CUSHMAN & WAKEFIELD

January 2018 Update:
Based on *Approved*
Tax Cut and Jobs Act

THE GREAT **TAX RACE**

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

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Executive Summary

Modest effects, items await clarification

- Modest impact on real GDP growth—6-12 basis points (bps) per year over next decade.
- 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.
- There remain many items that will need to be clarified through guidance.

Real estate investors benefit, some more than others

- Investors to benefit from a number of different provisions…
  - All REITs and many/most partnership investors should be eligible for 20% deduction on pass-through income
  - Reduced depreciation time-period for residential property and for qualified improvement property
  - Corporate tax rate reductions should make it more attractive for multinationals to expand U.S. operations or locate new operations in U.S., supporting demand for office
  - Interest deductibility elections for real estate businesses may see more owner-occupied stock monetized via sale-leaseback
- …While avoiding many of the potential pitfalls
  - 1031 exchange retained for real property as are Private activity bonds/ LIHTC
  - Carried interest retained past three-year hold (most/all real estate deals)
  - Real estate businesses can elect to use (slightly) longer depreciable life in lieu of being subject to interest deductibility limitation

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% of U.S. real estate assets are held by corporations

Biggest impact on some residential real estate markets

Higher economic growth, particularly in 2018 and 2019 should bolster CRE fundamentals and support market activity. Office and multifamily vacancy rates show modest tightening (4 - 5 bps) while the impact is more pronounced in industrial and retail (16 - 17 bps).

Office

- Corporations big beneficiaries—likely to see a net tax cut of $650 billion over 10 years. However, we anticipate that the tax cut may be preferentially used to return capital to shareholders or reduce debt, with a modest increase corporate spending.
- There may be some further 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. 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.

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

Source: Cushman Wakefield Research, January 2018

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This is the most significant overhaul of the U.S. tax code in more than 30 years and was written in record time. There remain many items that will need to be clarified through guidance.

Introduction

Taxes a lubricant, not a driver of CRE decisions

On December 22, the Tax Cuts and Jobs Act ("TCJA") was signed into law with provisions taking effect January 1, 2018, with immediate implications for financial reporting. This is the most significant overhaul of the U.S. tax code in more than 30 years and was written in record time. There remain many items that will need to be clarified through IRS guidance. While these items are unlikely to change the broad outline of the impacts, ambiguity surrounding the interpretation and implementation of aspects of the tax reform likely represent a near-term friction in capital markets transactions.

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 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.[1]

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)[2]. The CRE industry is likely to benefit from a prolonged economic cycle. These factors will continue to drive investment decisions and transaction volumes.

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

1 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.

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

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

Overview of Provisions Affecting CRE Industry

TCJA preserves like-kind exchanges (1031x) for real property. No material changes were made to the Foreign Investment in Real Property Tax Act (FIRPTA), 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.

Low/No Impact | Medium Impact | High Impact

POLICY AREA (CURRENT TREATMENT IN BRACKETS)	OUTCOME	IMPLICATIONS FOR CRE
CORPORATIONS		
Corporate income tax (currently 35%)	• 21% rate, no corporate AMT	• Real GDP growth increased by 6-12 bps per annum over next decade • Cuts less significant than headline figures possibly due to lower effective tax rate and base broadening provisions
Expensing	• 100% expensing • Phased out after 2022 • Real estate businesses are not excluded from 100% expensing • Not applicable to structures	• 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 through 2021 and 30% of EBIT thereafter • Excludes real estate businesses but requires election • Extended depreciable life will apply if exclusion elected (see below) • Indefinite carry-over	• 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
Cost recovery period/alternative depreciation system (27.5 years for residential; 39 years for nonresidential; 15 years for qualified leasehold improvements)	• Reduces residential ADS life from 40 to 30 years compared to Modified Accelerated Cost Recovery System (MACRS) 27.5 years • Qualified leasehold improvement property ADS reduced from 39 years to 20 years compared to MACRS 15 years	• Net effect is to narrow difference in depreciable lives between MACRS and ADS • Nearly costless for a real estate trade or business to elect to be exempt from the interest deductibility limitation
Carried interest	• 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%)	• 20% deduction of qualifying pass-through income from 2018 to 2025; limits deduction to the greater of 1) 50% of W-2 wages paid or 2) 25% of W-2 wages paid and 2.5% of tangible, depreciable property used in the business • Most services businesses do not qualify for deduction • Limitations do not apply to taxpayers with income under $157,500/315,000 (single/ married)	• Applicable to leasing income and REIT dividend income
INDIVIDUAL INCOME TAXES AFFECTING CRE		
State and Local Tax Deduction "SALT"–(unlimited)	• SALT (including property tax) deduction limited to $10,000	• Reduces 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)	• MID capped at $750,000 • Existing mortgages and refinancing grandfathered • Not limited to primary residence • Home equity loan interest deductibility repealed	• Affects rent vs. buy economics particularly for areas with high house prices and reduces tax incentives for homeownership

