itemize their deductions. It is the housing markets in these metros that are most vulnerable to a decline in home value. Correspondingly, it is these metros whose rental markets are most poised to see strong demand. Many of these metros also have high property taxes and good schools. In effect, one could

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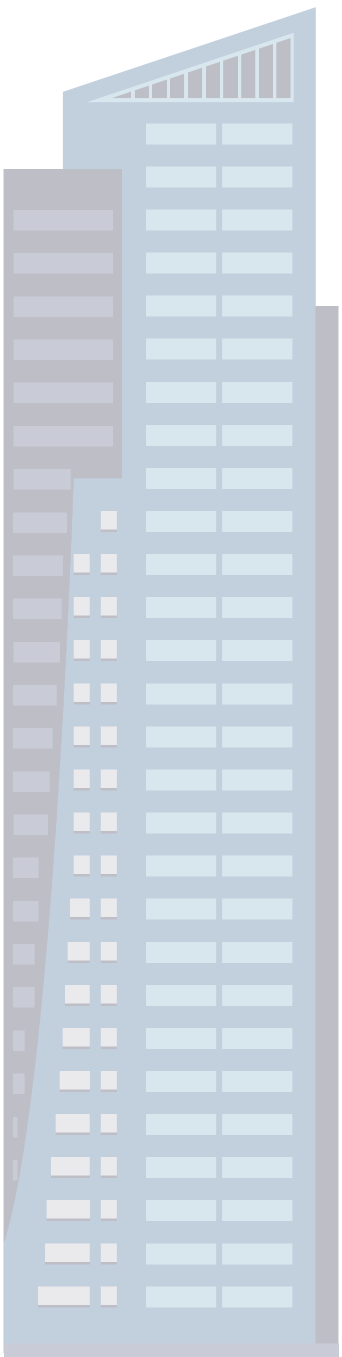

argue that these high ratios of tax filers serve as a signal for high property taxes and strong amenities. Residents may choose to move to rental properties in these suburban markets to take advantage of the amenities they offer yet avoid paying the property taxes for them. At the same time, the home values could decline as few will choose to buy in these markets.

As mentioned above, a number of apartment markets across the U.S. face a risk of overbuilding. A quick look at the Reis completions and expected demand data shows that few metros at the top of the table on pages 6-8 have a high apartment excess supply rate (expected completions in Q4 2017 through Q4 2018 less expected net absorption as a percent of inventory). Ironically, outside of Hartford, Washington, DC, Portland, and Westchester County most of the metros with a high excess supply rate have a very low rate of residents that itemize their deductions. New York City has the highest excess supply rate of 2.8%, yet only 32% of New York filers itemize deductions. Other metros with high excess supply rates such as Dallas, Nashville and Orlando rank at the bottom of the ratio of filers that itemize. In the case of Dallas and the Texas metros, few itemize their deductions as they have lower taxes to itemize in the first place.

The metros with high excess supply rates are already expected to see vacancy rates increase, some could see further vacancy increases if residents flee their borders due to the inability to deduct local, state and property taxes. Gauging the change in demand is challenging, however, since one might assume that metros with low homeownership rates and low rates of itemizing filers will continue to take the standard deduction –which has nearly doubled -- and stay where they are.

Tax Free Capital Gains Exclusion - Retained As Is

The tax-free capital gains exclusion that had been altered slightly under the proposed legislation, was left unchanged in the conference bill.

Thus...

We assert that those on the margin, that are choosing to relocate for life changing decisions – job change, marriage, children, etc. – will take the tax changes into account in choosing where to move, but most households will stay put. Not only will the individual tax changes expire in less than 10 years, but a new administration could reinstate some of the deductions sooner than that. Metros that have a high number of tax filers that itemize and have appealing amenities stand to see the strongest increase in apartment demand over the next few years, but most metros may not see much of a change at all. Furthermore, the marginal impact of the tax provisions on apartment demand will be difficult to measure without in-depth data; nevertheless, we hope to measure the impact of the tax changes over the coming years. (see details on pages 6-8)

Impact on Corporations: More Benefits, But Unclear Operational Impact

1031 Exchanges Remain Intact

Commercial property owners are easily the biggest beneficiaries of this tax bill. The Conference Bill preserves the deeply treasured "1031 exchange" provision that enables sellers of real estate to defer capital-gains taxes by reinvesting the proceeds in "like-kind" of properties.

