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Deeper Dive: Impact of Tax Reform

Sweeping tax reform legislation, originally known as The Tax Cuts and Jobs Act (TCJA) signals a key shift in economic policy focus from "redistribution" to "growth," with the difference in these priorities being about 1% per annum, or 17.25% of GDP lost over the last 16 years. For the most part, the tax reform legislation is neutral-to-positive for commercial real estate and very positive for the economy in general. Because the changes to commercial real estate are not dramatic, most investors should feel fairly confident.

The most important change in the TCJA is the lowering of the corporate tax rate from 35% to 21%, which is a "permanent" change unlike the cuts to individuals which sunset at the end of 2025. At 21%, the new U.S. corporate tax rate shifts from being the highest among large developed nations to one of the lowest. This reduced corporate tax burden will increase our international competitiveness and promote the U.S. as a place to grow a business.

For commercial real estate, one of the biggest changes will be the tax treatment of pass-through entities. Owners, partners, or shareholders of S-corps, LLCs, and partnerships are now entitled to a 20% deduction on pass-through income, with some wage and income restrictions.

REITs will benefit from this pass-through deduction, but REIT dividend deductions are excluded from the wage restriction. As a result, a REIT shareholder who had been paying the top-income tax rate of 39.6% on dividends will now pay just 29.6% of dividends in taxes. This is 7.2% lower than the new maximum tax rate of 36.8% for C-corporation dividends. However, the positive tax differential will only last through 2025 because the new maximum individual rate of 37%, and the 20% deduction on pass-through income will then expire, while the corporate tax rate cut is permanent.

Under the new law, business interest deductions are capped at 30% of adjusted taxable income. Notably, the business interest deduction limitation does not apply to interest incurred by any "real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business."

For those real estate companies that elect to deduct business interest expenses greater than 30% of adjusted taxable income, the TCJA requires that they use the Alternative Depreciation System (ADS) for depreciable real property as modified by the Act. This would require that commercial and residential properties are depreciated over 40 and 30 years, respectively. For companies with a lot of mortgage debt, the longer depreciation schedule will likely be well worth it.

The TCJA additionally allows for the immediate 100% expensing of qualified depreciable personal property placed into service after September 27, 2017 and before 2023. Beginning in 2023, the allowable expensing steps down 20% each year to 80% in 2023, 60% in 2024, 40% in 2025, 20% in 2026, and 0% in 2027. The catch is that property being expensed using the ADS method are not eligible for 100% expensing. This is important for those real estate companies that elect to deduct business/mortgage interest in excess of 30% of adjusted taxable income.

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