Keynote Speaker

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TAX CUTS & JOBS ACT (TCJA):

How it Effects Real Estate & the Economy

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In business there is an old rule of etiquette that suggests there are two things you should never discuss with clients….

Politics & Religion

Keeping that in mind, today's discussion of the **Tax Cut & Jobs Act (TCJA)** is not an endorsement of one political party or another, but rather just how it specifically effects real estate and the economy.

Today we are only discussing **real estate specific topics**. To learn how it will impact yours or your client's personal tax situation, please consult with your tax advisor.

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Sources of Data and Information

- Tax Policy Center
- the Balance
- OECD: O
- Tax Foun
- HowMuc
- PwC: Pri

What We'll Talk About in this Presentation

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- We'll discuss the new tax reform legislation signed into law by the President named ***Tax Cuts & Jobs Act*** or ***TCJA*** from two main viewpoints:
    - It's impact on real estate
    - It's impact on the economy
- The TCJA results in:
    - Mainly a positive for taxpayers and businesses – but not as large a tax cut as anticipated or as large as previous administrations have done
    - Most of the tax changes for **individuals** are *temporary:* lasting only until they sunset after 2025
    - Most of the tax changes for **businesses (corporations)** are *permanent.*

Why Are the Cuts for Individuals Temporary?

- ***Why?*** The sunset provision was necessary to meet the Byrd Rule requirement that only allows Senate legislation to be passed with a simple majority if it does not result in net tax cuts beyond a 10-year period (otherwise, it requires 60 votes to prevent a legislation-stopping filibuster).

- ***Will the tax cuts for individuals be made permanent?*** Republicans may try to make them permanent, perhaps only as the when the sunset is closer in time…

Let's Start with some Traditional Economic Points

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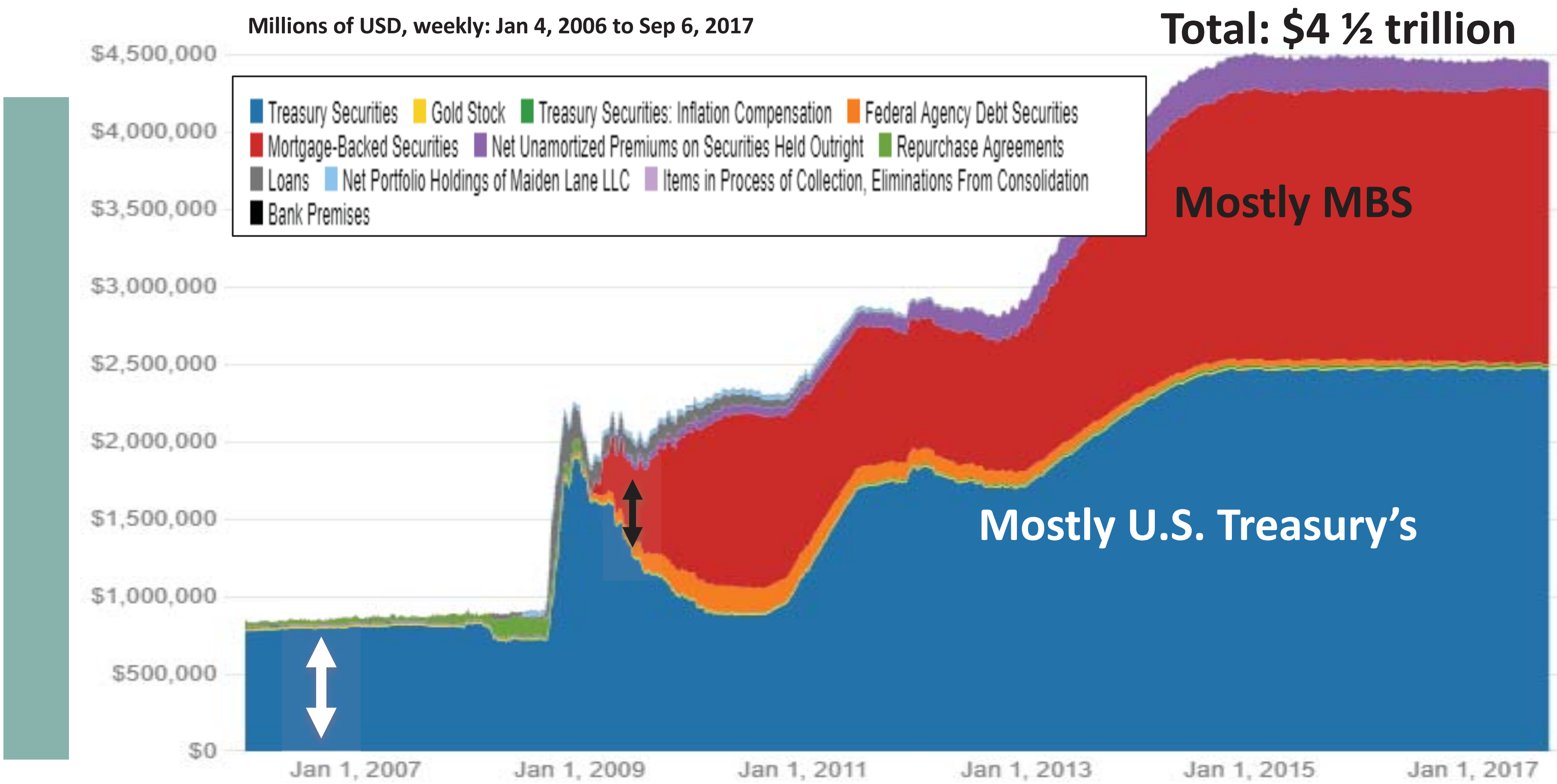
- So how is the economy doing?
- Much better than it was – and it is doing very well in real estate
- Stock market is also doing very well
- What has been the main driver(s) for all of this?
  - Ultra-low interest rates generated by the Federal Reserve's extreme monetary policy
- **But this is changing –** from an economy that was mainly driven by a very accommodating Federal Reserve – and moving forward we will be returning to an economic environment that is more normal or traditional. *Fiscal policy will be the driver rather than monetary policy…*

Return to Economic Basics

- Federal Reserve Bank:
  - For nearly 10 years, with huge increase in deposits and reserves, kept interest rates very low
  - But now the Fed will slowly, carefully deleverage – selling off those accumulated assets – hopefully without an adverse impact on the economy
  - Gently, but assuredly, raising interest rates – without tipping us into a recession
- Real Estate – both residential and commercial – will slow down a little bit – with rising interest rates and low supply issues
- Predictions:
  - Increase in market volatility: stock market, bonds, interest rates, nearly everything…
  - Fiscal mantle has already begun to shift from Monetary Policy to Fiscal stance
  - Return to the traditional business cycle (with the drivers noted below)
  - No recession in 2018 or 2019 despite being long into this expansion phase
  - Fed's will raise rates 3 to 4 times in 2018

Federal Reserve's Balance Sheet

Producing Ultra-Low Interest Rates Since 2008



Source: **FRED: created with DataRapper**

Fed Funds Rate at Historic Lows

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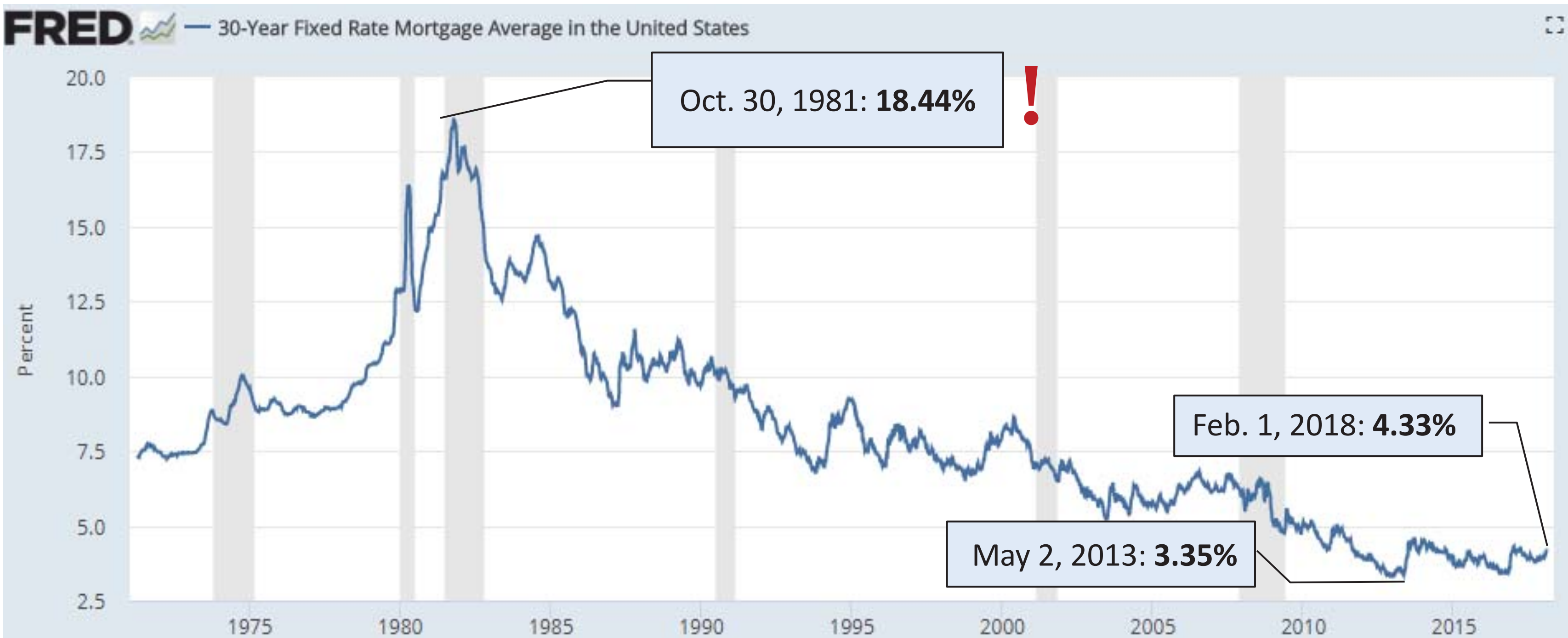
10-yr. U.S. Treasury Rate

- This shows the 35-year bond rally (from 1982 to 2017) – from which we will now experience rising interest rates…
- Today's 10-yr UST bond yield is about 2.7% +/-… The inverse of this yield (1/2.7) is analogous to the P/E ratio for equity investments (stocks).
- This inverse is equivalent to a P/E ratio of 37 – whereas the S&P 500 P/E ratio is "only" about 25 +/- TMT P/E – meaning that US Treasury's are still a bargain

