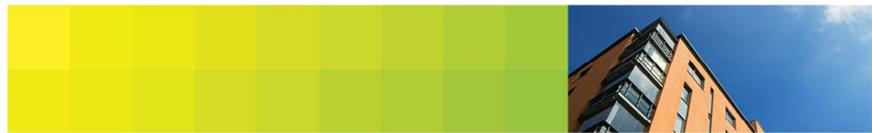
Freddie Mac MULTIFAMILY



How Will the Tax Cuts and Jobs Act Impact Real Estate?

The Tax Cuts and Jobs Act (TCJA) became law on December 22, 2017. The sweeping legislation is the largest tax reform since 1986 and everyone, from individuals to corporations, are seeing the changes when they file their taxes this year. In commemoration of this year's tax deadline and having a year to adjust to the new rules, let's review how these changes have affected multifamily real estate for both renters and real estate owners.

In this paper, we examine the tax bill from several different perspectives, including how the new law may influence the decision to purchase a home across different geographies. We discuss how the TCJA affects commercial real estate and potential investment decisions. We also look at previous changes to the tax law in 1981 and 1986 to see how those changes affected commercial real estate and if there are any parallels to the current law.

This is not intended to be a comprehensive analysis of all the costs and benefits of the TCJA. It is limited in scope and focused on how the law could affect real estate. We highlight general tax changes that effect all tax payers, including changes to the tax brackets and rates, the changes to the standard deduction and personal exemptions, and the sunsetting of certain provisions. We also examine the changes to the tax law that affect homeowners, or potential homeowners, who will make the choice to rent or buy. This includes the limits on deductions for state and local income tax and the lower limit on mortgage interest deductions. We consider how the TCJA will affect businesses with changes to the corporate tax rate and the reduction in the tax rate for pass-through businesses. Finally, we look at how the new law will affect real estate, specifically the impact of the bill on investors, and accelerated depreciation schedules. Although important, we do not touch on the alternative minimum tax for both individuals and businesses, inflation measures, family tax deductions and credits, education credits and deductions, medical expenses and deductions, or other corporate tax changes not related to real estate.

Previous Tax Law Changes

In 1981, the Economic Recovery Tax Act (ERTA) of 1981 became law and had a significant effect on the commercial real estate market in subsequent years. Those with a long memory of commercial real estate markets remember that the law created stress in the sector. So how does this one compare?

Multiple provisions of ERTA were beneficial to commercial real estate and greatly improved the rate of return for commercial real estate investments, which in turn rapidly increased demand for those investments. The most significant of these provisions was an Accelerated Cost Recovery System (ACRS) which allowed investors in commercial real estate to depreciate the structure over just 15 years and used 175 percent declining balance deprecation rather than pure straight-line depreciation. This increased the tax deduction in the first year from 3.6 percent to over 11.5 percent. The net effect of the ACRS was increased after-tax returns on commercial real estate relative to other types of assets. This was because the accelerated depreciation from real estate could be used to offset income in other non-related businesses or investments.

The Tax Reform Act of 1986 put an end to the significant tax advantages that the ERTA of 1981 had put forth. The new law ended the ACRS and the 175 percent declining balance depreciation schedule, which returned the annual depreciation rate to 3.6 percent and ended the ability of taxpayers to offset other income with tax losses from real estate.

