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U.S. TAX OVERHAUL HAS POSITIVE EFFECTS FOR COMMERCIAL REAL ESTATE INVESTORS

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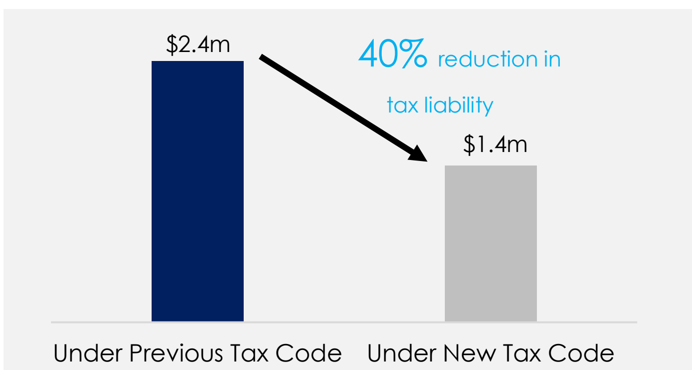
INVESTOR FRIENDLY TAX CHANGES SIGNAL THAT US REAL ESTATE IS OPEN MORE THAN EVER TO FOREIGN INVESTORS

The "Tax Cuts and Jobs Act (TCJA)", signed into law on December 22nd, 2017, is the single most significant overhaul to the US tax code in more than 30 years. While the TCJA is expected to have a significant impact on the US economy as a whole, the real estate industry is by far the biggest benefactor of the current tax overhaul. Foreign real estate investors in particular will see financial as well as structural efficiencies for investing in US real estate under TCJA. The combination of the reduction in the corporate tax rate from 35% to 21% along with the elimination of earnings stripping requirements means more net proceeds for yield-hungry foreign capital. Moreover, the elimination of URC 163(j) will simplify offshore structures allowing single investors to achieve tax efficiency in the US without having to resort to costly and complex multiple investor syndication models.

The following are the key drivers to the TCJA that foreign investors should take notice of and consider while making their allocations for 2018 and beyond, particularly if US real estate is not adequately represented in current portfolios.

IMPACT OF NEW TAX CODE FOR FOREIGN INVESTORS



Assuming a **typical $50 million real estate investment** in the US with 65% LTV and Net Equity Return multiple of 1.80x, the potential tax liability for a Middle Eastern investor would have been $2.4 million under the previous US Tax-Code.
Following the tax cut in the TCJA, it is now reduced to $1.4 million, a **savings of $1 million**.

Permanent Reduction in Corporate Tax Rates:

The reduction from 35% to 21% will have a direct impact on real estate owner's tax due upon sale, specifically, capital gains.

This is a 40% reduction in the tax bill due at the sale of a successful investment. Lower corporate tax also is expected to increase US GDP and promote expansion among some of the largest real estate occupiers in the nation: small and large corporations. Increased demand and ability to pay rent leads to higher occupancies and rental rates for Office, Industrial and Retail space.

Real Estate to Continue Enjoying Fully Deductible Interest Expense:

While most businesses will be impacted by a 30% limit on interest deductions, the limitation does not apply to those who are able to claim the "real estate exception". There is a threshold of $25 million gross annual receipts – any real estate business below this limit is automatically exempt from the application of deductibility of interest limitation. This last minute proposed exception will greatly benefit real estate owners by providing the opportunity to opt for full interest deductibility which will reduce their tax base and optimize cash flow returns on capital. This is a tremendous win for CRE owners investing for long-term yield that use moderate debt levels. Interest rate deduction is one of the most powerful tools in limiting tax leakage for real estate investing and that being preserved in the TCJA is critical. Depreciation schedule for commercial real estate changed from 39 years to 40 years which has a small upwards impact on the amount of taxes owed but in most scenarios, this would be offset by interest expense deduction.

Real Estate is the Only Sector to have Tax Advantage of Like-kind Exchange:

Excellent news for investors is that the 1031 exchange has been preserved for real estate. While the TCJA generally eliminates like-kind exchanges (1031 Exchange), it does not apply to like-kind exchanges for real properties. The "1031 exchange" provision enables sellers of real estate in the US to defer capital gains taxes by reinvesting the proceeds in other commercial properties in the US. This allows long-term CRE investors to continually sell and reinvest proceeds in other US commercial property with no capital gains tax.