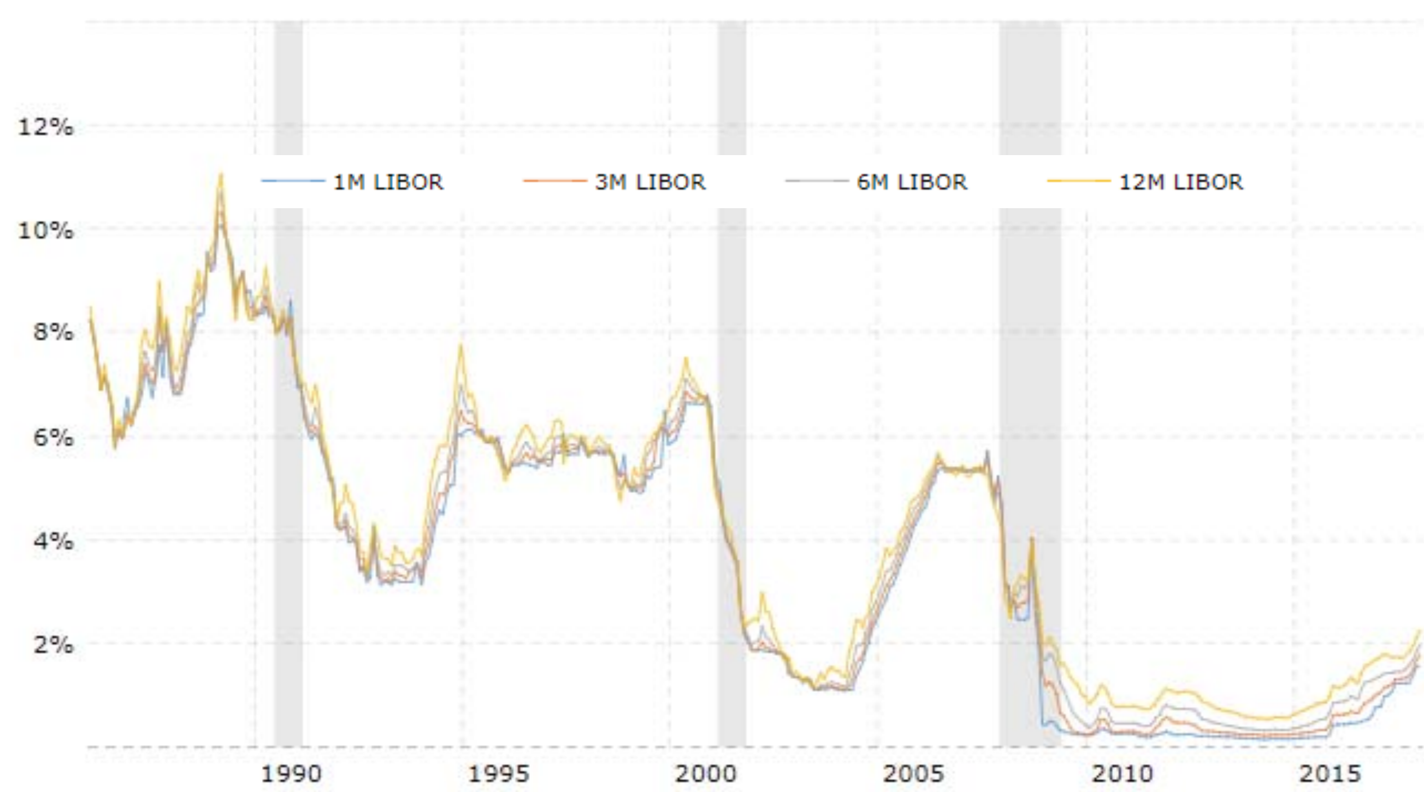
Record Low Mortgage Rates



- **From lowest measure in 2013, over almost five years we've experienced a very modest 100 bp or 1% increase in 30-year mortgage interest rates…**

Ultra-Low Interest Rates were/are Worldwide:

Central Banks were Staving Off the Great Recession



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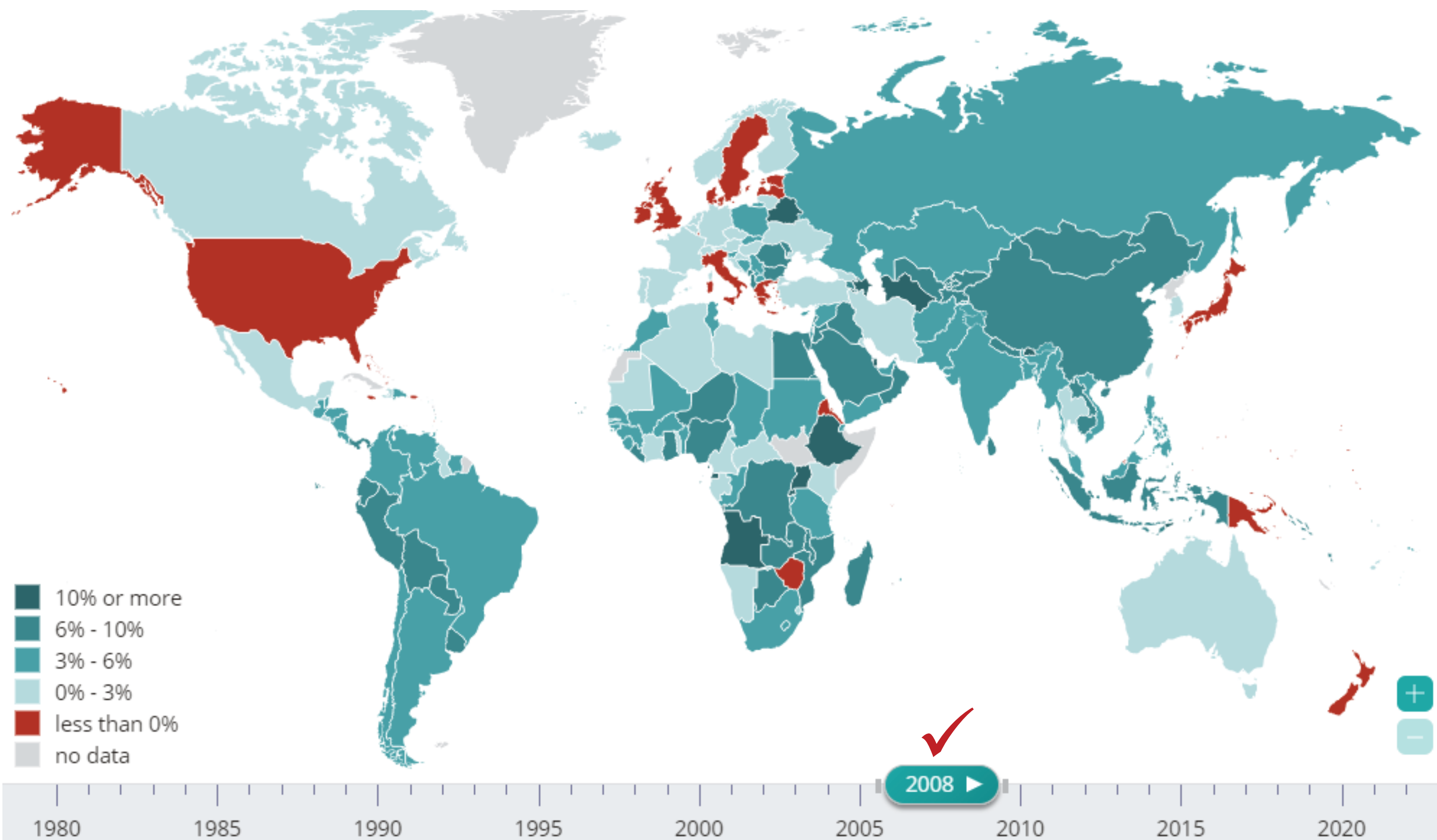
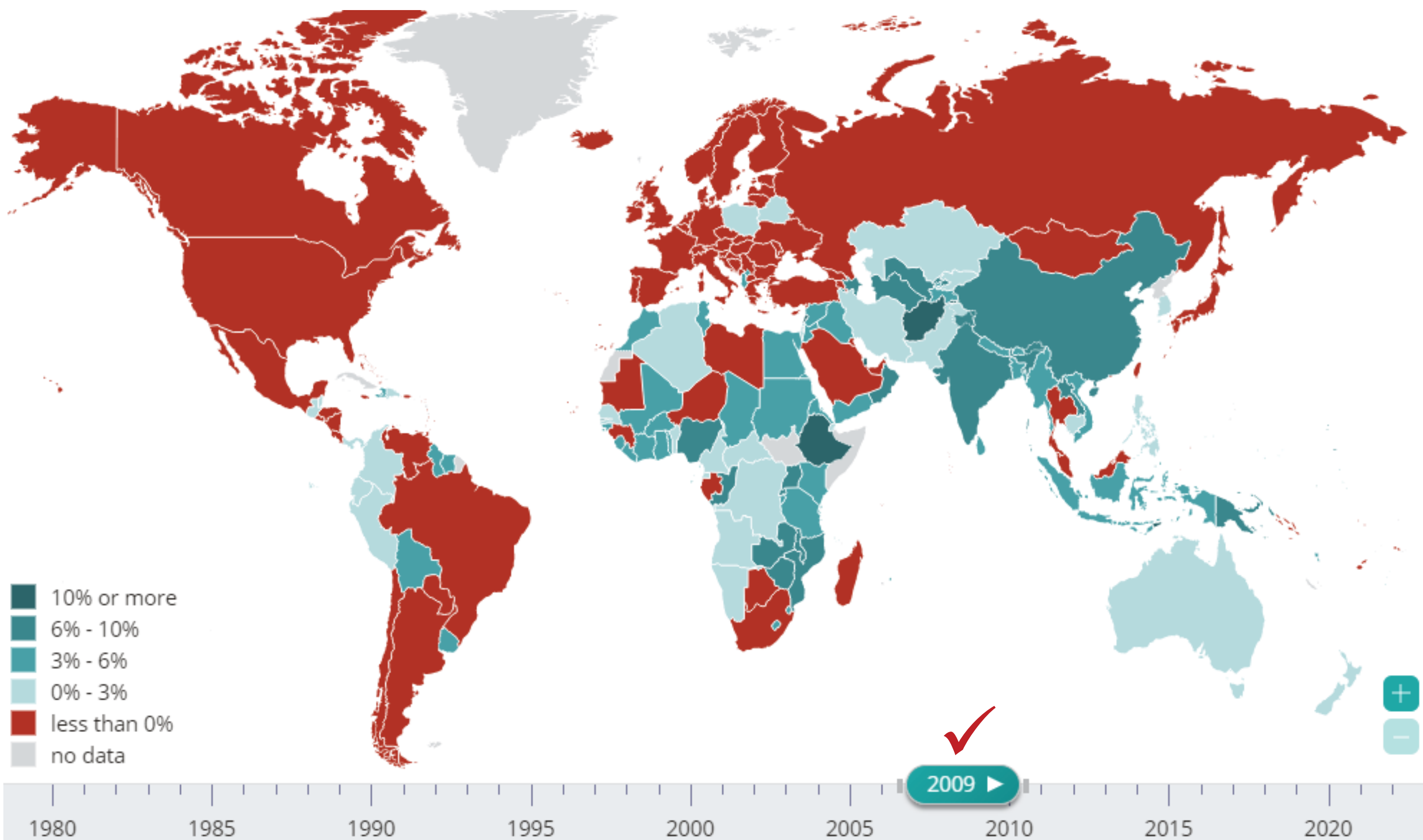
And the World's Economies Are Doing Better