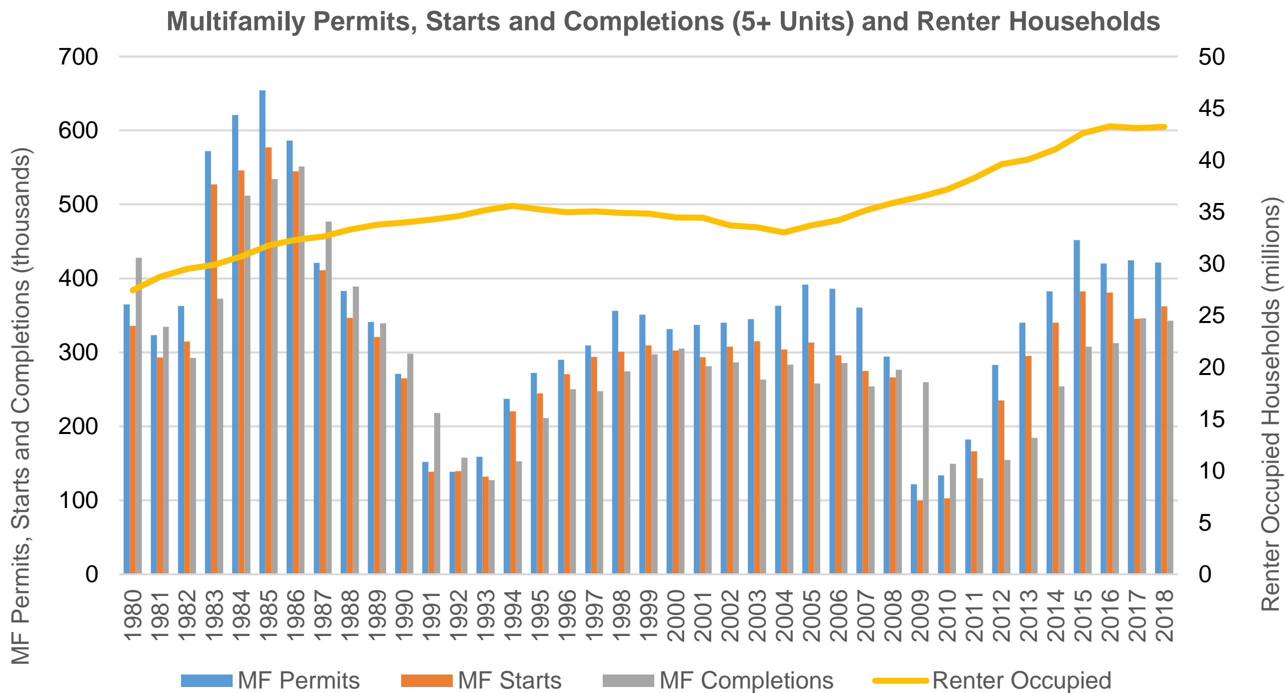
Exhibit 1 below depicts the amount of time a residential real estate building could be depreciated, including accelerated depreciation, and the total depreciation allowable during the year after delivery or acquisition.

Exhibit 1: Residential Tax Law Changes 1980 - 2017

Tax Years	1980	1981-1986	1986-2017	2018+
Residential Depreciation Schedule	27.5 Years	15 Years	27.5 Years	27.5 Years
Accelerated Depreciation	–	175%	–	–
First Year Depreciation	3.63%	11.7%	3.63%	3.63%

The accelerated depreciation schedules allowed by ERTA were the primary reason for the real estate boom in the 1980s. The resulting glut of real estate deliveries spurred by ERTA left the commercial real estate market hung over during the late 1980s and much of the 1990s with elevated vacancy and declining rents. According to data from the American Council of Life Insurers (ACLI), multifamily delinquency rates in 1988 averaged 4.38 percent compared with essentially zero today. As shown on the following chart, multifamily permits ballooned to over 650,000 in 1985 due to ERTA, however since 1990 have they have averaged just under 300,000 units annually.

Exhibit 2: Multifamily Supply



Sources: Moody's Analytics DataBuffet.com and U.S. Census Bureau

The ERTA was a disruptive change to the tax code. We do not anticipate the TCJA will have a similar impact or create artificial demand for commercial real estate.

Major Changes for Individual Taxpayers

The Tax Policy Center projects that the average individual 2018 tax break will be $1,610, and that 80 percent of taxpayers would receive a tax cut. It is also estimated that approximately 5 percent of taxpayers will have an increased tax burden in 2018, which would increase to roughly 9 percent by 2025.

The TCJA almost doubled the standard deduction, increasing it from $6,350 for single filers and $12,700 for married couples filing jointly, to $12,000 and $24,000 respectively. What has not been as widely reported is the elimination of the personal exemption. When this is added to the standard deduction for 2017, the total deduction for single filers is $10,500, and $21,000 for joint filers. When the standard deduction and the personal exemption are combined, the difference is $1,500 and $3,000 respectively when compared with the higher standard deduction under the new law. The Tax Policy Center estimates that filers who itemize taxes will drop from roughly 46.5 million under the previous tax code to just 19.3 million under the TCJA. IRS data for 2015 indicates that 29.6 percent of taxpayers filed itemized returns, while roughly 70 percent took the standard deduction. For those homeowners that utilize the standard deduction going forward, the tax benefits of home ownership were eliminated.

