



**CUSHMAN &
WAKEFIELD**

THE GREAT TAX RACE

**How the World's Fastest Tax
Reform Package Could Impact
Commercial Real Estate**

Special Report
December 2017

Executive Summary

A modest set of proposals

- Modest impact on real GDP growth—3-9 basis points (bps) per year over next decade.
- Commercial Real Estate (CRE) industry largely exempt from significant provisions regarding limitations on interest deduction and 1031x repeals.
- History suggests that tax law changes by themselves are often not key drivers for transactions or for investment performance. However, there is likely to be a period of transition and market flux as investors restructure to optimize tax outcomes with implications for the underlying asset classes. Corporations are likely to separate the real estate aspects of their businesses.
- Cushman & Wakefield anticipates that a version of tax legislation reform has an 80% chance of enactment by year-end 2017 with immediate implications for financial reporting.

Biggest impact on residential real estate; modest to minimal impact on other sectors

Office

- Corporations big beneficiaries—likely to see a net tax cut of \$400 billion over 10 years. However, we anticipate that the tax cut will be preferentially used to return capital to shareholders or reduce debt, rather than to increase corporate spending.
- There may be a modest pick-up in M&A activity leading to real estate consolidations.

Residential

- Short-term drag on home values and number of home sales with greatest impact in areas with high state and local tax deductions (“SALT”), high property taxes, high median incomes and medium-to-high home values such as California, New York and New Jersey. Still, this is likely to be counteracted to some extent by robust underlying real estate fundamentals and job growth in these high-home-value markets. It also alters the rent vs. buy economics in favor of renting.
- Limited emigration effect of between 2-4% on high earners from high cost/ tax areas to lower cost areas. Florida and Texas key beneficiaries of net migration.

Real estate investors benefit, some more than others; much depends on which version passes

61% OF INVESTMENT IN U.S.-BASED DIRECT COMMERCIAL REAL ESTATE IS VIA PASS-THROUGH ENTITIES THAT DON'T PAY CORPORATE INCOME TAX

29% FLOWS THROUGH TO TAX-EXEMPT ENTITIES, EITHER DIRECTLY OR VIA PASS-THROUGH ENTITIES

9% JUST OF U.S. REAL ESTATE ASSETS ARE HELD BY CORPORATIONS

- Passive investors in pass-through entities likely to benefit substantially from lower rates under the House plan, but their eligibility for tax deductions are limited by wage provisions under the Senate proposal.
- REITs and publicly-traded partnerships, however, would be eligible for the full deduction without regard to the wage limitation.
- Should the Senate proposal be enacted, expect to see a shift over time towards REITs, as well as conversions to corporate structures.

▲	▼	▬
MODERATE POSITIVE IMPACT	MODERATE NEGATIVE IMPACT	MINIMAL IMPACT
Multifamily / renting economics	Single family homes / home ownership	Office
Pass-through entities, REITs, Corporations	Student housing	
Retail / Industrial	Medical office / healthcare	
Real estate investment market	High SALT, income states - California, New York, New Jersey	
Low SALT states - Texas, Florida		

Source: Cushman Wakefield Research, December 2017

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Introduction

Taxes a lubricant, not a driver of CRE decisions

On November 16, the House of Representatives passed its version of the tax reform bill. A Senate tax reform proposal was passed on December 2. Cushman & Wakefield, along with other market observers¹ anticipate that a version of tax legislation reform has an 80% chance of enactment by year-end 2017, with immediate implications for financial reporting.

THE ECONOMY IS CURRENTLY GROWING, WITH UPWARD REVISIONS TO REAL GDP GROWTH FORECASTS.

The tax incentives and breaks that the CRE industry enjoys are a lubricant (or friction cost) for the transaction market, but often not a key driver of transactions themselves or investment performance. A Goldman Sachs analysis notes that in May 2003, REITs outperformed the rest of the market despite an adverse tax change that disadvantaged them.²

The economy is currently growing, with upward revisions to real GDP growth forecasts (expected to be an annualized 2.5% in the fourth quarter of 2017)³. The CRE industry is likely to benefit from a prolonged economic cycle. These factors will continue to drive investment decisions and transaction volumes.