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

Implications for CRE Asset Classes

Office

Modest growth stimulus at best

Some proponents claim that the 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 6-12 bps[3] per year on average over the next decade with much of the impact concentrated in the next several years.

While exact figures may differ, Cushman & Wakefield believes that the relatively modest size of tax cuts is unlikely to generate significant growth or push up inflation expectations. 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.

ESTIMATES OF THE GDP GROWTH BOOST RANGE FROM 6-12 BPS PER YEAR OVER THE NEXT DECADE.

3 Oxford Economics, Penn-Wharton Budget Model

Corporates are the key beneficiaries — but benefits to office sector muted if it does not translate into increased spending

Corporations benefit from a tax cut of almost $650 billion over 10 years on a static basis, with an effective tax rate estimated at less than 20%[4]. Pass-through entities will benefit from a tax cut of $265 billion, with the effect being even larger when taking into account individual rate reductions[5]. The hoped-for result is that this will lead to an increase in capital spending and hiring.

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%[6]. 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 increase[7]. 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 employment[8] 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 tax reform legislation, they are less likely to do so.

The TCJA exacts a one-time tax on overseas profits reinvested in foreign subsidiaries payable over eight years. Liquid assets are to be taxed at a 15.5% rate and other assets at 8%. 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.

4 NIPA accounts, U.S. Bureau of Economic Analysis
5 Joint Committee on Taxation
6 Goldman Sachs
7 Peterson Institute for International Economics
8 Bureau of Economic Analysis, "Activities of U.S. Multinational Enterprises in the United States and Abroad" (December 2016)

Implications for CRE Asset Classes (continued)

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 industry. Furthermore, about 98% of retailers are small businesses with 50 employees or less[9] 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. Overall we expect vacancy rates to tighten by 17 bps from the baseline.[10]

THE DIRECT IMPACT OF THE TCJA WILL PLAY OUT MOST VISIBLY FOR UPSCALE CONSUMERS AND THE RETAILERS THAT CATER TO THEM.

With some retail sectors in contraction mode, it is inevitable that the question is asked: "Will TCJA help those retailers that are on the edge?" The answer ultimately comes down to the issue of profitability. If a retailer did not do well enough to owe taxes, the tax rate is irrelevant. However, even these retailers may see some short-term benefit from increased consumer spending.

In terms of boosting retail spending, the most significant beneficiaries TCJA likely to be higher income individuals, hence we will likely see the biggest boost in spending for the luxury retail sector. This is not to say that consumer spending won't likely see a modest gain across most retail sectors in 2018; underlying economic fundamentals were already pointing that way before the tax bill was approved. However, the direct impact of the TCJA will play out most visibly for upscale consumers and the retailers that cater to them.

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 elimination of 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.

The final bill included a provision to repeal advance refunding of bonds, but allowed tax-free bond financing to remain for 501 c(3) organizations. Many nonprofit healthcare organizations use public bonds to finance construction and real estate projects. The repeal of advance refunding bonds restricts refinancing of bonds to those that are callable at the time of the refunding. The law preserves deductions for charitable giving but restructured other elements that may disincentivize giving to nonprofits; these changes may impact negatively health systems' philanthropic campaigns, many of which are used to fund new buildings. Other provisions which are expected to impact healthcare systems include a provision whereby tax-exempt organizations will be required to pay an excise tax on employee compensation exceeding $1 million paid to any of its "covered employees" but the tax does not apply to payments made to licensed medical professionals whose compensation relates directly to the performance of medical services.

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

9 National Retail Foundation
10 Moody's

Implications for CRE Asset Classes (continued)

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 the 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 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. The TCJA limits SALT or 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%.

Since mortgage interest deductibility is reduced, this represents 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.