An interesting way to examine the effect the new tax bill will have on the home ownership decision is to look at the point where there is no monetary difference between taking the standard deduction and itemizing returns, meaning there is no tax advantage to home ownership. In 2017 under the previous tax law, a single tax filer making $28,000[1] who purchased a home for $132,500 or less would have no tax advantage from home ownership. In 2018, the income point where itemizing and taking the standard deduction are at parity balloons to roughly $50,500[1] with a home value of $252,300.

How much the tax law changes affect the decision to purchase a home is unknown, but the new provisions do not incentivize homeownership as much as the previous tax law, particularly in states with high income taxes, property taxes and home values, as well as in areas with low to moderate incomes and home values.

It should also be noted that the individual changes to the tax law will expire on December 31, 2025, in order to comply with the Byrd Rule which forbids increasing the deficit beyond the budget window of ten years.

The Effects on Homeowners

Because of the tax law change and the uncertainty that surrounded it when it was first signed, there was a rush by homeowners in high tax areas to prepay their 2018 real estate property taxes. One of the provisions in the law limits the combined deductions for state and local income tax, sales tax and property taxes (SALT) to $10,000. Homeowners in areas with high state and local taxes rushed to local government centers in an attempt to prepay their 2018 property taxes in 2017, when they could fully claim the deduction. The IRS quickly put an end to the practice and issued guidance prohibiting writing off property taxes paid before assessments were issued. A recent estimate by the New York State Department of Taxation and Finance estimated that the cap on SALT would cost New York taxpayers an additional $14.3 billion in 2018 and an additional $121 billion cumulatively through 2025.

As noted above, the law signed by President Trump in December 2017 will increase the number of households that take the standard deduction in lieu of itemizing deductions. For filers taking the increased standard deduction, the mortgage interest deduction is no longer a benefit to them. Another provision of the law eliminates the deduction of interest for some home equity loans. In addition, the law reduces the amount of interest that is deductible on mortgages from $750,000 to $1 million, however current loans are grandfathered in and will not be subject to the lower ceiling. The effect of these two provisions of the TCJA most impacts states with high home values, high income households, high state income tax rates and high property tax rates. Examples of these

[1] Assumes 30 percent of income goes toward home cost, with a 20 percent down payment, 4.5 percent fixed-rate 30-year mortgage, with 2/3 of mortgage payment attributable to interest, 4 percent state income tax rate and 1 percent annual property tax rate.

states are New York, New Jersey, Connecticut and California, however most large metro areas also have relatively affluent areas where these provisions of the tax bill will make homeownership less attractive.

We have performed an analysis of the effects of the tax bill on households who own median value homes in six different counties, and the median priced home in the U.S. These tax changes are presented in Exhibit 3. "Median Home Price" represents the midpoint for home transactions in the given area. The "Income Required" column is the amount of income needed to purchase the home assuming 30 percent of income is allocated toward housing costs, with a 20 percent down payment, excluding utilities (which is a common assumption). The "State Income Tax Rate" is that average rate of state income tax for a single filer at the income required to purchase the home. The "Property Tax %" is the annual rate at which the home is taxed by the locality and it is expressed as a percentage of home value. "Annual Tax Change 17 – 18" shows the change in taxes the homeowner (as both a single and joint filer) in each jurisdiction can expect, given the tax law changes from 2017 to 2018.