Overall, CRE a winner; passage of tax reform legislation will prompt restructuring and short term market flux as investors adapt to new regime

A lot of the structuring around CRE transactions is dictated by the need to minimize taxes. Sweeping changes in the tax code could be the cause of material value leakage, and players in the industry are likely to respond by changing their behaviors and tax structures to minimize their tax exposure.

¹ Cushman & Wakefield Research, PwC (December 2017)

² In May 28, 2003 the highest tax rate on dividends was reduced to 15% from 38.6%. However, the tax rate on REIT investment returns remained at the personal income tax rate level, whose highest bracket fell to 35% from 38.6% (in 2002). Despite this, the REIT Index outperformed the S&P 500 by 4.1% in 2003.

³ Oxford Economics, Moody's Analytics (December 2017)

Overview of Provisions Affecting CRE Industry

Both the House bill and the Senate plan preserve like-kind exchanges (1031x) for real property. No material changes were made to the Foreign Investment in Real Property Tax Act (FIRPTA) in either version, although foreign investors do benefit from the overall reduction in the corporate tax rate. Changes in tax credits and elimination of exemption from income for contributions to capital are also expected to affect the real estate markets and participants.



POLICY AREA (CURRENT TREATMENT IN BRACKETS)	HOUSE PROPOSAL	SENATE PROPOSAL	CURRENTLY ANTICIPATED OUTCOME	IMPLICATIONS FOR CRE
CORPORATIONS				
Corporate income tax (currently 35%)	20% rate, effective 2018, no corporate AMT	20% rate, effective 2019, corporate AMT retained	20% rate, effective 2019, corporate AMT retained	Real GDP growth increased by 3-9 bps per annum over next decade. Cuts less significant than headline figures suggest due to lower effective tax rate and base broadening provisions.
Expensing	100% expensing (expires after 2022). Excludes Real Estate businesses. Not applicable to structures.	Similar to House. Phased out after 2022. Real estate businesses are not excluded from 100% expensing. Not applicable to structures.	Similar to Senate	Real estate businesses will want to characterize as much investment spending as possible as non-structure in order to benefit from immediate expensing.
Interest deductibility (unlimited)	Limit net interest deductibility to 30% of EBITDA; excludes real estate businesses. Carry forward for 5 years.	Limit net interest deductibility to 30% of EBIT; excludes real estate businesses but requires election. Extended depreciable life will apply if exclusion elected (see below). Indefinite carryover.	Similar to Senate	May increase relative attractiveness of real estate as an asset class, although partially offset by expensing provisions. Restructuring to separate real estate component of business.
Excess leverage test for U.S. corporations that are members of a worldwide group (none)	Links U.S. interest to U.S. earnings relative to worldwide earnings and component share of worldwide interest. Not grandfathered for existing debt.	Similar to House provisions. Linked U.S. debt mirrors worldwide debt to equity ratio.	Links U.S. interest to U.S. earnings relative to worldwide earnings and component share of worldwide debt. Not grandfathered for existing debt.	May prompt restructuring to not trigger consolidation issues.
Cost Recovery Period/Alternative Depreciation System (27.5 years for residential; 39 years for nonresidential; 15 years for qualified leasehold improvements)	None	Decreases depreciable life for assets acquired after 2017. Real estate businesses that elect exemption from interest limitation subject to longer ADS. ADS for nonresidential real estate unchanged.	Similar to Senate	Low leverage owners of real estate may find this advantageous on a case-by-case basis. Real estate businesses could choose to accept limitations on interest deductibility in exchange for shorter depreciable lives on real estate.
Private activity bonds "PAB"	Repeal	None	None	If repealed, adverse impact on infrastructure with knock on effect on CRE.
Carried interest	Three year minimum holding period and then taxed at 20%	Three year minimum holding period and then taxed at 20%	Three year minimum holding period and then taxed at 20%	New York, New Jersey and, most recently, Illinois considering imposing 19%-20% tax on carried interest.
PASS-THROUGH STRUCTURES				
Qualified business income/pass-through rate (currently 39.6%)	25% rate on passive income, 70/30 rule for eligible pass-through income. Excludes investment income, i.e. capital gains, dividends, interest and other portfolio income.	23% deduction of qualifying pass-through income; limits total deduction to 50% of W-2 wages paid and to domestic income. Expires in 2025-below 30%	Closer to Senate provision	Likely to be applicable to real estate fund managers and investors. Applicable to leasing income. REIT dividend income likely to qualify.
INDIVIDUAL INCOME TAXES AFFECTING CRE				
State and Local Tax Deduction "SALT"-(unlimited)	Limit property tax deduction to \$10k Repeal deductibility of SALT	Limit property tax deduction to \$10k Repeal deductibility of SALT	Limit property tax deduction to \$10k Repeal deductibility of SALT	Reduce value of homes above property-tax threshold. In conjunction with enlarged standard deduction, increases incentive to rent vs. buy as fewer taxpayers itemize.
Mortgage Interest Deduction "MID" (Limited to \$1 million)	Limit MID to \$500k & only for primary residence. Existing primary residence grandfathered. Repeal home equity interest deductibility	Maintain MID to \$1 million Repeal home equity interest deductibility	Maintain MID to \$1 million Repeal home equity interest deductibility	Reduces attractiveness of second homes as investments. Affects rent vs. buy economics.

