COMMERCIAL PROPERTY
EXECUTIVE™
CPExecutive.com
June 26, 2018

Another Day at the Office, But With Tax Reform

While the real estate world is still awaiting guidance about some aspects of the Tax Cuts and Jobs Act, the impact on the office market is becoming more apparent.

By Laura Jackson

A total of five months has passed since the Tax Cuts and Jobs Act, commonly known as the TCJA, entered our lives. While the real estate world is still awaiting guidance about some aspects of the TCJA, the impact on the office market is becoming more apparent.

The TCJA itself was designed to increase the Federal Deficit by $2 trillion, likely affecting both inflation and interest rates. Rising interest rates can be a detriment to real estate owners who are reliant upon debt to purchase assets or are looking to refinance debt on existing property. On the flip side, rising interest rates are also a sign of a strong economy, which investors hope will continue to drive asking rents in the office sector.

In New York, for example, financial services firms still represent a substantial portion of office leasing demand. During the 2017 presidential campaign, both candidates discussed the repeal of the so-called "carried interest loophole," a tax vehicle used by private equity firms to take advantage of capital gains rates (maximum 20 percent) that are substantially lower than ordinary income rates (now maxed at 37 percent). While it was feared that the TCJA would eliminate this so-called "loophole," the new tax law merely requires a longer three-year holding period for asset managers to meaningfully benefit from the capital gains rates. Keeping the carried interest rules in significantly the same form as before the tax reform should have minimal adverse impact on financial services firms and allow them to continue to flourish, thereby boosting New York office rent demands.

The vibrant tech economy is taking over the office market in New York. The technology sector already represents an even greater percentage of the office lease market in San Francisco. The growth of the technology sector, which may be spurred by the TCJA, will drive demand for office space. Tech giants with cash overseas will likely bring their cash back to the U.S. because of the TCJA's provision to tax overseas cash at 15 percent and other profits at 8 percent. Tech giants' cash surplus in the U.S. may also stimulate further job creation, and ultimately the need for more office space. While the larger tech companies may utilize the cash to build their own office space, smaller companies may find renting more suitable.

Generally, office landlords stand to benefit from the following provisions added by the TCJA:

- A deduction of 20 percent of pass-through income was added to allow most real estate owners to exclude 20 percent of taxable income on their personal income tax returns. This 20 percent deduction is limited to the greater

of: 50 percent of wages paid or 25 percent of wages paid, plus 2.5 percent of real estate. Many real estate companies hire independent contractors or property management firms rather than hire employees who receive W-2s, and thus adding 2.5 percent of real estate is a win for the real estate industry. In addition, the legislation defined real estate as gross depreciable real estate basis and not net depreciated basis, removing the need to decrease for depreciation. Thus, an individual who purchased an office building in a pass-through for $10 million would be able to exclude up to $250,000 of taxable income ($10 million times 2.5 percent) from their personal tax returns starting in 2018.

- The TCJA added 100 percent expensing, known as bonus depreciation, for certain property placed in service on or after September 27, 2017 (such as machinery and equipment, certain real property improvements, furniture and fixtures). The bonus depreciation percentage declines annually until 0 percent is allowed after 2026. In addition, prior to the TCJA, only new property was eligible for bonus depreciation, whereas the TCJA allows property to be eligible even if it is not the property's first use. This will make cost segregation studies for building owners that much more important in the coming years. With elevated construction levels already widespread in the office sector, the TCJA may make new development more affordable for real estate owners.
- The TCJA created a new opportunity for development called Qualified Opportunity Zones. A taxpayer can sell real property and reinvest the proceeds into a Qualified Opportunity Fund. The Qualified Opportunity Fund will invest the proceeds in areas designated by the Federal Government in exchange for deferral (or possibly elimination) of the gain on the sale of the real property.
- Prior to the TCJA, Section 163(j) previously disallowed the deduction of interest expense on certain overcapitalized companies. Under the TCJA, all business entities are required to limit the deduction of interest expense to 30 percent of adjusted taxable income (essentially EBITDA). Real estate firms were granted the ability to deduct all interest expense in exchange for slower depreciation lives. As mentioned above, this is a very favorable exception for real estate firms that rely heavily on leverage. However, one cost of making this election is that bonus depreciation cannot be taken on qualified improvement property (i.e., interior improvements to building).
- Like-Kind Exchanges continue to be an important vehicle used by office property owners to sell an asset and defer tax gain by investing in another property. The TCJA now disallows like-kind exchanges for any property other than real property. For example, like-kind exchanges of automobiles are no longer allowed. Therefore, when selling a building that includes personal property (otherwise known as furniture, fixtures and equipment or "FF&E") purchase price allocations between building and FF&E will be a critical piece of any sale negotiation. A seller will have an incentive to allocate as little as possible of the purchase price to FF&E to maximize the amount of the sale price that can be used for a like-kind exchange of replacement property. A buyer, on the other hand, will likely want to allocate more of the purchase price to FF&E so the buyer can expense the FF&E as bonus depreciation. Whether a buyer can conduct a cost segregation study to allocate the basis of the assets after the acquisition that is inconsistent with purchase price allocation has been the subject of much debate. There is one court case that ruled a buyer cannot have a cost segregation study post-closing that is inconsistent with a purchase price allocation agreed to in the purchase and sale agreement.

Conclusive evidence as to the economic effect of the TCJA on the office market is not yet available. Yet, there are enough favorable real estate provisions added by the TCJA to give office landlords a competitive advantage. Without a doubt, office landlords must carefully analyze their decisions to maximize the benefits provided by the TCJA for 2018 and beyond.

Laura Jackson is a managing director in the tax practice of the Real Estate & Infrastructure industry group at FTI Consulting. She may be contacted at laura.jackson@fticonsulting.com

The views expressed herein are those of the author and not necessarily the views of FTI Consulting Inc, their management, their subsidiaries, their affiliates, or their other professionals. FTI Consulting Inc., including its subsidiaries and affiliates, is a consulting firm and is not a certified public accounting firm or a law firm. CPE

Posted with permission from *Commercial Property Executive.* Copyright © 2018. All rights reserved.
#C88045 Managed by The YGS Group, 800.290.5460. For more information visit www.theYGSgroup.com/content.