



Multifamily Market Commentary – April 2018

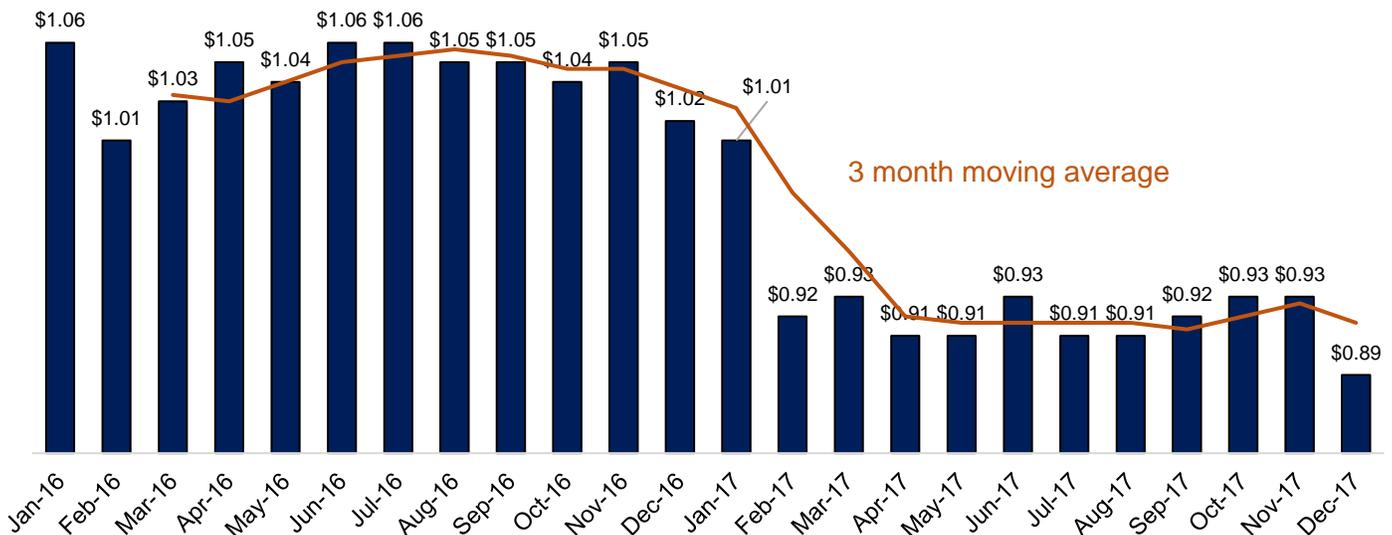
The Tax Cuts and Jobs Act of 2017 and the Impact on the Multifamily Market

In early 2017, the prospect of corporate tax reform had investors in commercial real estate, including multifamily, quite worried. Early versions of the proposed reform contained several significant proposals that would have dramatically changed the way commercial real estate taxes were implemented, and how investments are financed and structured. But in the end, the permanent changes from the Tax Cuts and Jobs Act (TCJA) that will likely result from 2017’s tax reform are expected to be minor and subtle, with one important exception.

LIHTC Immediately Impacted

That important exception is the low income housing tax credit (LIHTC) market. The lowering of overall corporate tax rates has materially changed the LIHTC market, with the value of the tax credits being diminished. As a reaction to the presidential election, and the expectation that the Trump Administration would lower corporate tax rates, prices for LIHTC began to decline in November 2016, according to data from Novogradac & Company, LLP. Put simply, a lower corporate tax rate means the value of the tax credit element of a LIHTC is diminished, along with its pricing, as illustrated in the chart below.

Low Income Housing Tax Credit Equity Pricing per Credit (January 2016 – December 2017)



Source: Novogradac & Company, LLC

As a result, Novogradac believes that since “...2017 tax credit equity pricing was widely based on a 25 percent corporate tax rate underwriting assumption... the enacted 21 percent will lead to an additional decline of about 3 percent in affordable rental home production and preservation. The aggregate decline of housing production and preservation per dollar of tax credits attributable to the decline in the corporate tax rate is anticipated to be about 14 percent.”



Another major change for LIHTC projects involves those with foreign owners or affiliates. According to Novogradac, the TCJA resulted in an altered tax scheme for foreign companies, as well as domestic companies with major foreign components: “The alternative tax calculation subjects companies to a potential base erosion and anti-abuse tax (BEAT). The BEAT is intended to establish a minimum tax level for certain foreign investors. The BEAT tax rate is 5 percent in 2018, 10 percent in 2019 to 2025, and 12.5 percent after 2025.” For a LIHTC investor subject to the BEAT, the BEAT has the potential to erode “the benefit from the LIHTC by up to 20 percent through 2025, and up to 100 percent thereafter” and “roughly one-half of the tax benefits from tax losses.” Thus, the BEAT could negatively impact the appetite of certain LIHTC equity investors.