Source: Joint Committee on Taxation, House Ways and Means Committee, PwC, Cushman Wakefield Research

Implications for CRE Asset Classes

Office

Modest growth at best

Some proponents claim that the proposed tax cuts will lift real GDP growth closer to 3% per annum from the approximately 2% that has prevailed during the current expansion. However, most of their analyses do not consider the likely effects of tax reform on a higher-than-expected trajectory for interest rates or the impact of higher levels of debt that deficit-financed tax cuts will entail. When these are factored in, estimates of the GDP growth boost range from 3-9 bps⁴ per year on average over the next decade.

While exact figures may differ, Cushman & Wakefield believes that the relatively modest size of tax cuts

ESTIMATES OF THE GDP GROWTH BOOST RANGE FROM 3-9 BPS PER YEAR OVER THE NEXT DECADE.

provided for under the current proposals is unlikely to generate significant growth or push up inflation expectations significantly. Tax cuts can deliver growth when the economy is in recession. But with the economy at or near full-employment, multiplier effects are liable to be constrained, further reducing the potential impact on near-term growth.

Corporates are the key beneficiaries — but those benefits are unlikely to translate into increased spending

Both the House and Senate proposals would give corporations a net tax cut of almost \$400-\$600 billion over 10 years on a static basis, with an effective tax rate estimated at less than 20%⁵. Pass-through entities will benefit from a tax cut of almost \$300 billion in the Senate proposal, and around \$450 billion in the House proposal⁶. The hoped-for result is that this will lead to an increase in capital spending and hiring.

4 Moody's Analytics, Penn-Wharton Budget Model

5 NIPA accounts, U.S. Bureau of Economic Analysis

6 Moody's Analytics

However, most large U.S. corporations have effective tax rates well-below the statutory rate with a median S&P 500 tax rate of 27%⁷. In addition, history suggests that even large cuts are not transformative. The statutory corporate tax rate was cut from about 50% in the 1960s and 1970s to about 35% in 1988, but the rate of business investment did not substantially increase⁸. In the current economic environment, higher interest rates resulting either from increased deficit spending or a more aggressive Fed are liable to offset much of the intended reduction in corporate after-tax cost of capital from lowering rates.

Moving from a global to a territorial system, coupled with heightened tax cuts and incentives being made available to U.S.-based entities, is likely to diminish inversions by U.S.-based multinationals, ensuring more headquarters remain in the U.S. Our analysis indicates that in 2014, there were 4,139 U.S.-headquartered multinational corporations with domestic employment⁹ of 26.6 million. However, just 463 of those companies accounted for 76% of total domestic employment. These are the companies that were previously most likely to consider changing domicile for tax purposes. But under the proposed tax reform legislation, they are less likely to do so.