Non-US Real Estate Owners will also Benefit from Reduced Tax Rate:

As existing FIRPTA rules are not to be materially revised, the lower rates for US taxpayers also would apply to non-US persons owning real estate properties in the US. When building a stable investment portfolio, typically no news is good news. That is the case with foreign investment structures being left untouched, but with the added benefit of non-US investors also getting the reduced tax rate. Additionally, since the previous IRC 163(j) rules limiting interest deductions have been eliminated, broad syndication among multiple investors is no longer required to achieve optimal tax efficiency.

Immediate Expensing of Assets:

Real estate owners are given the option to make an election between 'full deductibility of net interest expenses' or 'immediate expensing of 100% of the acquisition cost' in the year of transaction. The ability for real estate owners to utilize the immediate expensing will be limited as TCJA restricts a taxpayer's ability to utilize its net operating loss deduction to 80% of the taxable income. This could be a more viable option for non-US real estate owners who are unable to minimize tax impact on the cash yield due to their inability to maximize interest expense deductibility.

However, this option is short-term and the percentage of a purchase eligible for immediate expensing will start declining starting 2023 through 2028. Regardless, this gives international investors optionality that previously did not exist. All cash investors or low leverage investors would greatly benefit.

Limitation on State Tax Deductions Does Not Apply to Corporations:

Owners of pass-through companies and sole proprietors ("taxpayers other than corporations") will be taxed at their individual tax rates less a 20% deduction for business-related income, subject to certain wage limits and exceptions. For businesses offering "professional services" above a certain threshold, however, the deduction would be removed; phase-ins begin at $157,500 for individual taxpayers and $315,000 for married taxpayers filing jointly.

It is expected the limitation on state deductions will shift population from high State and Local Tax (SALT) states

EXPECTED TRENDS

Yield Focused Real Estate Investors – Most real estate investments are structured in pass through entities that will benefit from the 20 percent deduction on business income. The beloved 1031 Exchange remains intact for long-term investors looking to reinvest the proceeds from real estate without paying capital gains

E-Commerce – Large e-commerce companies will not only directly benefit from lower corporate taxes, but will also have incentives to expand their footprint. New warehouses and equipment installed as tenant improvements can be deducted faster to offset other gains. Expect an increase in big box industrial space and corporate offices.

Sale and Leasebacks - Corporations are paying less tax and are expected to lock in gains by shedding assets. The benefits of corporate sale leasebacks will be pronounced due to higher tax efficiency with paying rent versus corporate ownership of real estate. With potentially rising interest rates selling financially intensive real estate assets may prove to be a better way for corporations to unlock capital.

Multifamily – Due to the shift in the cost benefit of renting versus buying, with more favorable rental dynamics an uptick for demand in Multifamily is expected. Population migration to low State tax states as well as a shift from home ownership in high state tax states will drive multifamily across the country.

(California, New York, New Jersey) to lower SALT states (Texas, Nevada, Florida). Investors should be aware of these macroeconomic changes, but the change has no negative impact on their investing in these states from a tax perspective.

Positive Implications for Middle East Investors: Middle East investors, who are currently flocking to mature real estate markets in search of stable risk adjusted yield, will certainly be one of the winners from the US tax overhaul. As with all real estate investors they will enjoy the rewards of the reduced corporate tax rate from 35% to 21% (from 2018 onwards). In addition, the TCJA's admissibility of interest expenses for real estate businesses implies that Middle Eastern investors will not be required to restructure their (on-shore/off-shore) investment vehicles (as was initially thought prior to TCJA's enactment) which utilize the deductibility of interest on shareholders loan to optimize tax efficiency. Finally, with the elimination of the IRC 163(j) rules limiting interest deductions, single investors who were previously subjected to complex tax structuring in order to reduce effective tax liability will no longer be disadvantaged. Under the TCJA Middle East public institutions, public companies or family offices making solo investments in US based real estate assets will be able to deduct interest payments made on shareholder loans without limitations that were in place under the previous tax rules.

SECTORAL OPPORTUNITIES AS A RESULT OF TCJA

Multifamily – Capitalize on the exodus of people from high SALT (State and Local Taxes) states to states with less state tax as the new bill has limited state deductions to $10,000.

Industrial / Office / Retail – Higher discretionary spending from individuals and lower tax rates for corporations could spur the commercial real estate sector.

Hotels – Benefit from consumer's higher discretionary income that can be spent on travel.

Medical Office / Healthcare – The repeal of individual insurance mandate could create short-term disruption. Demographics still favor the sector and increased economic activity could result in more employers paying for healthcare.

Student Housing – The initial proposal removed many of the tax deductions that drive donating to schools.

Fortunately, many of these negative amendments were removed in the final bill but still, a new tax on university endowments was implemented which could have a minor effect on scholarships and therefore total enrollment.

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