Early Proposals Were Concerning for Multifamily

The TCJA impact is expected to be neutral at worst and positive at best for the multifamily sector. While there were early concerns about drastic changes to interest deductibility and depreciation rules, the final reforms were quite marginal, with special consideration for real estate investment being part of the final legislation. And with the overall corporate tax rate having been significantly reduced, investors in commercial real estate should experience mostly positive results.

Several of the early tax reform proposals could have upended the multifamily market. One of the most concerning was the potential elimination of 1031 Exchanges. A 1031 Exchange is a tax deferral strategy to delay payment of taxes on capital gains from the sale of property. The rules allow for investors to defer tax payments if sale proceeds are invested in a legally similar asset within a specified time frame. A substantial portion of apartment building sales utilize 1031 Exchanges each year, and its elimination could have caused apartment buildings to be both less liquid from an investment perspective and more expensive to buy and sell due to the taxable event. Fortunately for commercial real estate investors, 1031 Exchanges were unchanged by the TCJA, though they were eliminated for certain non-real estate personal property.

The early proposal to eliminate the deductibility of interest was also of great concern for multifamily investors. The early proposal would have eliminated interest deductibility, and, instead, apartment building owners would have needed to expense the full cost of buying or constructing a building while carrying forward the operating losses from the initial investment. This proposal could have dramatically changed the cost of using debt to finance a property. This proposal did not make it to the final reform, and interest deductibility was instead given special consideration in the new tax code, subject to some new but minor conditions.

Another early proposal that was of great concern but did not make it to the final legislation was a substantial change to Private Activity Bonds. These bonds are highly utilized in the financing of subsidized affordable properties. This tax exemption was also maintained in the final legislation.

Several Positive Changes for Some Multifamily Investors

One of the most important changes for the multifamily sector resulting from the TCJA is the change to interest deductibility. While the rules for interest expensing were changed for many corporations, an exception was included that allows companies that are primarily real estate operators to fully deduct the interest they paid from their income. There are conditions that have to be met for real estate companies to qualify for this exception, as well as a requirement that companies use a longer depreciation schedule, but these changes should not dramatically change the cost of owning or operating a rental apartment building.

It’s likely that the net effect of the TCJA will make the federal income tax bill for an apartment rental property slightly lower. While companies will have to slightly reduce the amount deducted from a building’s income by taking a slightly smaller annual depreciation deduction, the net-of-interest income from the property will be subject to a substantially lower tax rate, in many cases a decrease to 21 percent from 35 percent.

An additional element of the TCJA that should lower the tax bill for multifamily investors is a 20 percent deduction for individuals for qualified business income earned through “pass-through” entities. “Pass-throughs” are common legal structure and includes partnerships, S corporations, and sole proprietorships, structures that can be used by multifamily equity investors. For example, many real estate investment trusts are organized as pass-through entities. And the 20 percent



deduction allows real estate investors to deduct a portion of their commercial real estate income from their individual income taxes.

In addition, according to a January 25, 2017 report from Goodwin Proctor, LLP, investors in a real estate investment trust (REIT) can also deduct “up to 20 percent of most ordinary REIT dividends and qualified publicly traded partnership income. When the full deduction is available, it reduces the top effective rate on such income (before any additional 3.8 percent Medicare tax) to 29.6 percent.”

Other Changes with Potential Impact

Other than the impact to LIHTC, there are other TCJA changes that could potentially complicate investing in multifamily. One example is the change to the length of time that an equity investor or partnership manager must hold on to an asset to receive favorable capital gains tax treatment. These “carried interest” investments must now be held for three years before sale, instead of one year, in order to qualify for the lower capital gains tax rates rather than higher ordinary income tax rates. Although this longer hold time should not negatively impact real estate investors with a long-term hold strategy, it will likely affect those investors with assets that gained significant appreciation in just a year or two, as well as “flippers,” those investors that buy properties, renovate them, and then quickly re-sell them at a profit.

Conclusion

If tax rates had not been reduced, some of the TCJA’s changes could have made it more expensive to be an investor in the multifamily market. But the significant reduction in corporate tax rates will likely overwhelm virtually all of the subtle changes in the underlying economics of apartment building tax strategies. Furthermore, the lack of changes to 1031 Exchange rules likely means that this acquisition strategy should not be significantly altered by the TCJA.

While the Internal Revenue Service is expected to issue a substantial amount of rulemaking regarding many elements of the TCJA over the coming months, and there remain lingering concerns regarding the limits on state, local, and real estate tax deductions being scaled back for individuals, the newly-reduced tax rates should result in lower tax bills for the great majority of multifamily investors. Overall, we believe it is unlikely that the TCJA’s reform will negatively impact the income potential for buying, selling, financing, owning, operating, building, or rehabilitating most market-rate multifamily properties.

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