Lawmakers are planning a one-time tax on overseas profits, but at different rates in the legislation proposed by the two chambers. The House proposes a rate of 14% for liquid assets and 7% for other assets; the Senate version proposes rates of 14.49% for liquid assets and 7.49% for other assets. The overseas cash hoard that came back into the country following the 2004 repatriation cuts was primarily used for share buybacks. However, relative to 2004, Cushman & Wakefield would expect to see relatively more capex, M&A and, over a longer period, debt repayment backed by overseas cash.

Other Sectors

The retail sector pays the highest effective corporate tax rate of any sector in the U.S. economy and indeed the world—at or close to the maximum 35%. This is thought to undermine retail's international competitiveness. A lower corporate rate might encourage foreign retailers to invest more in their U.S. operations, larger corporations and consumers with larger tax savings to spend more and retailers to invest additional capital in their own businesses and employees—all favorable outcomes for the

7 Goldman Sachs

8 Peterson Institute for International Economics

9 Bureau of Economic Analysis, "Activities of U.S. Multinational Enterprises in the United States and Abroad" (December 2016)

industry. Furthermore, about 98% of retailers are small businesses with 50 employees or less¹⁰ who would directly benefit from special provisions for small businesses such as higher eligibility limits for cash accounting, favorable pass-through provisions and higher expensing provisions.

Along these lines, we expect a similarly modest positive impact on the eCommerce sector, which, apart from benefiting from the corporate tax rate reduction, also benefits from full expensing which is geared towards industrial business/capital goods/manufacturing.

Investment in real estate by the healthcare industry is expected to be curtailed. The Senate's provision to eliminate the "individual mandate," is likely to raise health insurance premiums by 10% and increase numbers of un- and underinsured. This is liable to have a negative impact on overall demand for healthcare services. A countervailing effect of increased insurance premia, however, could be to further incentivize adoption of corporate wellness programs.

The House bill includes changes to the treatment of interest on qualified 501c(3) bonds, which many nonprofits use to finance construction and real estate projects. However, we do not expect this provision to be included in the final bill. Both bills reduce exemptions for charitable giving, which could significantly impact health systems' philanthropic campaigns, many of which are used to fund new buildings.

THE DRAG ON HOME VALUES IS LIKELY TO BE LARGEST IN AREAS WITH HIGH PROPERTY TAXES AND MEDIUM-TO-HIGH HOME VALUES.

The increase in deficits under the plan could trigger automatic cuts in Medicare and Medicaid spending as soon as next year. Any cuts if implemented will further affect the financial health of healthcare companies.

Residential Sector

Limited short-term potential drag on home values in certain markets

Home values tend to implicitly incorporate the dollar value of property tax and mortgage interest deductions (MID); therefore any limitations to such tax benefits may negatively affect home prices. Also,



the higher mortgage rates that result from the higher deficits and debt under the plans currently being reconciled weaken housing demand. Assuming full capitalization of the property tax deduction into home prices, the cap on (and lower usage of) the property tax deduction would lower nationwide home prices by 1-5%¹¹.

The drag on home values is likely to be largest in areas with high property taxes and medium-to-high home values. There is also likely to be a larger impact in parts of the country where incomes are higher and where a disproportionate proportion of taxpayers itemize. Both versions of the tax reform limit property tax deductibility to \$10,000. While only 9.2% of households nationally report property taxes above this threshold, this figure rises to as high as 46% in Long Island, 34% in Newark and 20% in San Francisco according to Trulia data.

The Mortgage Bankers Association (MBA) estimates that 22% of mortgages in the U.S. have balances over \$500,000, with most of these concentrated in high costs areas such as Washington, DC and Hawaii—where more than 40% of home purchase loans originated last year exceeded \$500,000. This is followed by California at 27%, and New York and Massachusetts at 16%.