Generous Depreciation Schedules

Also, the time over which landlords can depreciate property has been reduced – from 27.5 years to 25 years for residential property and from 39 years to 25 years for nonresidential property.

Fully Deductible Commercial Mortgage Interest

While most businesses will be impacted by a 30% limit on interest deductions, the limitation does not apply to landlords. They can still deduct their mortgage interest in full and, like all corporations, will benefit from lower taxes on their net income from 35% to 21%.

Lower "Pass Through" Income Tax

Owners of pass-through companies and sole proprietors ("taxpayers other than corporations") will be taxed at their individual tax rates less a 20% deduction for business-related income, subject to certain wage limits and exceptions. For businesses offering "professional services" above a certain threshold, however, the deduction would be removed; phase-ins begin at $157,500 for individual taxpayers and $315,000 for married taxpayers filing jointly.

Asset Depreciation Schedules May Spur New Construction Over The Next Five Years

Businesses will be able to immediately expense many asset purchases; after five years of 100% expensing, the rate will phase out at 80%/60%/40%/20% rates over the ensuing four years. There is the possibility that cash rich corporations may choose to overinvest in real assets and development in the next five years, stimulating supply growth in moribund sectors like office and retail.

This will raise construction costs that will force businesses to reassess the economic prospects of their specific industries: with the threat of e-commerce still dampening demand for brick and mortar retail space, it seems unlikely that there will then be a rush to build or buy new malls just because businesses can now deduct asset investments in the first year. E-commerce companies, however, that were contemplating the decision to build their own warehouse/distribution facilities, may accelerate their plans.

Eliminates the Alternative Minimum Corporate Tax

The provision signed by the Senate called for a corporate AMT, but the conference bill removed it.

What of the Future? Individual Tax Changes Expire by 2027

All of the changes that apply to individuals will expire on December 31, 2025 and reset to current law. This was necessary to comply with the Byrd Rule which does not allow any increases to the deficit "beyond the 10-year budget window." Note, however, that this sunset clause applies only to individual taxes, **changes to corporate rates are currently permanent.**

Conclusion: Winners and Losers, But What Will Change, Really?

To call the changes "sweeping" is an understatement, and yet it is still too early to say what the impact will be.

Still, if we assume that most of what has been agreed to becomes law, this will have a significant near-term impact on the commercial real estate market. In the short run, it will surely help landlords and developers across the industry. However, the triple whammy from the doubling of the standard deduction, the capping of both SALT deductions and the property tax deductions will unambiguously lead to a decline in home prices.

Many cities could also see an exodus of residents that will want to avoid high state and local taxes which will further lower values and property assessments. While this may help some commercial real estate markets (apartment, office, retail and industrial) in suburban areas, it raises a number of policy issues surrounding the funding for a number of government sponsored programs including infrastructure improvements, education, Medicare and Medicaid to name a few.

This will have a significant near-term impact on the commercial real estate market.

While some claim that the tax cuts "will pay for themselves," no one has released a true economic impact of the tax provisions, mainly because it is too soon and it is a very complicated plan.

The plan will add $1 trillion to the U.S. debt — a staggering amount. This will have a significant impact on long term interest rates as the government will need to issue Treasury securities to finance the debt. If interest rates rise as a result, higher borrowing costs will hurt the housing market even more, as well as the overall economy, potentially slowing growth.