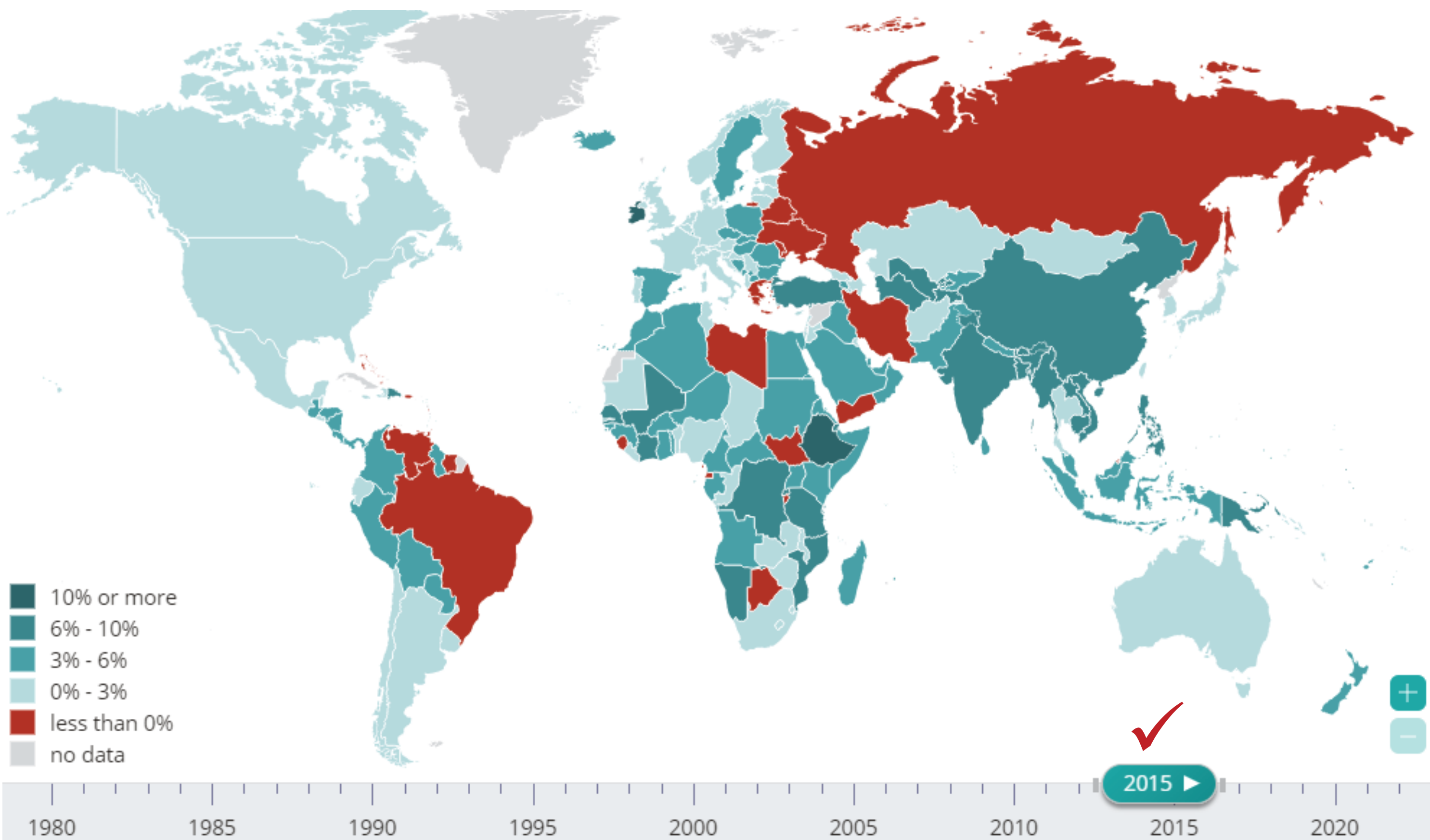
Since the Start of the Great Depression in 2008



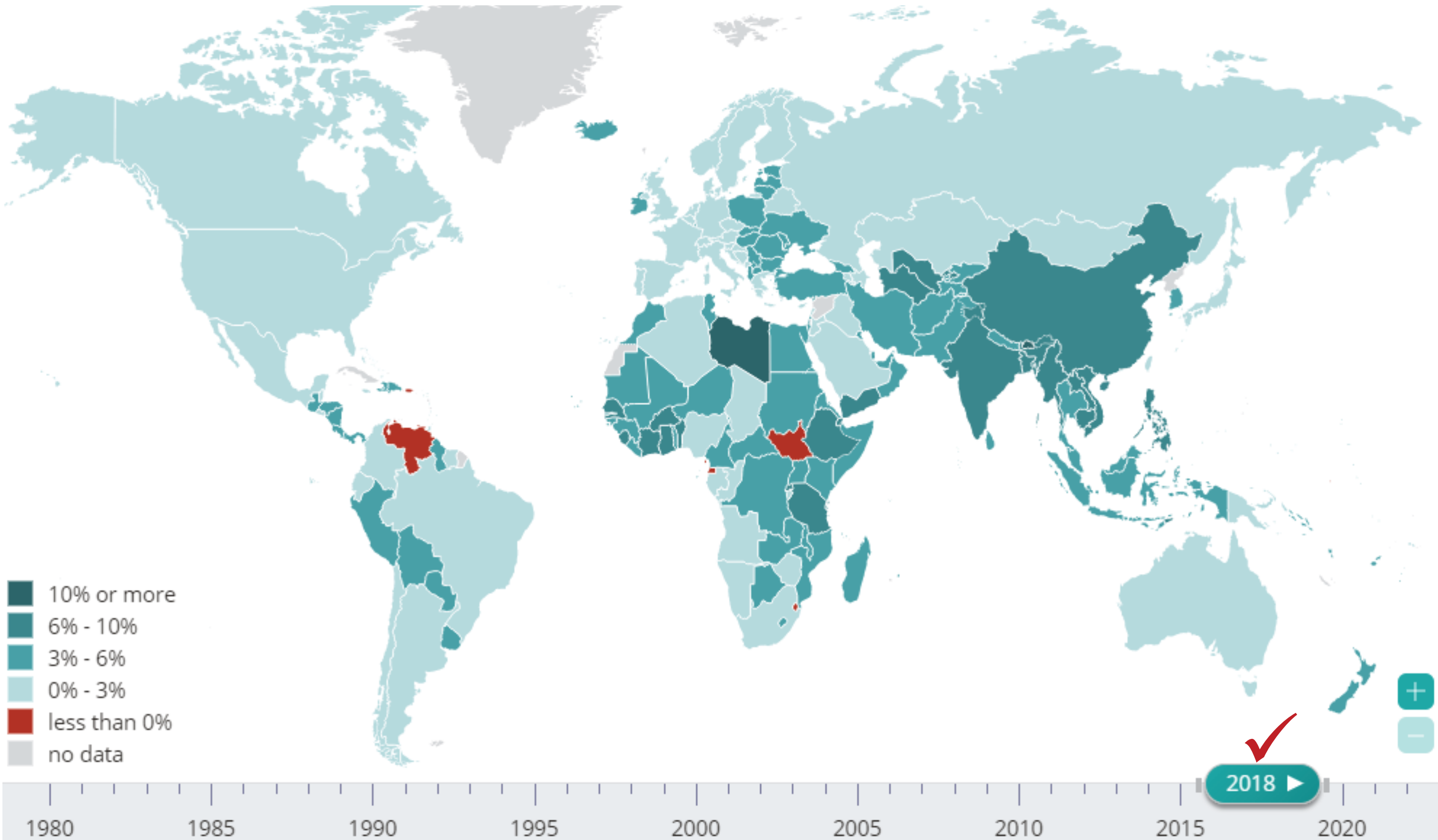
The World's Economies at Their Worst 2009