Exhibit 3: TCJA Effect on Taxes for Homeowners

Area	Median Home Price	Income Required	State Income Tax Rate (Single)	Property Tax %	Annual Tax Change 2017 – 2018		2015 % Itemize
					Single	Joint	
United States	$205,000	$41,015	4.1%	0.98%	-$180	-$300	29.6%
Fayette Co., GA	$277,500	$56,014	4.2%	1.04%	-$298	-$655	48.0%
Montgomery Co., MD	$475,300	$90,245	3.6%	0.86%	-$704	-$321	51.2%
Morris Co., NJ	$433,100	$99,757	2.8%	1.90%	-$546	-$312	53.0%
Marin Co., CA	$940,000	$184,725	6.0%	1.12%	$377	$775	53.3%
Fairfield Co., CT	$423,200	$86,992	3.8%	1.30%	-$604	-$328	46.3%
Oklahoma Co., OK	$149,700	$30,661	3.3%	0.96%	-$336	-$300	26.3%

Sources: Freddie Mac, American Fact Finder, Tax-Rates.org.
Mortgage Assumptions: 20 percent down payment, 4.5 percent interest and 2/3 of mortgage payment goes toward interest

As illustrated in the chart above, homeowners in most of the areas see annual tax savings under the new tax code ranging from a savings of $180 per year for a single filer with the median home price in the U.S., to an annual savings of $655 for a married couple in Fayette County, Georgia. The outlier in the chart above is Marin County, California where the median home price is $940,000. Taxes are expected to increase by $377 per year for a single filer and $775 for joint filers. This is due almost entirely to the cap on state and local taxes of $10,000. In the example above, the homeowner in Marin County would pay over $11,000 in state income tax and over $10,500 in property tax, and will lose almost $12,000 in deductions due to the tax law change. Most of the counties examined are relatively affluent and have a high proportion of filers that itemize returns compared with the national average. The exception to this is Oklahoma County, which has a much lower median home price and a much lower percentage of taxpayers who are likely to itemize their deductions.

Exhibit 4 below shows the annual tax changes for single and joint filers who are taking the standard deduction at various income levels from $25,000 to $150,000 per year. Under the TCJA, filers who take the standard deduction realize more significant savings than those who itemize their returns. Almost every renter household in the country will take the standard deduction, meaning the new tax law is especially beneficial to renters.

Exhibit 4: TCJA Effect on Taxes for Filers Taking the Standard Deduction

Income	Annual Tax Change 2017 - 2018	
	Single	Joint
$25,000	-$282	-$209
$50,000	-$975	-$564
$75,000	-$1,892	-$1,256
$100,000	-$2,585	-$1,949
$125,000	-$3,250	-$3,092
$150,000	-$4,173	-$3,784

An Example of How Tax Changes Can Affect a Homeownership Decision

Let's take a closer look at how these changes impact individual families using two families in Morris County, New Jersey as an example. The family who recently purchased a median priced home, with an income of $99,757, would realize a tax savings of $312 annually under the new law (see Exhibit 3 on the previous page). If the other family lived in similar rental housing earning $100,000 per year and took the standard deduction, their tax burden would be $1,949 lower under the revised tax law (see Exhibit 4 above), which equates to a difference of more than $1,600 annually.

This example captures how the revised tax code differs for homeowners and renters. The increase in the standard deduction, coupled with the deduction limits on state and local taxes (including real estate property tax) reduces the benefit to homeowners. When the law was passed, the National Association of Realtors predicted that home sales would be 0.4 percent lower in 2018, and prices would be 1- 3 percent lower than they otherwise would have been without new tax law, primarily due to the diminished tax benefits of homeownership. However, a recent analysis by Core Logic on the 500 zip codes with the highest housing costs reveals that, for the first half of 2018, there was no discernable effect on the high end of the housing market (where the provisions of the new law are most likely to be felt) due to the new tax law.

The Effects on Commercial Real Estate

Numerous provisions of the TCJA are extremely favorable to commercial real estate, their owners and operators. One is the 100 percent immediate depreciation for new and used assets with a useful life of less than 20 years. This means that improvements such as new carpeting, appliances, HVAC, landscaping, driveways and other similar improvements can be immediately written off for the entire cost of those improvements through 2022. In a change from the previous law, the TCJA now allows used property acquired in a real estate transaction to be 100 percent depreciated, as well.

A tax rate reduction of 20 percent for pass-through businesses has the potential to put a lot of extra dollars into the pockets of real estate developers. It is reasonable to think they may very well reinvest that money into real estate.