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

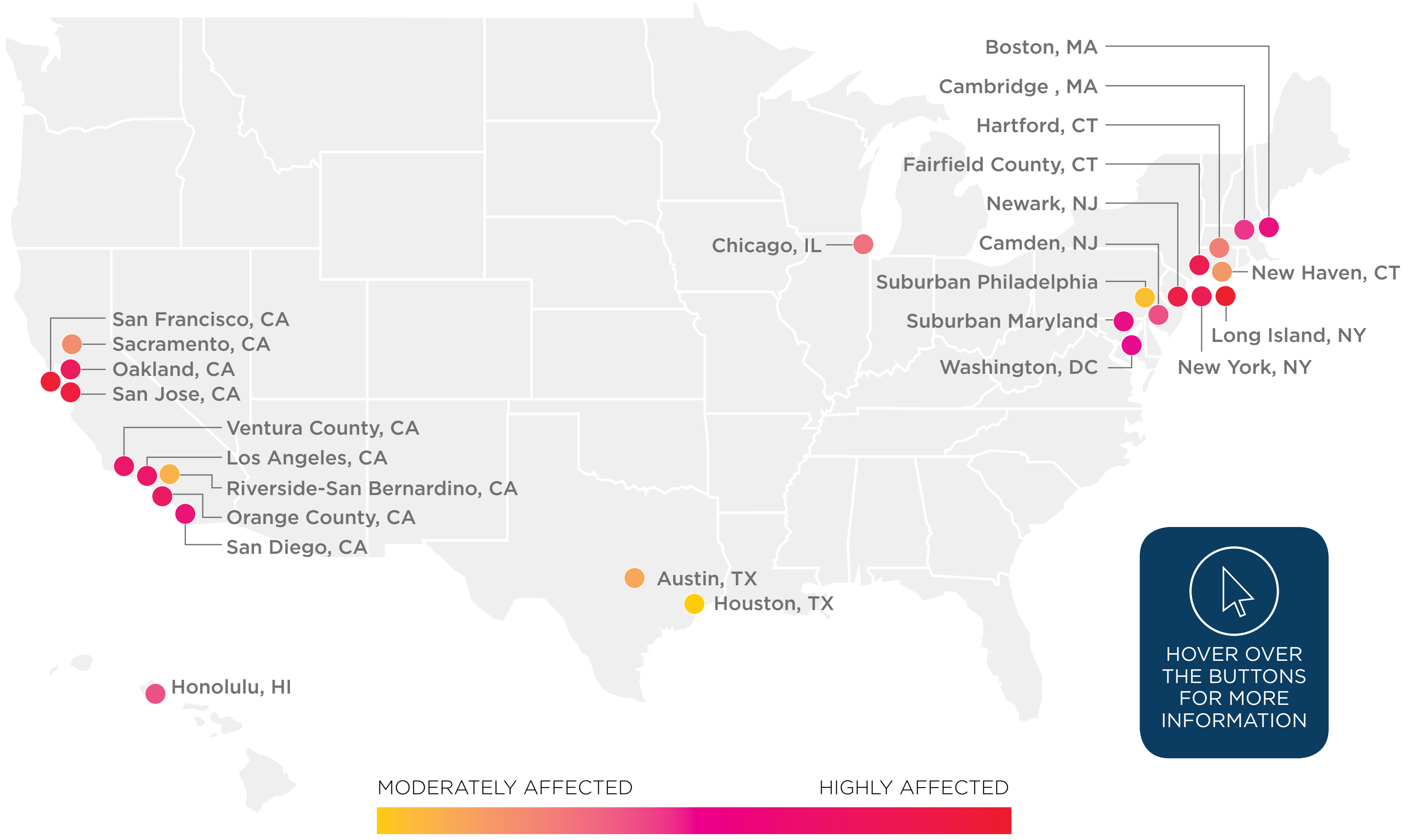
11 Goldman Sachs, Moody's Analytics (December 2017)

Implications for CRE Asset Classes (continued)