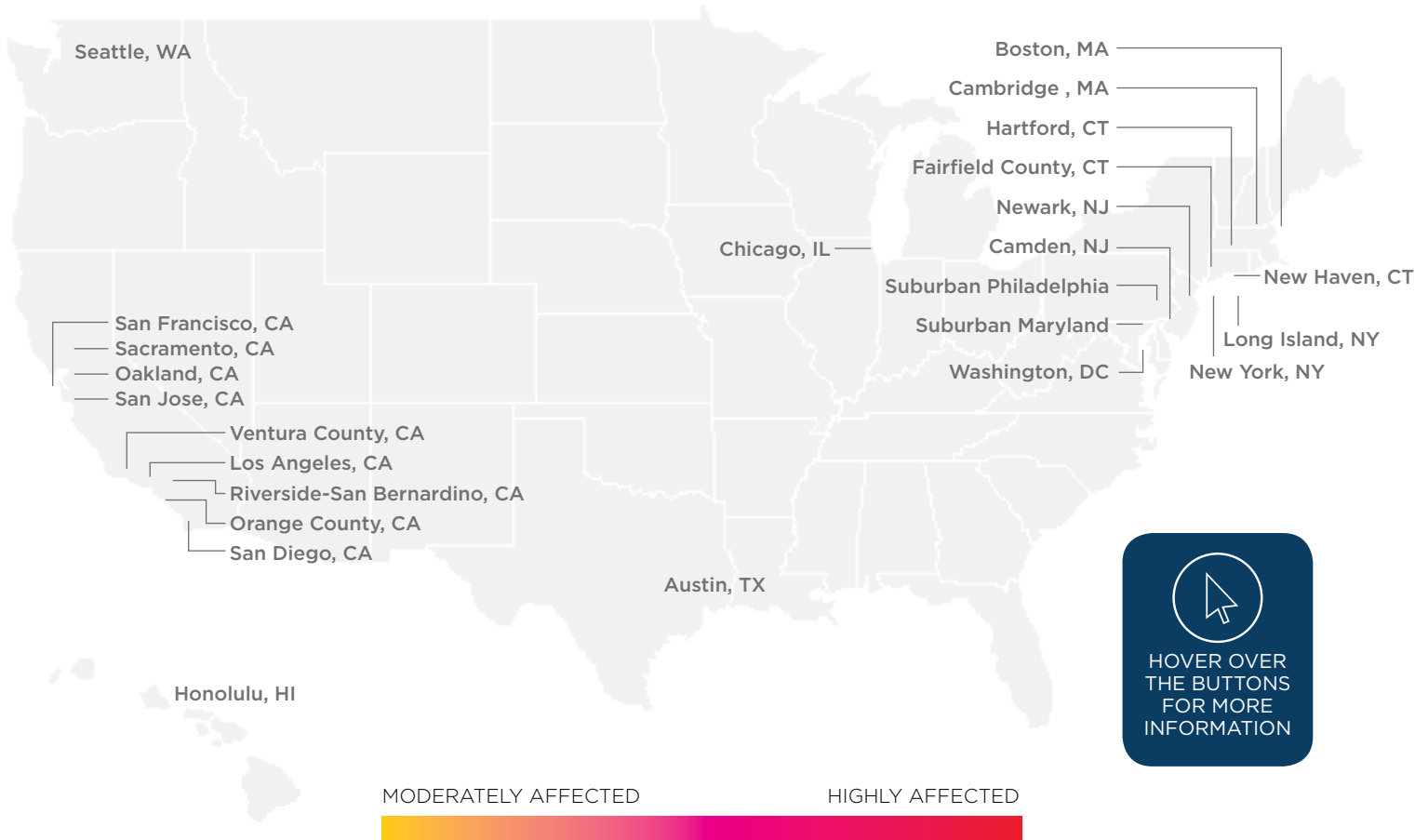
In the unlikely event that mortgage interest deductibility is ultimately eliminated, this would represent a short-term potential downside risk to home prices. An increase in interest rates is also likely to have a knock-on effect on home prices, as a larger proportion of mortgage payments is allocated to interest.

10 National Retail Foundation

11 Goldman Sachs, Moody's Analytics (December 2017)

Potential Effect of Tax Reform on Residential Real Estate

25 Most At-Risk Markets



Full data set available upon request. See footnote for methodology.¹²

Potential uptick in migration of high-income earners to lower-tax areas

The increased effective tax differential between high- and low-tax areas may increase movement from the former to the latter. An initial review of the academic literature on taxes and mobility reveals limited effects on low- and middle-income earners, but the median estimate suggests a 2%-4%¹³ decline in the number of top-income earners after 3-10 years per percentage point increase in the tax rate gap.