If one of the stated goals of reforming corporate tax policy is to encourage the repatriation of dollars currently held in accounts offshore, the results may or may not be forthcoming. By focusing on changes to the price of debt, the new tax plan will primarily affect the financial economy: specifically, how individuals and corporations value the issuance and use of debt, versus the use of equity, in financing expenses and investments. It will influence location decisions and home buying behavior in the short run – and negatively impact firms that rely on debt financing. But it is unclear whether there will be any real operational impact on how the largest corporations currently run their businesses. Dell, which took on about $50 billion in debt for its merger with EMC Corporation, warns that it will see an estimated $200 million hit in taxes every year because of the proposed tax changes.[2] Apple may reprice the composition of its debt and equity over time to maximize profits, but will it now source more of its input needs from US companies versus overseas?

The impact of the tax changes on these policy issues can and will be debated for weeks. We hope to revisit this study periodically over the next year or so.

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[2] If the Senate Bill's restrictions on interest deductions are adopted, versus the House version. "Dell Executive Warns of Tax Bill's 'Devastating Consequences,'" The Wall Street Journal, November 29, 2017.

Metro	Percent who Itemize their Tax Returns[1]	Homeownership Rate[2]	Excess Supply as a % of Inventory[3]	YTD Rent Growth[4]	State Tax Rate[5]
Suburban Virginia	50%	65%	0.2%	2.3%	5.8%
Suburban Maryland	49%	64%	0.2%	1.7%	4.9%
Long Island	48%	80%	0.2%	0.9%	6.8%
Westchester County	47%	61%	1.3%	0.0%	6.8%
Fairfield County	45%	65%	0.3%	-0.5%	5.8%
Baltimore	45%	64%	1.1%	1.3%	4.9%
Central New Jersey	44%	70%	0.2%	1.1%	6.2%
San Jose	43%	56%	0.5%	4.1%	9.3%
San Francisco	43%	49%	0.4%	1.6%	9.3%
Hartford	42%	65%	1.8%	1.1%	5.8%
Oakland-East Bay	41%	57%	0.2%	2.3%	9.3%
District of Columbia	40%	39%	1.6%	3.0%	8.2%
Minneapolis	39%	67%	0.8%	3.6%	7.5%
Portland	39%	61%	1.4%	2.2%	9.5%
Northern New Jersey	39%	53%	1.1%	2.4%	6.2%
Raleigh-Durham	39%	61%	0.5%	2.8%	5.5%
Philadelphia	39%	67%	0.4%	1.7%	3.1%
New Haven	39%	61%	-0.2%	0.7%	5.8%
Boston	39%	60%	1.1%	3.6%	5.1%
Richmond	38%	64%	0.4%	0.9%	5.8%
Orange County	38%	57%	0.2%	1.8%	9.3%
Ventura County	37%	62%	-0.1%	3.3%	9.3%
Atlanta	37%	58%	0.9%	4.5%	6.0%
Kansas City	37%	67%	0.9%	2.4%	5.2%
Sacramento	36%	59%	0.1%	1.8%	9.3%
Salt Lake City	36%	70%	-0.4%	4.7%	5.0%
Chicago	35%	63%	0.7%	3.7%	5.0%
Seattle	35%	59%	0.9%	4.8%	0.0%
Charlotte	35%	57%	1.0%	4.6%	5.5%
St. Louis	34%	67%	0.2%	2.7%	6.0%

[1] Source: Internal Revenue Service - 2015 Statistics of Income (SOI) data

[2] Source: Census data on Housing Units by Tenure: B25003

[3] Excess supply measures expected completions less expected net absorption from Q4 2017 through Q4 2018 divided by current inventory. Source: Reis.

[4] Apartment rent growth from Q4 2016 though Q3 2017. Source: Reis.

[5] State tax rates were calculated based on an average salary of $50,000 to $75,000. States with no income tax include: Alaska, Florida, Nevada, South Dakota, Washington and Wyoming.