An example:

An investor holds a large office building that was purchased seven years ago in an LLC co-owned with two other individuals in equal shares. The purchase price of the investment was $21 million, of which $18 million was

attributable to the structure. The investor's share of the purchase price of the property was $7 million, $6 million of which is attributable to the structure, and his share of the annual rental income is $1 million. The LLC pays no W-2 wages; rather, it pays a fee to a management company. Under the previous tax bill, no deduction would be available to the investor against the $1 million of income because no wages are paid against the income. The TCJA, however, is much more beneficial and allows the investor to take a 20 percent deduction up to 25 percent of W-2 wages plus 2.5 percent of the original cost of building itself.

Under the new tax law, the investor is entitled to a deduction equal to the LESSER of:

- 20% of qualified income, or $200,000 ($1 million * 20%)
- 25% of W-2 wages ($0) plus 2.5% of the investor's share of the unadjusted basis of the structure (2.5% * $6,000,000) = $150,000
- Thus, the investor gets a deduction of $150,000 that would not have been available under the previous legislation

Assuming the investor is in the top tax bracket and is not taxed at 37 percent on $150,000 that was deducted, then the net benefit would be $55,500. Across the three investors in this property, this would be $166,500. If the group decides to reinvest that money back into multifamily at 80 percent leverage, that could produce $832,500 ($166,500 / 0.2) of additional investment in multifamily.

Please Note: The tax law changes discussed for commercial real estate are general and there are constraints that may not allow all to benefit from the tax law changes. The analysis is intended to be high level and not property specific and should not be considered tax advice.

Opportunity Zones

Under the TCJA, Opportunity Zones are a new way for investors to shield capital gains from taxes. The intended goal of opportunity zones is to leverage private capital to revitalize communities that struggle with high rates of poverty and underinvestment. There are over 8,700 Opportunity Zones (classified at the census tract level) spread across the nation, home to roughly 35 million people. Each state is responsible for choosing their own zones and may designate up to 25 percent of their low-income communities (certified by the IRS) to be Opportunity Zones. Investors can roll over capital gains into funds that will make equity investments in Opportunity Zones, known as an Opportunity Fund. Opportunity Funds can be invested in a wide variety of projects, which can include investments in real estate, local businesses and business assets. Both individuals and institutions can invest capital gains in these funds.

Investors have roughly $2.3 trillion in unrealized capital gains, which provides an immense amount of potential investment under this initiative. Some industry analysts predict that this tax break will be among the largest in U.S. history and has the potential to infuse a vast amount of capital into real estate in Opportunity Zones.

Investors who make qualifying investments in Opportunity Zones will receive preferential tax treatment in several ways:

- Tax deferment on capital gains until the year 2026 or sale of the property
- A 10% reduction in the amount of gain subject to tax if the investment is held for 5 years
- A 15% reduction in the amount of gain subject to tax owed if the investment is held for 10 years
- Tax-free growth on the Opportunity Fund as long as the investment is held for at least 10 years

As shown above, to get the maximum tax deferred benefit, an investment in an opportunity zone fund must be held for seven years. With the requirement to recognize all gain rolled over by December 31, 2026, , that means

investments must be placed by the end of 2019. This may create a rush to invest in these zones, which may create additional risks for the investors. Another aspect of the law to bear in mind is that, in 2026, the capital gains will be due regardless of a sale of the investment. In other words, if no sale occurs, then the investor must come out of pocket to pay the tax liability, when in other cases they would have the proceeds from the sale to pay the capital gains taxes. Despite this, many investors are planning to hold their investments beyond the 10-year period in order to take full advantage of the tax-free growth allowed in an Opportunity Fund.

Conclusion

The TCJA is the most significant tax change in the past 30 years and provides significant economic benefits to many individuals and businesses. The law is considered economically beneficial for commercial real estate and investors. With the exception of tax credit properties, where the lower tax rate has devalued the tax credits used to help fund the property, almost every provision of the law is beneficial for the development, operation and financing of commercial real estate. In particular, the 100 percent bonus depreciation for investments with a useful life of less than 20 years, as well as the ability to shield capital gains in Opportunity Zones improves the after-tax rate of return for commercial real estate.