¹² Cushman & Wakefield evaluated 100 select residential markets across the five listed variables, assigning a risk score for each variable. Markets were ranked by multiplying each of these risk scores by a coefficient representing a cross-section of the impact of that factor on pricing dynamics and likelihood of inclusion in a final bill and then summing for a composite score.

¹³ Goldman Sachs Research (November 2017)

Impact on housing market liquidity and buy vs. rent economics

The median length of time people had owned their homes was 8.7 years in 2016—more than double what it had been 10 years earlier. Now that interest rates have begun to tick upward from their historic lows, the housing market may face a problem called the “lock-in” effect, where homeowners are reluctant to move, since moving might entail taking out a new mortgage at a higher rate. This leads to the possibility of decreasing housing market liquidity in high-priced markets.

All things considered, the doubling of the standard deduction and the cap on the property tax deduction is likely to have the largest impact on the buy vs. rent incentive, especially as it seems likely that there will be



Implications for Key Players in the Direct CRE Market

Cushman & Wakefield estimates that approximately 61% of investment in direct CRE in the U.S. is via pass-through entities that are not subject to corporate income tax. Another 29% flows through to tax-exempt entities either directly or via pass-through entities. Corporations hold just 9% of U.S. CRE assets.

The earnings of pass-through entities flow to their owners' individual income tax returns. The current tax reform plans envisage substantial reduction in rates for qualified pass-through income (25% top rate under the House plan and a 23% deduction under the Senate plan).

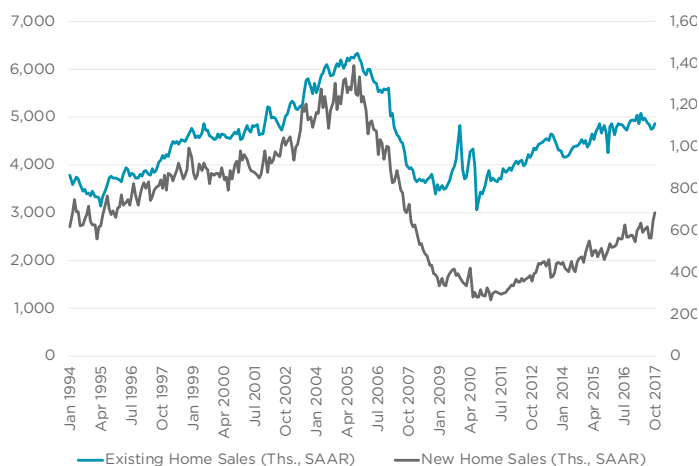
The largest categories of pass-through structures by share of real estate income are partnerships, followed by REITs and finally S corporations. Sole proprietorships, another form of pass-throughs, are not significantly represented.

minimal changes to the mortgage interest deduction in any final tax reform bill.

The homeownership rate in the U.S. is 64%, and is already under pressure from millennials' (the largest demographic group in the country) preference for renting.

However, mirroring the negative impact on buying condos and single-family homes, we see the tax reform bill as a positive driver for multifamily and single-family rentals (SFR). Given that elimination of the mortgage interest deduction for second homes and the impact on home equity would tend to reduce incentives for second homeownership, this could provide further boost to scale/institutional SFR vehicles.

New Versus Existing Home Sales

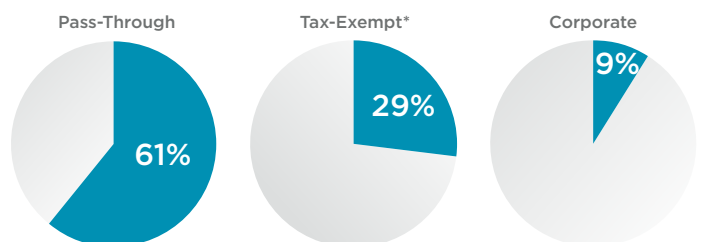


Source: National Association of Realtors®, U.S. Census Bureau

THE FINAL PASS-THROUGH TAXATION RULES WILL HAVE SIGNIFICANT IMPLICATIONS FOR REAL ESTATE INVESTORS.