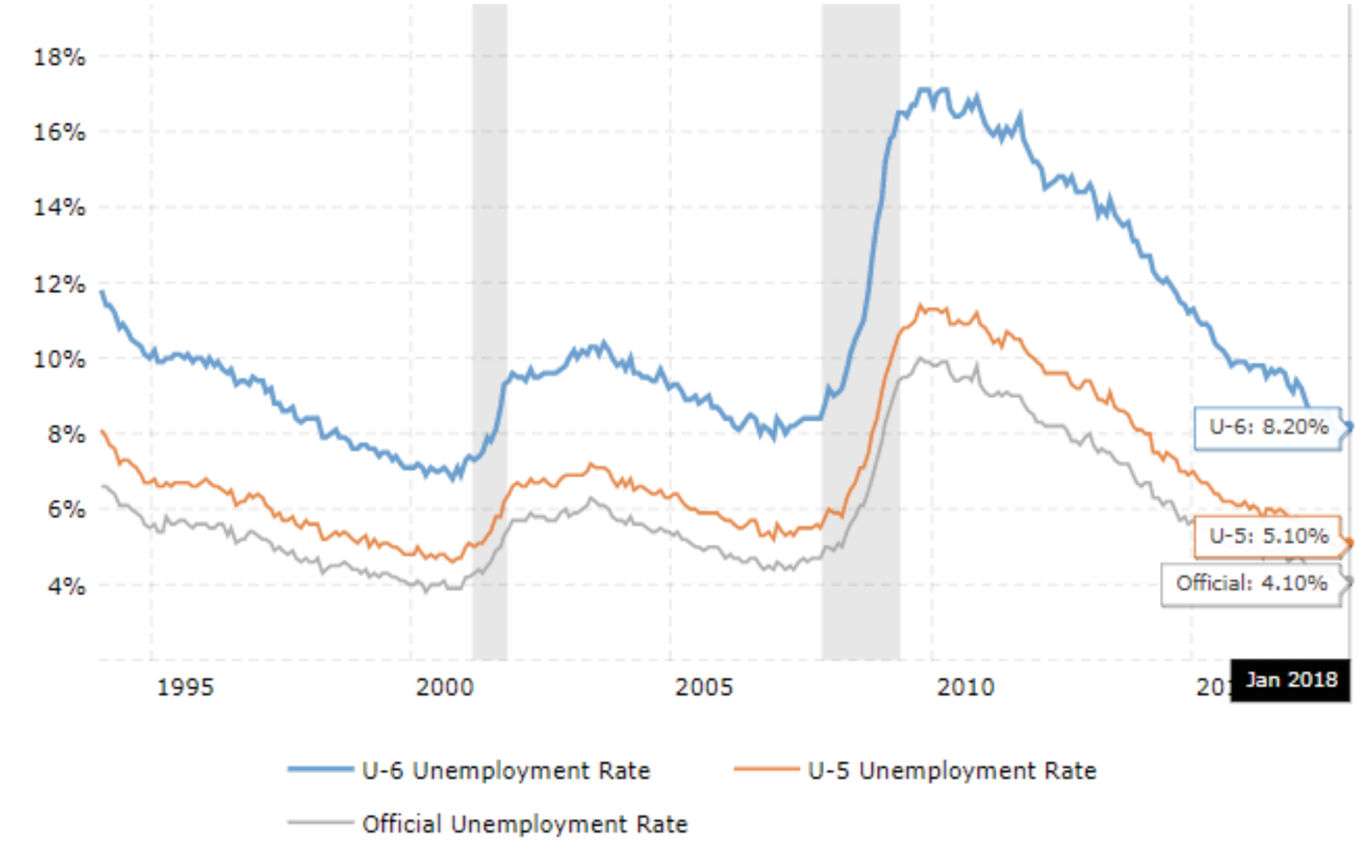
And the World's Economies Recovering



And the World's Economies Are Doing Better

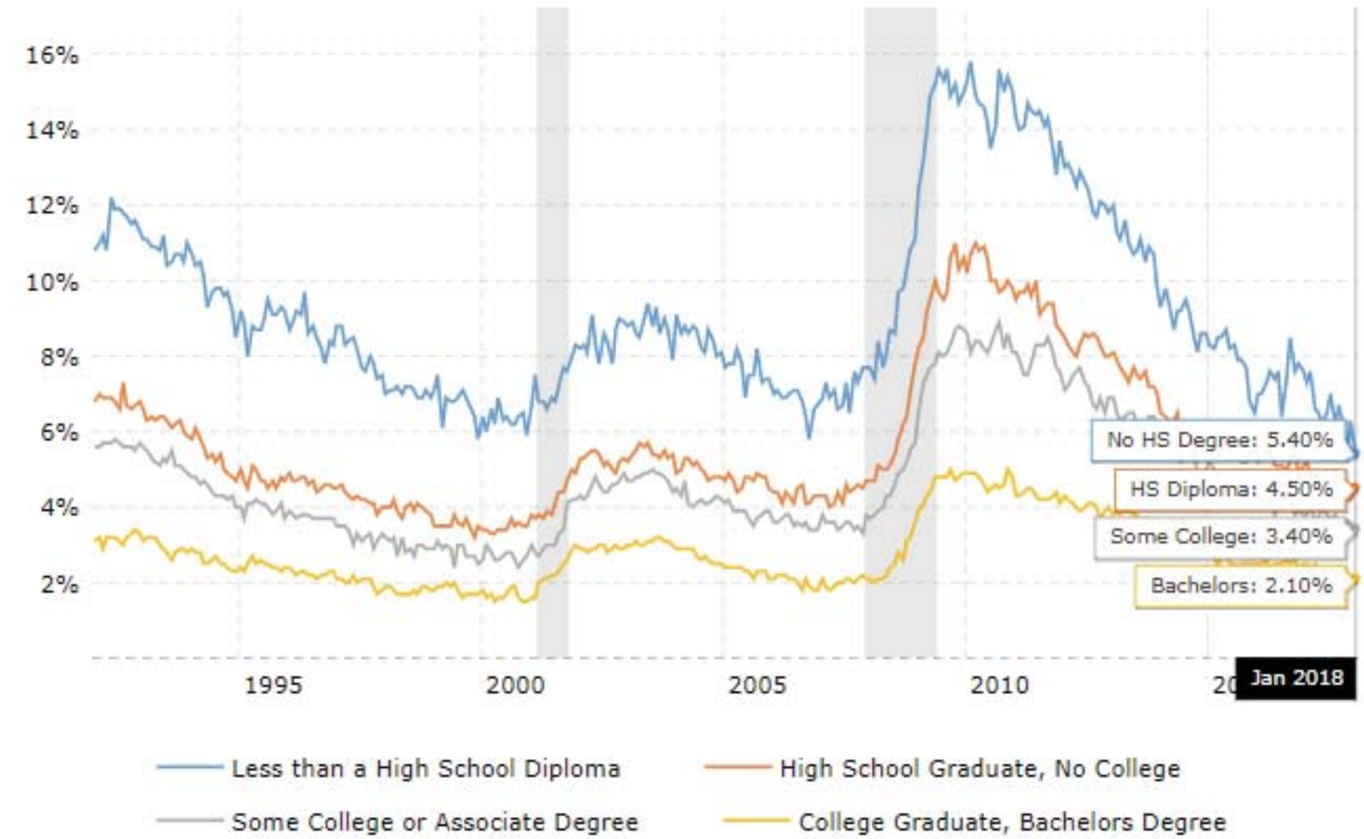


Unemployment Rate Measures (from MacroTrends)



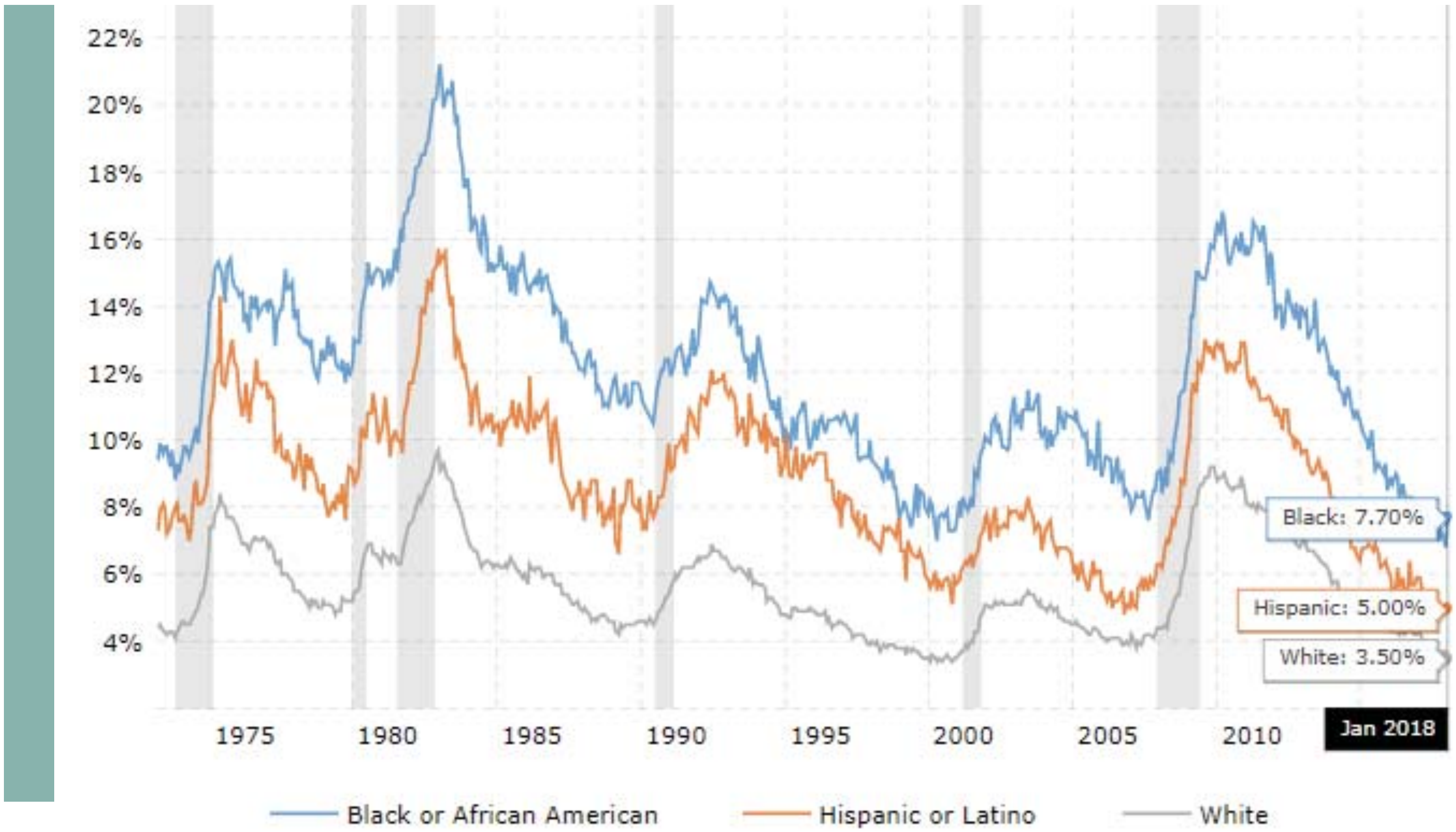
- U3 is the "traditional" or official reported unemployment rate. **(4.1%)**
- But U6 is a better measure of *true* unemployment because it includes discouraged workers, marginally attached workers, and workers who are part-time purely because of economic reasons. **(8.20%)**

Unemployment by Education Level (from MacroTrends)



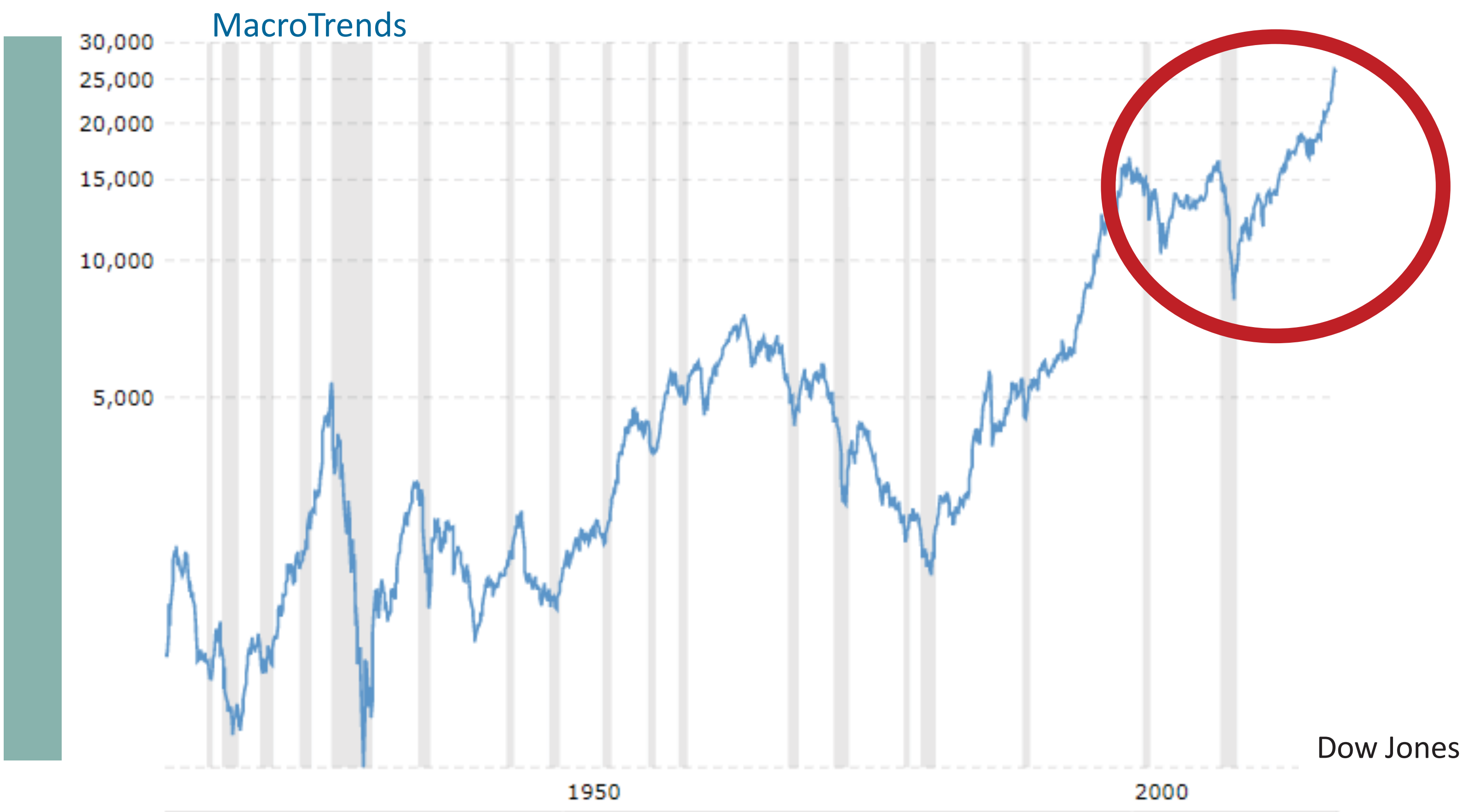
This interactive chart compares the historical unemployment rate based on the level of education attained for individuals 25 years and over. Current as of January 2018.