Metro	Percent who Itemize their Tax Returns[1]	Homeownership Rate[2]	Excess Supply as a % of Inventory[3]	YTD Rent Growth[4]	State Tax Rate[5]
Norfolk/Hampton Roads	34%	59%	-0.2%	1.2%	5.8%
San Diego	34%	52%	0.8%	2.3%	9.3%
Birmingham	34%	68%	-0.5%	4.1%	5.0%
Omaha	33%	63%	0.8%	1.0%	6.8%
San Bernardino/Riverside	33%	61%	-0.7%	1.8%	9.3%
Denver	33%	61%	1.2%	4.5%	4.6%
Milwaukee	33%	57%	0.9%	2.5%	7.0%
Lexington	33%	56%	0.7%	2.1%	6.0%
Los Angeles	32%	45%	0.5%	3.8%	9.3%
New York	32%	32%	2.8%	1.1%	6.8%
Providence	32%	58%	0.6%	1.1%	5.4%
Syracuse	32%	65%	0.5%	2.2%	6.8%
Columbia	31%	65%	0.5%	2.6%	7.0%
Charleston	31%	65%	0.7%	4.0%	7.0%
Rochester	31%	66%	0.8%	2.7%	6.8%
Cincinnati	31%	64%	0.3%	1.7%	4.0%
Louisville	31%	61%	1.2%	1.1%	6.0%
Phoenix	31%	60%	0.4%	3.0%	4.4%
Detroit	31%	66%	0.1%	2.9%	4.3%
Palm Beach	31%	68%	0.7%	4.6%	0.0%
Columbus	30%	54%	0.6%	2.9%	7.0%
Tacoma	30%	60%	0.0%	5.2%	0.0%
Greenville	29%	61%	1.0%	2.9%	7.0%
Cleveland	29%	60%	0.5%	2.2%	4.0%
Little Rock	29%	56%	-0.8%	-0.8%	6.9%
Indianapolis	29%	62%	1.2%	1.0%	3.2%
Austin	29%	57%	1.2%	5.7%	0.0%
Colorado Springs	29%	63%	1.3%	5.2%	4.6%
Albuquerque	28%	67%	0.4%	1.6%	4.9%
Greensboro/Winston-Salem	28%	66%	1.0%	2.8%	5.5%

[1] Source: Internal Revenue Service - 2015 Statistics of Income (SOI) data

[2] Source: Census data on Housing Units by Tenure: B25003

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Metro	Percent who Itemize their Tax Returns[1]	Homeownership Rate[2]	Excess Supply as a % of Inventory[3]	YTD Rent Growth[4]	State Tax Rate[5]
Fort Lauderdale	28%	61%	0.8%	1.9%	0.0%
Tucson	28%	63%	-0.6%	3.0%	4.4%
Dallas	28%	56%	1.4%	4.5%	0.0%
Buffalo	27%	66%	0.5%	2.6%	6.8%
Tulsa	27%	60%	-0.1%	1.0%	5.0%
Oklahoma City	27%	61%	-0.5%	0.2%	5.0%
Houston	27%	58%	0.7%	2.5%	0.0%
Memphis	27%	56%	-0.7%	1.6%	5.0%
Pittsburgh	27%	69%	-0.1%	2.5%	3.1%
Fort Worth	26%	60%	0.7%	4.3%	0.0%
New Orleans	26%	58%	0.7%	2.7%	6.0%
Dayton	26%	62%	1.5%	1.4%	4.0%
Las Vegas	25%	52%	0.5%	2.7%	0.0%
Nashville	25%	63%	2.2%	2.2%	5.0%
Miami	25%	51%	1.0%	5.5%	0.0%
Wichita	24%	64%	-0.5%	2.2%	5.2%
Chattanooga	23%	67%	2.3%	3.0%	5.0%
Jacksonville	22%	60%	0.5%	1.8%	0.0%
Tampa-St. Petersburg	22%	63%	0.2%	2.7%	0.0%
Orlando	21%	55%	1.3%	4.4%	0.0%
San Antonio	21%	58%	0.7%	2.0%	0.0%
Knoxville	21%	66%	0.1%	3.2%	5.0%
Metro Average	33%	59%	0.7%	2.9%	--

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