Potential Effect of Tax Reform on Residential Real Estate

25 Most At-Risk Markets

METHODOLOGY



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

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

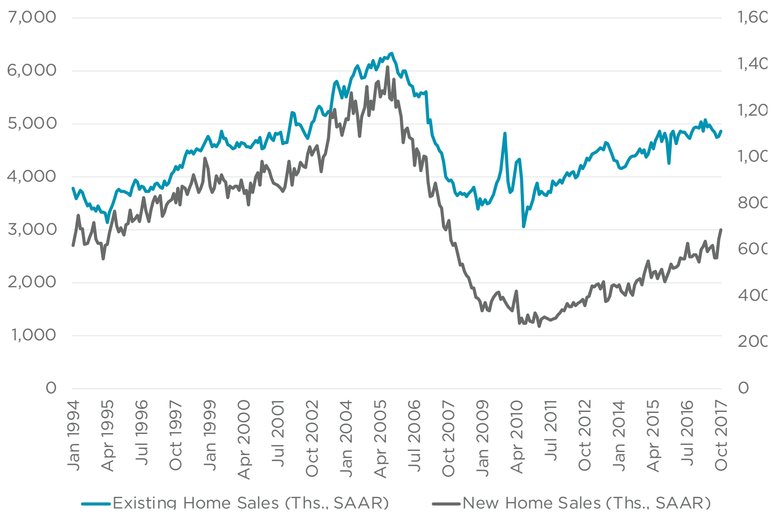
The increased effective tax differential between high- and low-tax areas may increase movement from the former to the latter. An initial review of the academic literature on taxes and mobility reveals limited effects on low- and middle-income earners, but the median estimate suggests a 2%-4%[13] decline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

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.

The doubling of the standard deduction, cap on the property tax deduction, creation of trade-off with other SALT deductibility, and curtailment of the MID combine to significantly reduce the tax incentives that have heretofore favored buying vs. renting housing. 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). Overall we expect vacancy rates to tighten by 16 bps from the baseline.[14]

New Versus Existing Home Sales



Source: National Association of Realtors®, US Census Bureau

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)

14 REIS

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.

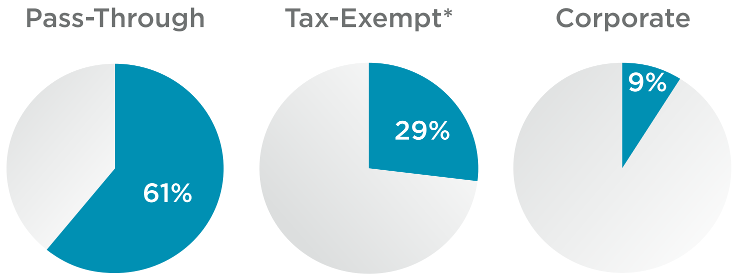
The earnings of pass-through entities flow to their owners' individual income tax returns. The TCJA substantially reduces tax rates for qualified pass-through income via a combination of a lower marginal tax rate and a 20% deduction resulting in a top marginal effective rate of 29.6%.

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.

While the stated goal of the TCJA was tax simplification, the 20% deduction which is effective from 2018 to 2025 comes with important qualifications and limitations, the exact interpretation of which will have significant implications for real estate investors.

First, the deduction is limited to the greater of 1) 50% of W-2 wages paid by a business and 2) 25% of W-2 wages paid and 2.5% of tangible depreciable property used by the business. More to the point, the second test includes real property used in a qualified trade of business. This makes it possible for a much wider range of investors in real estate partnerships to benefit from the tax provision. Note however, the emphasis on the words "investor" or "limited partner." So-called specified service businesses are not eligible for the deduction. It is quite likely that general partners in certain kinds of real estate funds would fall under this definition. Rental and operating property however does not—nor does passive rental income derived therefrom. Put simply, the TCJA should increase after tax returns to real estate investors but not necessarily fund managers.

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



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

*Tax-exempt includes endowments, pension funds, sovereign wealth funds, educational & religious entities, non-profits, and government.

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

Investors in REITs and publicly traded partnerships are able to take the full deduction without limitations. As such, the bill is relatively more favorable to REITs as opposed to other structures for investing in real estate. Where other considerations do not predominate, we could expect to see a migration of capital REITs and conversion of vehicles to REIT structures.

Implications for Key Pass-Through Structures

PLAYERS	COMMENTARY
Partnerships	• 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 the Senate version is adopted • Uncertainty surrounding classification of triple net income
REITs (currently exempt from corporate taxes, top pass-through rate of 39.6%)	• REIT dividends would qualify for the deduction • Accordingly, if a fund is allocated REIT dividend income, 100% of such income could qualify for the pass- through rate • REITs are not eligible for overseas dividend deduction from non-U.S. entities

Source: Cushman & Wakefield Research, PwC (January 2018)

About Cushman & Wakefield

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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