Unemployment by Race (from MacroTrends)



- Please note: Statistics for Asian unemployment are not included here as the Bureau of Labor Statistics did not start including this measure until 2000 and does not provide a seasonally adjusted series as yet.

Dow Jones Industrial Average: 100-year average



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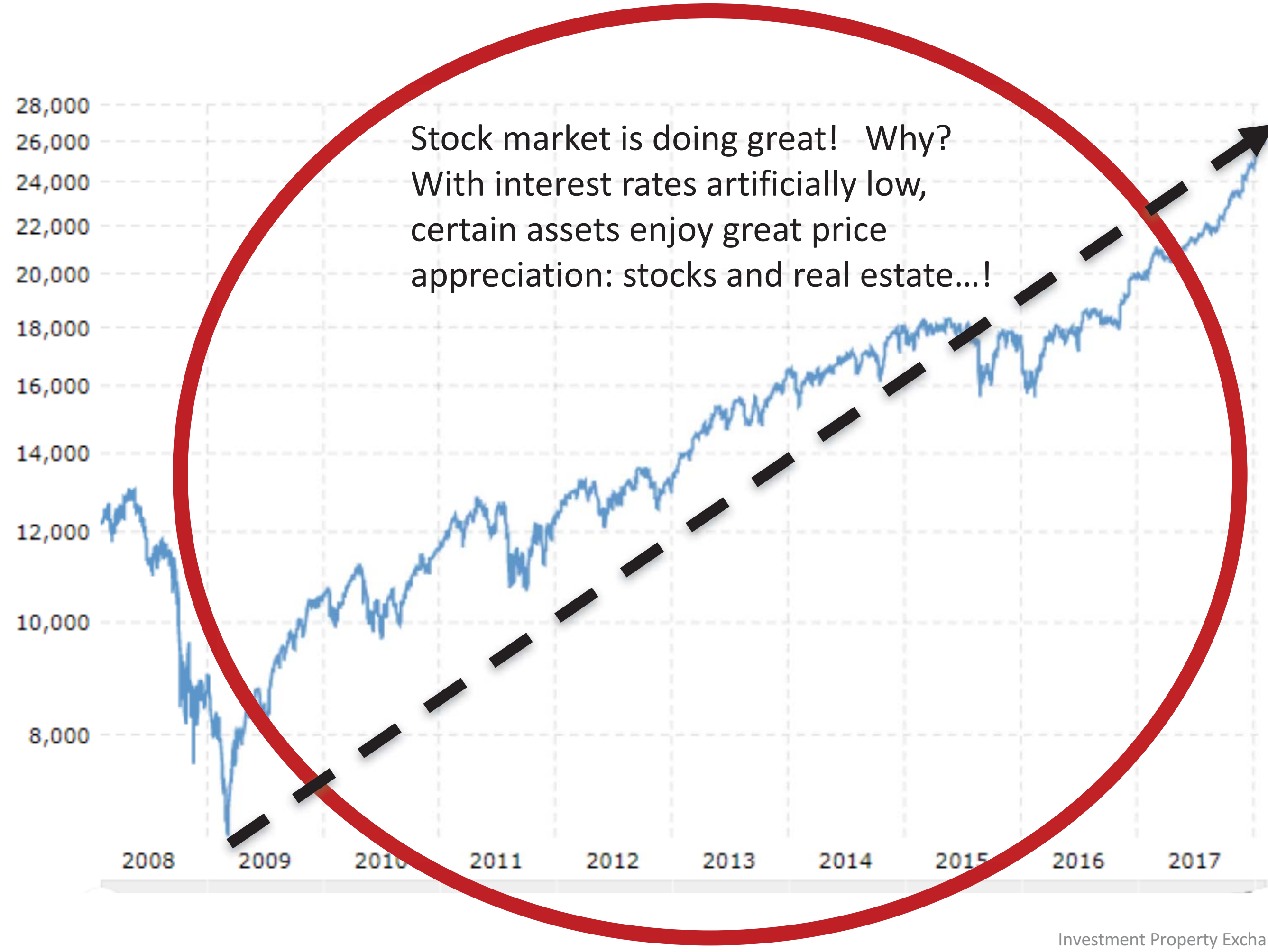
Dow Jones Industrial Average

Dow Jones Industrial Average Since 2008



From a low of 6,626.93 on March 6, 2009 in the Great Recession to a recent peak of 26,616.71 on January 26, 2018 – a nearly 20,000 point increase! (Monday's closing was 24,343.30)

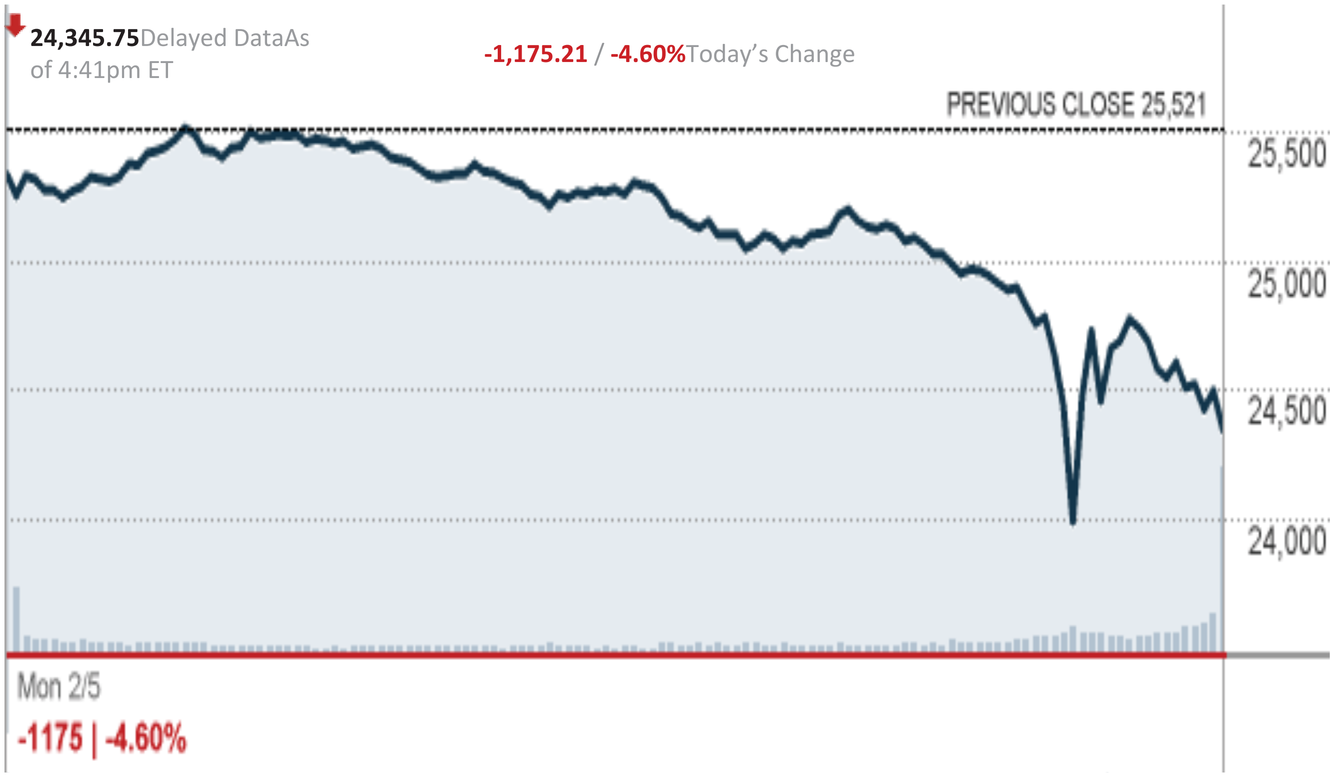
Dow Jones Industrial Average: 1 month

DJIA recently…

Dow Jones Industrial Average: 5-Day Change

- A “pullback” is a 5% drop in price
- A “correction” is a 10% drop in price
- Bear market is defined as a 20% drop in price…

Dow Jones Industrial Average drops…



- DJIA fell 1,175 in one day or 6.3%
- Largest one-day drop in history – but by percentage it wasn't even in the top 25 of drops
- For example, 1987's drop was 22.61%
- *Why?* Some reasons:
- Historic prices were running ahead of themselves
- Job creation reported was better than expected – and the concern is that the Fed's will indeed begin to raise rates in earnest…

Welcome to the new normal…
Volatility is coming our way…

How About Real Estate? Housing Starts Nationwide

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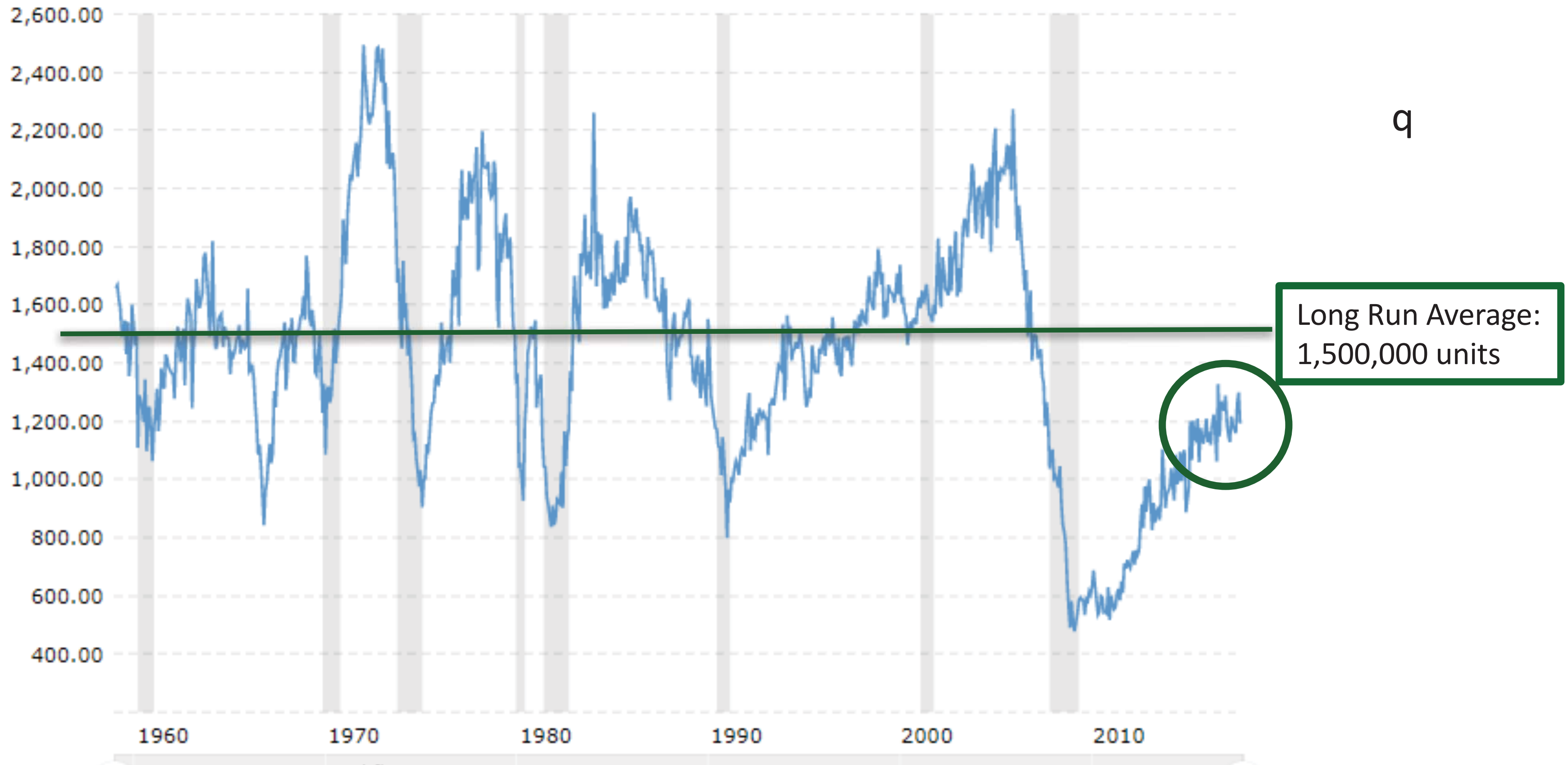