The final pass-through taxation rules will have significant implications for real estate investors. For passive investors, rental income is considered passive income and therefore would be eligible for the 25% rate under the House plan. This would apply to all pass-through vehicles—partnerships, S corporations and REITs—as well as to the owners/investors in those entities. Arguably, tax relief under the House plan would be greater for real estate investors than

Distribution of Investible Commercial Real Estate by Holder Taxable Structure % of Total



Source: RCA, Prequin, Cushman & Wakefield Research (November 2017)

*Tax-exempt includes Endowments, Pension Funds, Sovereign Wealth Funds, Educational & Religious Entities, Non-profits and Government.

Based on Prequin data assumes, that 90% of equity fund, investment manager and open-ended fund holdings ultimate investors are tax-exempt.

for investors in other asset classes, shifting the comparative after-tax IRR, which might result in a greater proportion of capital shifting to real estate over time.

The Senate plan has very different implications for real estate investors. As currently drafted, most real estate fund managers and investors would likely see little to no benefit from the 23% deduction as the deduction is limited to 50% of W-2 wages paid by a business. To illustrate, an investor in an LLC that owns a property but which has no employees (and therefore pays no wages) would not benefit from this provision. In the case of a management company, with employees and wages, the deduction would be allowed but would be circumscribed by provisions governing so-called “specified service businesses,” preventing owners with income of over \$250K/\$500K (single/married) from claiming the deduction. Put simply, the Senate proposal leaves partnership and S corporation investors in real estate out in the cold.

PUT SIMPLY, THE SENATE PROPOSAL LEAVES PARTNERSHIP AND S CORPORATION INVESTORS IN REAL ESTATE OUT IN THE COLD.

REITs and publicly traded partnerships, however, are eligible for the full deduction without regard to the 50% wage limitation. Should this become law, we would expect to see a shift over time towards REITs as preferred means to access real estate as well as conversions to corporate structures. There would also likely be a meaningful amount of economically inefficient reorganization within partnerships. To provide just one example, properties would be consolidated within fewer tax reporting units and previously outsourced services would increasingly be internalized in order to increase the wage bill that could be used for deductions.

Implications for Key Pass-through Structures

PLAYERS	COMMENTARY
Partnerships	<ul style="list-style-type: none"> Investing in partnership interests seems to describe the services provided by real estate fund managers It may be advisable to separate the investment management activities of a taxpayer from other activities of the taxpayer, i.e. splitting rental from other activities Some management companies may consider converting to C corporations, given potentially lower corporate rates Similarly, some funds may consider converting to REITs if Senate version is adopted Uncertainty surrounding classification of triple net income
REITs (currently exempt from corporate taxes, top pass-through rate of 39.6%)	<ul style="list-style-type: none"> REIT dividends would qualify for the 25% rate or a 23% deduction Accordingly, if a Fund is allocated REIT dividend income, 100% of such income could qualify for the pass-through rate REITs not eligible for overseas dividend deduction from non-U.S. entities
Tax-exempt investors	<ul style="list-style-type: none"> State pension funds: The House bill subjects public pension funds (or partnerships/funds with these investors) to unrelated business income tax on earnings from investments such as real estate. If passed, may need to consider restructuring their partnerships Other tax-exempt investors: Senate bill includes a provision limiting netting of unrelated business income/losses

Source: Cushman & Wakefield Research, PwC (December 2017)



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Cushman & Wakefield is a leading global real estate services firm with 45,000 employees in more than 70 countries helping occupiers and investors optimize the value of their real estate. Cushman & Wakefield is among the largest commercial real estate services firms with revenue of \$6 billion across core services of agency leasing, asset services, capital markets, facility services (C&W Services), global occupier services, investment & asset management (DTZ Investors), project & development services, tenant representation, and valuation & advisory. To learn more, visit www.cushmanwakefield.com or follow @CushWake on Twitter.

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