JLL Achieve Ambitions

United States | December 5, 2017

JLL Research

A Guide to Tax Reform

How will tax reform impact CRE?

What's the current status of tax reform?

Both the House and the Senate have now passed separate versions of the Tax Cuts and Jobs Act (TCJA).

A House-Senate conference committee will now work to reconcile the differences to create a single "compromise" version.

Will it pass and when?

Congress is aiming to finalize reconciliation and have the president sign the bill before Christmas (roughly three weeks).

We predict that the current probability of success at roughly 75% now that both chambers of Congress have passed fairly similar bills.

What does this mean for the real estate industry?

- Overall, stronger economic growth (even if marginal) would benefit the entire commercial real estate (CRE) industry, especially retail which would benefit from an increase in consumers' discretionary income.

- For commercial real estate owners and developers not much changes. For CRE businesses set up as pass-throughs, a lower rate would boost after-tax income.

- For CRE lending institutions, particularly banks, the lower corporate tax rate would improve after-tax profits. If stronger growth puts upward pressure on interest rates, that is likely to increase the net-interest margin, which should also support their profits.

- For CRE private equity firms, the House version of the bill could cap interest deduction from earnings before interest, taxes, depreciation, and amortization (EBITDA) at 30 percent. Both the House and Senate versions extend the holding period of investments for carried interest from one year to three years. Carried interest allows the firms' owners' profits that they personally earn from investing client capital to be taxed as long-term capital gains and not ordinary income. This incurs a lower rate.

- For CRE investment management firms, who typically pay a relatively high corporate tax rate, the lower rate would be a boon to after-tax profits.

- Limiting the mortgage and property tax reduction should reduce the value of for-sale housing, but the exact implications are uncertain. While this could reduce the incentive to purchase housing in short term while buyers wait for any price adjustment to occur, in the medium run it could create more demand for housing by incentivizing buyers who could more easily afford to purchase a home at reduced prices. In the long run, home ownership remains a cultural norm in the U.S. Many countries, such as Canada, have similar homeownership rates as the U.S. but without tax incentives. Multifamily could capitalize on any short to medium-term disruptions while the housing market adjusts. But we should not expect to see a shift away from home ownership solely because of tax policy changes.

- The House version of the bill eliminates tax-exempt private activity bonds (PABs) which are frequently used to fund construction of affordable multifamily projects. The bonds also help developers to gain access to the low income housing tax credit. But even for developers that do not use the bonds, the reduction in the corporate tax rate from 35 percent to 20 percent would reduce the benefits of investments made using the tax credits because the value of depreciation deductions would decline. Without these tax advantages many affordable housing developments are not economically feasible and the U.S. already has a notable shortage of affordable housing. A slowdown in affordable housing supply growth would benefit existing affordable housing projects as well as lower-quality, market-rate rental properties.

What do the two versions have in common…
and what's different?

Key similarities

The standard deduction would roughly be doubled for individuals (from $6,350 to $12,000) and for couples (from $12,700 to $24,000)

Eliminates personal exemptions of $4,050 per individual including oneself, spouse, and each dependent

The child tax credit would be expanded though the amounts differ. Current credit is $1,000 per child. Senate version would raise it to $2,000, the House version would raise it to $1,600. We see this as a minor difference.

Both versions eliminate the deduction for state and local taxes (SALT), except for the first $10,000 of property taxes.

Companies can now fully and immediately deduct the cost of their investment ("expensing") for five years rather than slowly depreciate investments over time

For businesses, carried interest would be limited, applying only to gains on sales of assets held for three or more years

The corporate tax rate would be lowered from 35 percent to 20 percent.

For more information, please contact:

Ryan Severino
Chief Economist, JLL
+ 1 732 590 4182
ryan.severino@am.jll.com

Key differences

The number of individual tax brackets (7 in the Senate version, 4 in the House version) and the top marginal tax rate (38.5 percent in the Senate version, 39.6 percent in the House version).

The House version begins the corporate tax cut in 2018 while the Senate version begins the cut in 2019.

Both lower taxes on pass-through business income, though the rates differ.

The Senate version includes a repeal of the individual mandate from the Affordable Care Act (ACA) which requires individuals to purchase health insurance or pay a penalty. The House version leaves the mandate intact.

Switch to territorial tax system: companies would only owe U.S. tax on profits earned in the U.S. Companies can also repatriate existing overseas profits at reduced tax rates though they differ slightly (14.5% on cash assets and 7.5% on non-cash assets in the Senate version, 14% and 7% rates in the House version).

Medical expense deduction: While the House version gets rid of that deduction, the Senate version not only keeps it but temporarily lowers that 10% threshold to 7.5% for tax years 2017 and 2018.

The House version repeals the estate tax while the Senate version does not.

The House version repeals the Alternative Minimum Tax (AMT) while the Senate version does not.

The Senate version leaves the mortgage interest deduction threshold unchanged at $1,000,000 while the House version lowers the threshold to $500,000.

What are the overall impacts to the economy?

The current versions of the bill could add up to 50 basis points to economic growth above 2017 levels (estimated to be 2.5 percent)

Although many household should receive an income boost, a significant percentage of the tax savings should accrue to high-income households who are more inclined to save tax savings than lower income households. That should somewhat limit the boost to personal consumption.

The impact of the corporate tax cuts remains more uncertain because the empirical relationship between income and spending is not as tight as it is for consumers. Companies currently boast financial assets at record highs and credit conditions remain relatively easy. Repatriation of earnings should not have much impact because they are already predominantly held in dollar-denominated assets. The previous repatriation program in 2004 did not result in significant changes in corporate investment.

That static scoring shows that the deficit and debt over the next 10 years will increase by roughly $1.4-1.5 trillion dollars. Dynamic scoring, which aims to take into account economic feedback effects, shows the deficit and debt rising closer to $1 trillion over the next 10 years. All other things equal, this will increase Treasury debt outstanding and put upward pressure on interest rates, especially at the long end of the yield curve.