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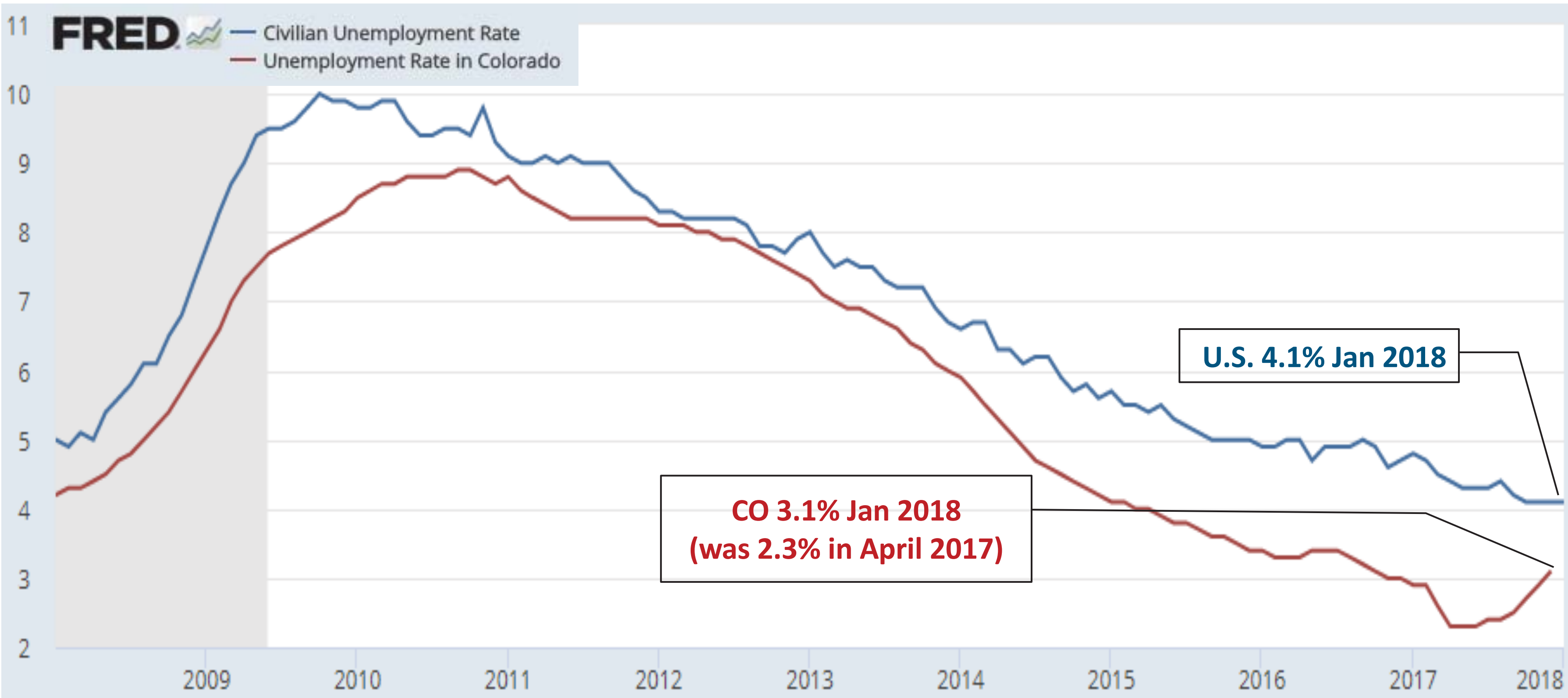
Unemployment Rate for U.S. and Colorado



Source: FRED Economic Data

House Price Appreciation Change in % by State

Seasonally Adjusted • House Price Index • Federal Housing Finance Agency

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Period ended September 30, 2017

State	Rank*	1-Yr	Qtr	5-Yr	Since 1991Q1
District of Columbia (DC)	1	11.59%	4.45%	47.06%	434.55%
Washington (WA)	2	11.53%	2.04%	56.97%	234.97%
Hawaii (HI)	3	10.04%	2.70%	41.43%	151.76%
Arizona (AZ)	4	9.99%	2.19%	54.24%	198.99%
Nevada (NV)	5	9.56%	2.65%	82.31%	127.85%
Idaho (ID)	6	9.21%	1.69%	45.88%	191.13%
Utah (UT)	7	9.20%	2.37%	46.54%	276.13%
Oregon (OR)	8	8.84%	1.80%	55.64%	303.17%
Tennessee (TN)	9	8.66%	2.40%	35.65%	148.99%
Colorado (CO)	10	8.52%	1.02%	58.17%	327.28%

Over the last 26 years Colorado is first in price appreciation change among all states & DC

Some Reasons for Housing Shortage

- Baby Boomers (born between 1946 to 1964) are NOT moving:
  - 85% of Boomer homeowners plan to stay put in 2018 according to *Realtor.com*
  - So until Boomers move out of their “larger" homes, Gen X's can't move up, and Millennials can't buy the Gen X's home.
  - Owners don’t want to let go of their (old) low mortgage rates
  - Inventory for them to buy their next home is low. Why move when you don’t have to and cannot find a place to live?
- Investors are not selling their rentals:
  - Demand for rentals is still growing – with strong price appreciation
  - And since rents are rising too – and thereby increasing cash flow – the typical cash-on-cash return is greater than 10%
- Builders are focused higher-end product, ignoring entry-level buyers
  - This is because of the high cost of land and labor to build homes
  - Labor shortage; skill-set shortage
  - Regulations add additional costs to the building of a new home. The NAHB say regulations account for about 25% of the cost of a home.

TCJA Economic Impact at the State Level

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- Tax Foundation's *Taxes and Growth (TAG)* macroeconomic model predicts that with lower marginal tax rates the *TCJA* will:
  - Lower the cost of capital
  - Leading to a 1.7% increase in GDP
  - And 1.5% increase in higher wages
  - Increase of 339,000 new full-time jobs
  - Increased after-tax income by 1.1%
- This link shows estimates for each state of increased FTE jobs and after-tax incomes:
  - https://taxfoundation.org/final-tax-cuts-jobs-act-state-impact/
- For Colorado:
  - 6,092 new additional jobs
  - $776.23 increase in after-tax income for average family

Colorado's Cannabis Industry…

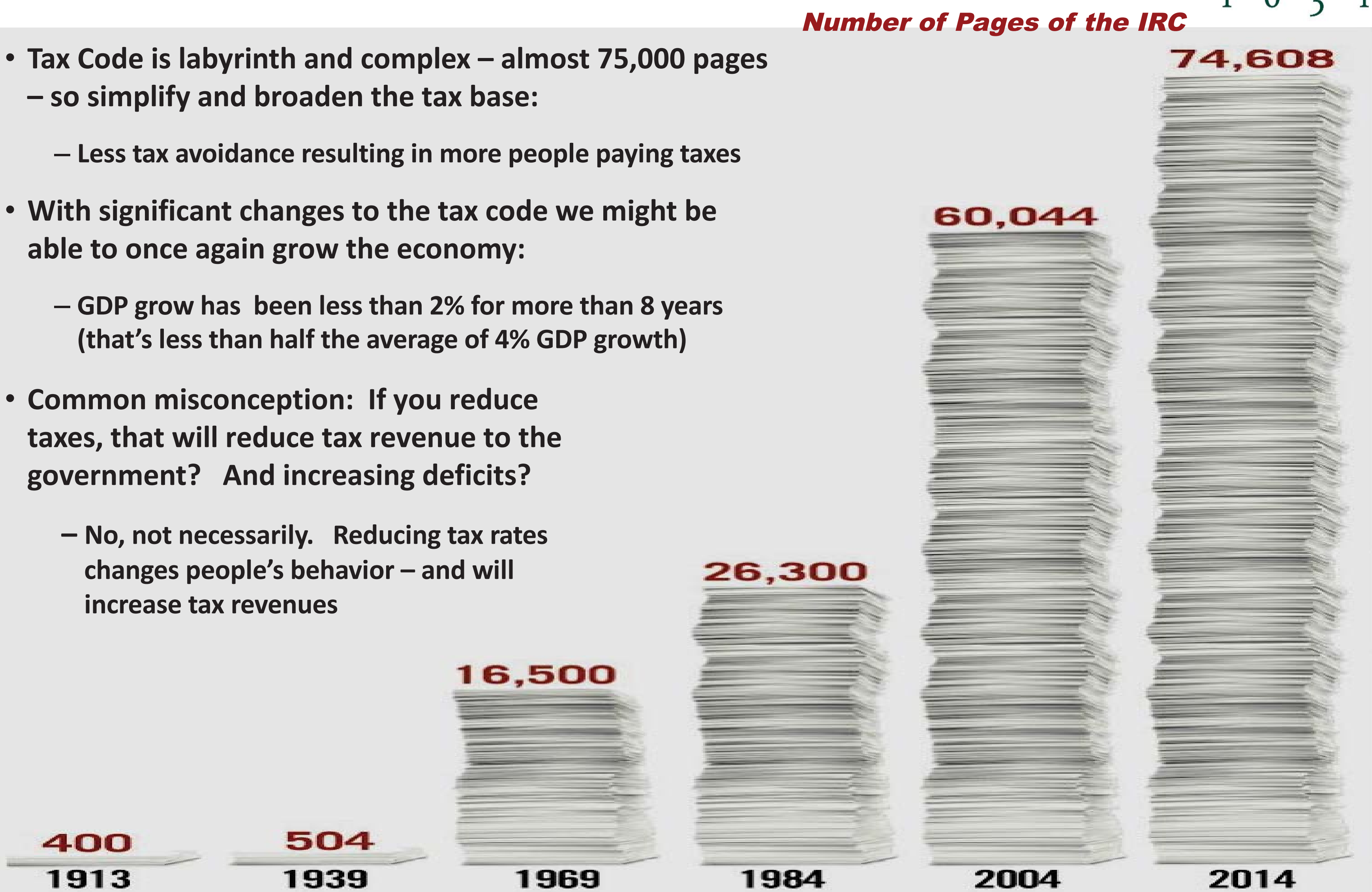
Some interesting Notes:

- There are now more cannabis workers than dental hygienists in CO
- Nine states (AK, CA, CO, ME, MA, NV, OR, VT, WA) and Washington D.C. have legalized cannabis

- Cannabis will be a $21 billion industry by 2021 (less than than 3 years)
- Cigarette industry in the U.S. is $121 billion – making cannabis about 1/6th the size – but growing nearly exponentially
- Federal Reserve Bank of Kansas City will allow Colorado Fourth Corner Credit Union to service the industry

What Should be the Reasons for Tax Reform?

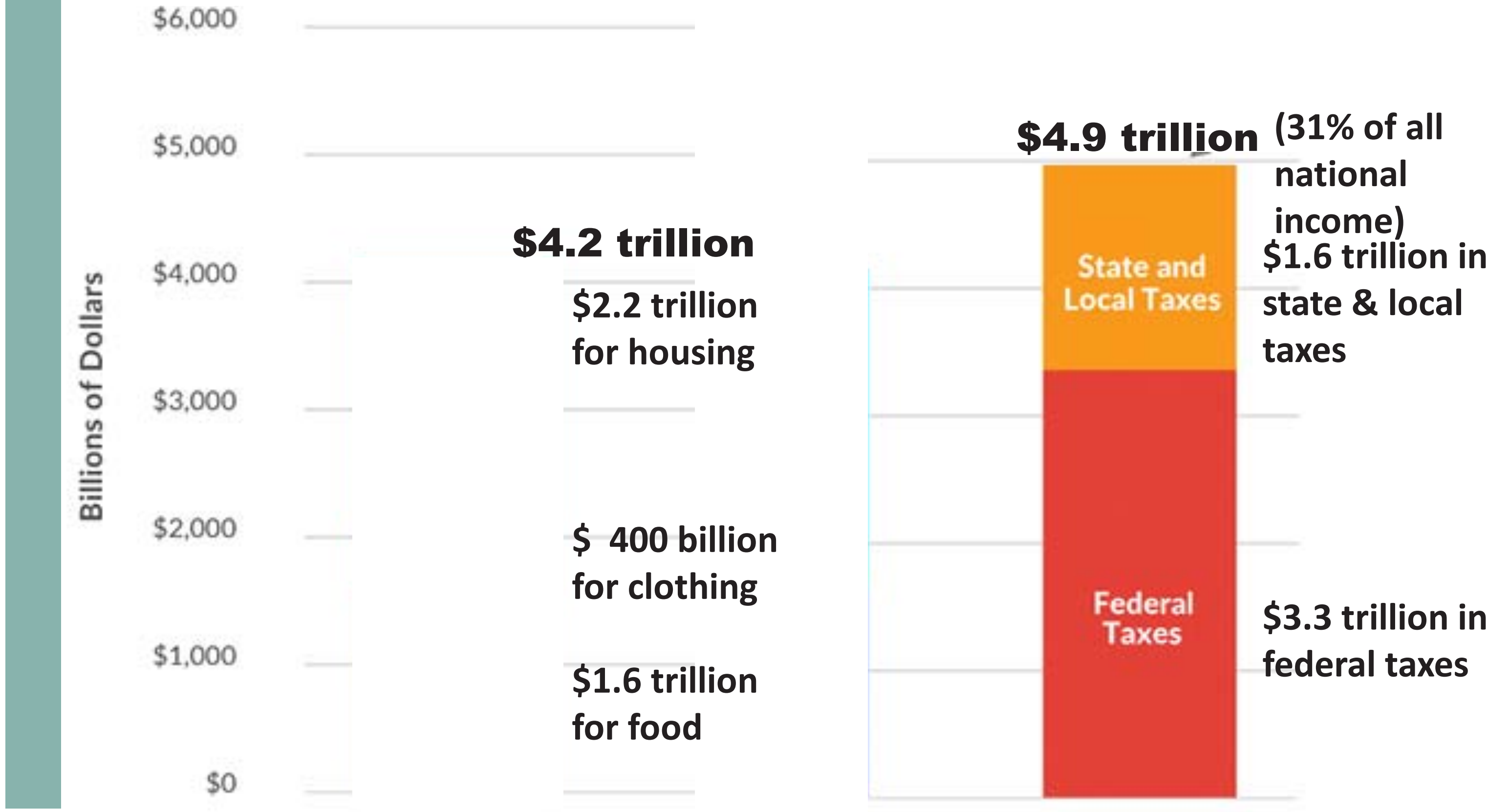
- Tax Code is labyrinth and complex – almost 75,000 pages – so simplify and broaden the tax base:
  - Less tax avoidance resulting in more people paying taxes
- With significant changes to the tax code we might be able to once again grow the economy:
  - GDP grow has been less than 2% for more than 8 years (that's less than half the average of 4% GDP growth)
- Common misconception: If you reduce taxes, that will reduce tax revenue to the government?   And increasing deficits?
  - No, not necessarily.   Reducing tax rates changes people's behavior – and will increase tax revenues



Source: Wolters Kluwer, IRS

Americans Pay *More in Taxes* Than for Housing, Food, & Clothes *Combined*

Source: BEA, Tax Foundation – 2016 Year End Data



Source: Bureau of Economic Analysis; Tax Foundation calculations.

Economic Backdrop of Why Tax Reform Is Needed

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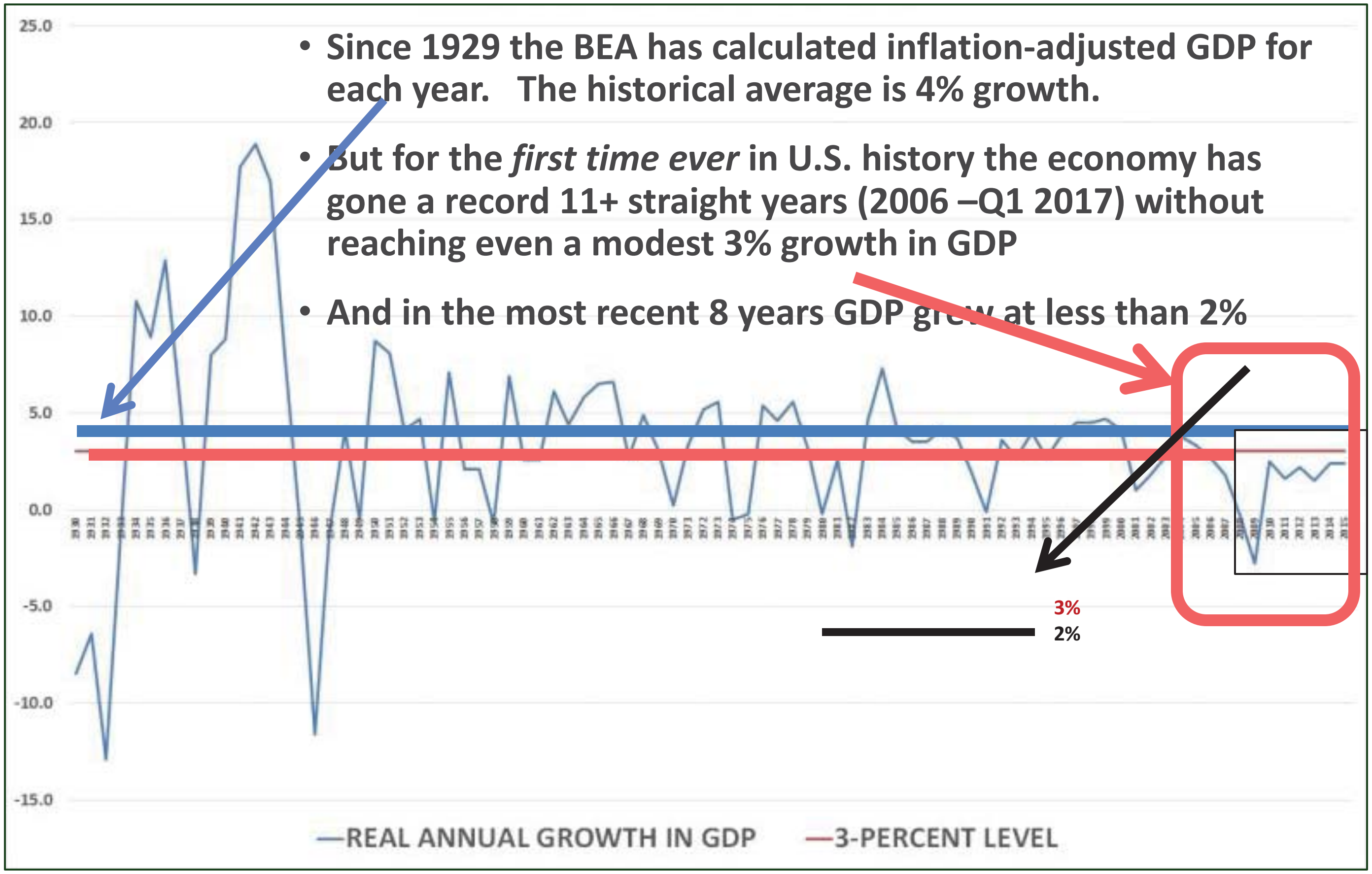

Sources: BEA, and cnsnews.com, and https://web.stanford.edu/~chadj/facts.pdf

Recent Economic Growth as Measured by GDP

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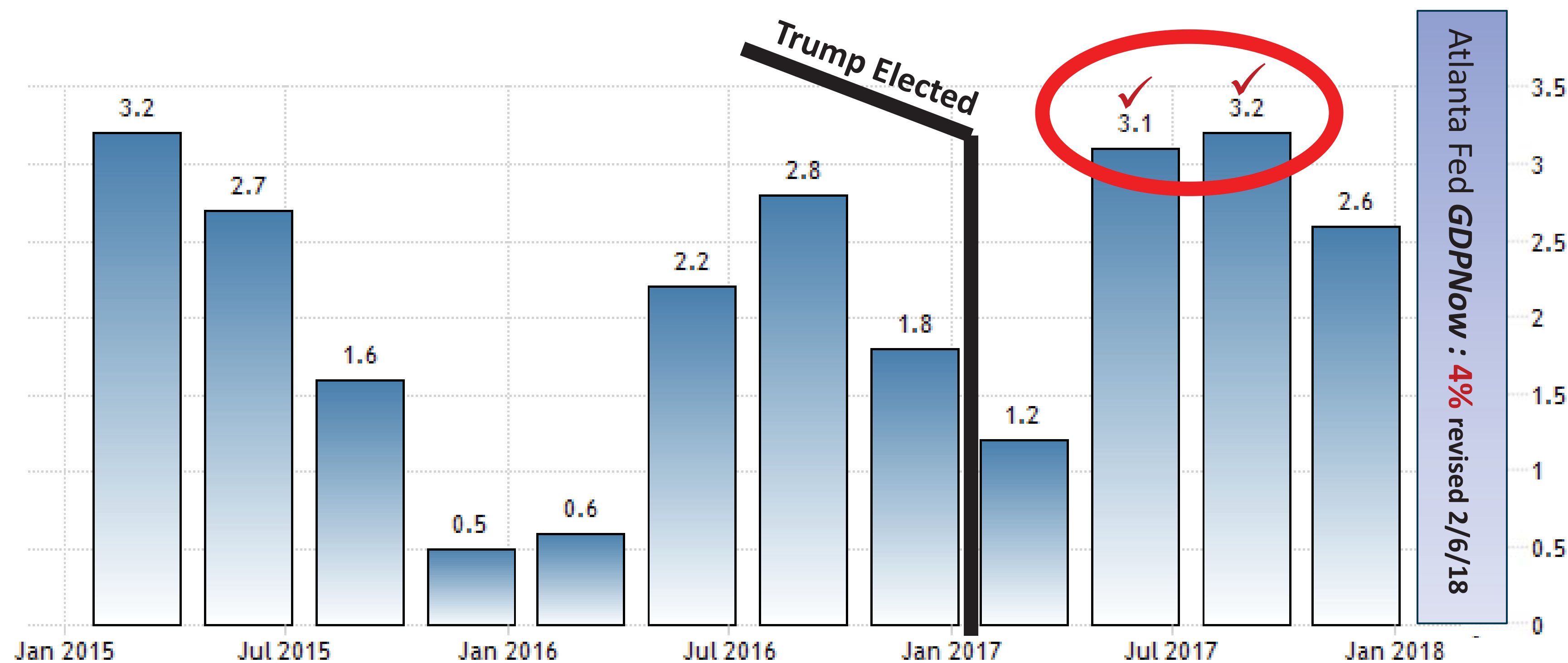
U.S. Gross Domestic Product or GDP Growth by Quarter



Source: TradingEconomics.com; U.S. Bureau of Economic Analysis

TAX CUTS & JOBS ACT (TCJA)

Highlights of Tax Cuts & Jobs Act

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- The **3.8% surtax** for ACA individual mandate reduced to zero $'s **in 2019** – *not 2018…*
- **Estate tax** exemption doubled (from $5.6MM to $11.2MM per person) – but **no repeal.** Will revert after 2025. **Step up in basis** (§1014) retained.
- **Capital gains tax** rates stay the same – *"swap till you drop!"*
- **Mortgage interest deduction (MID)** retained, *with some changes:* only applies to maximum **new** debt of $750K on one primary residence (down from current $1MM), plus any second home MID on debt retained; equity debt like HELOCs **eliminated**, including current HELOCs
- **Personal home sale exclusion of gains (§121)** retained – still 2 out 5 years
- **SALT: State And Local Taxes,** eliminated except for **first $10K** which can be used for State or Local property taxes, income taxes, and/or sales taxes
- **Carried Interest** retained, but expanded to a minimum three-year holding period
- **Technical Termination** avoided: exchanges involving partnerships or LLCs *could get easier*
- **Immediate expensing** and **no more depreciation** for capital assets – *but not for real estate*
- **Corporate income tax rate** reduced from 35% to 21%
- **Deduction of 20% of income** for pass-through entities: sole proprietorships, S-corps, partnerships, LLCs
- https://taxfoundation.org/final-tax-cuts-and-jobs-act-details-analysis/

Tax Cuts, Tax Cuts, Tax Cuts…

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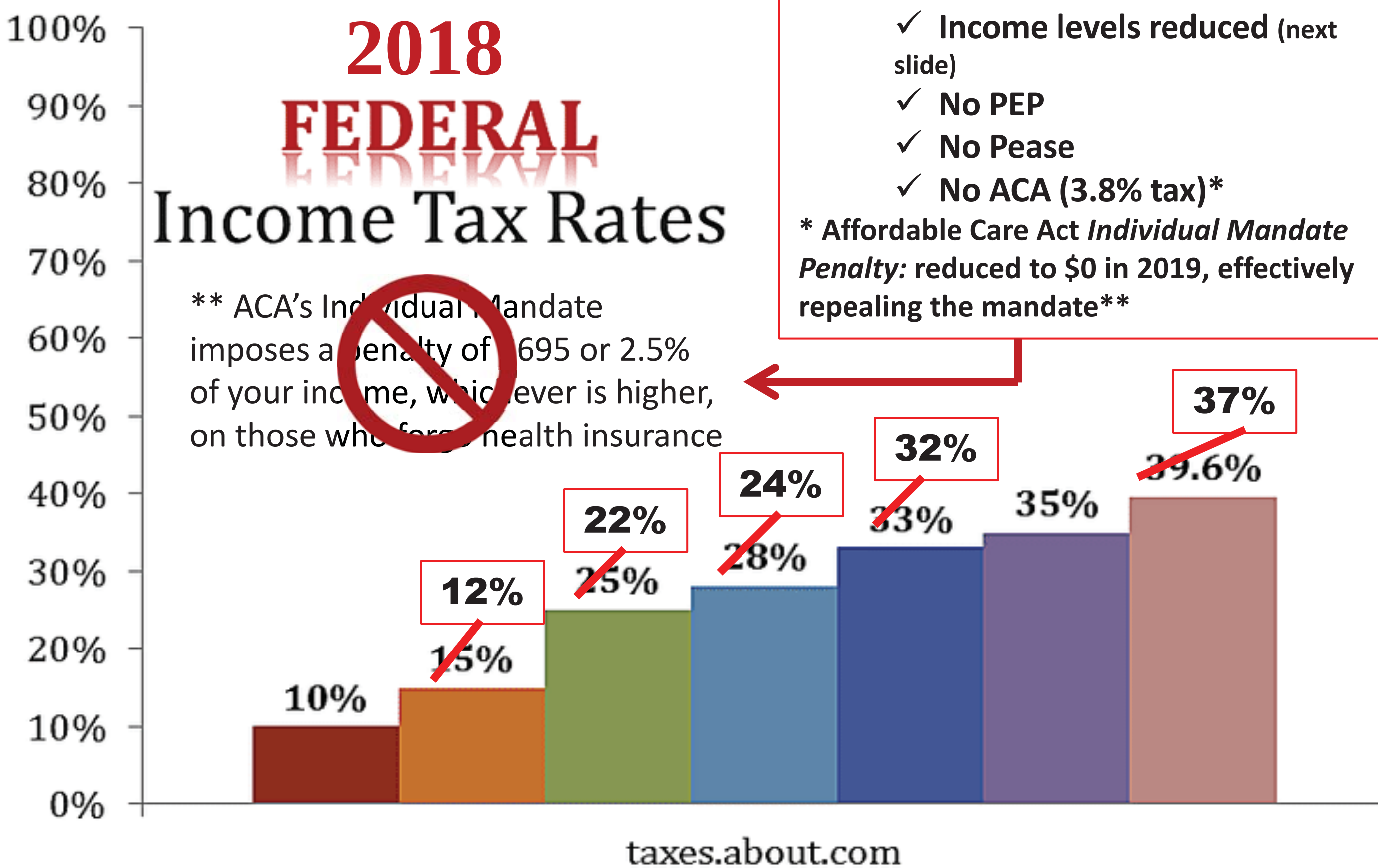
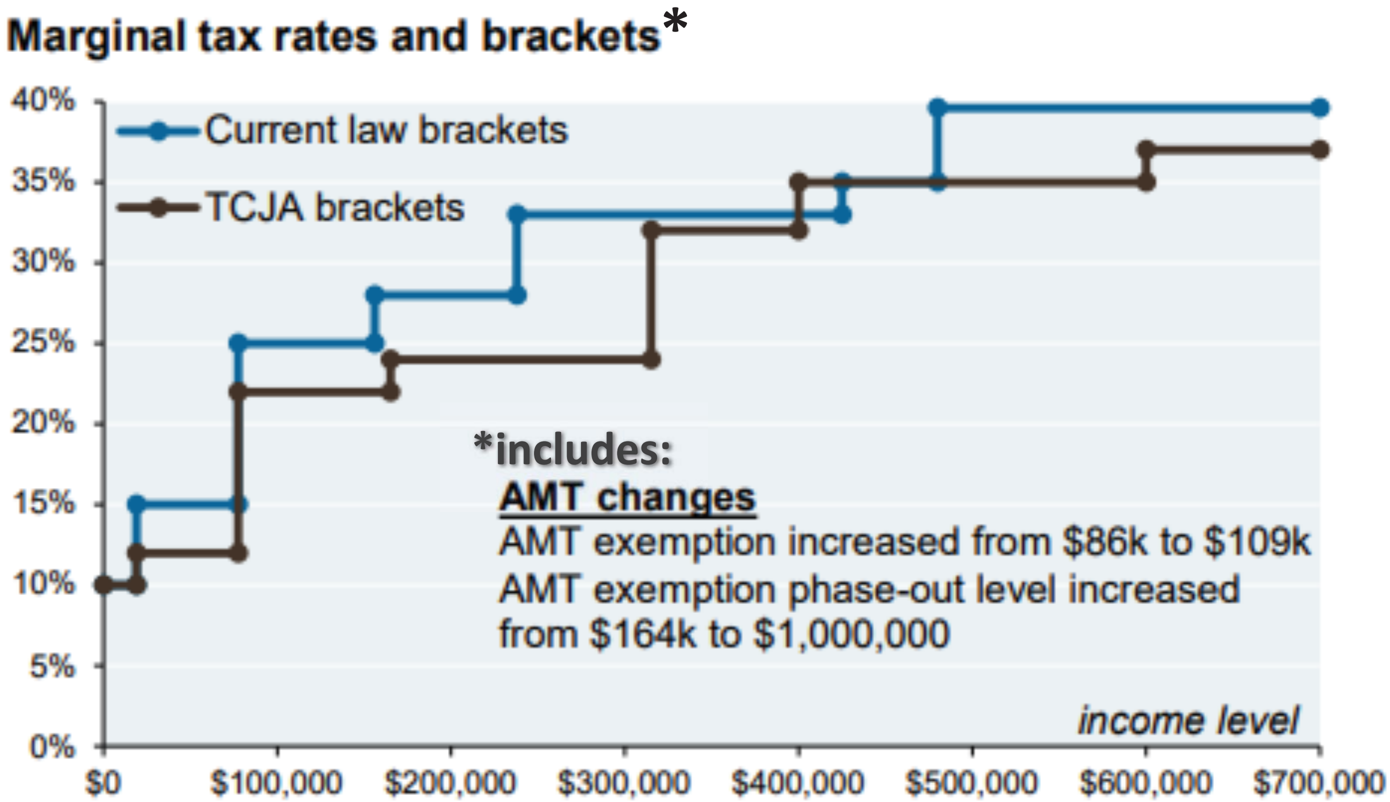
Still 7 brackets, but:

- ✓ **Five are reduced**
- ✓ **Income levels reduced** (next slide)
- ✓ **No PEP**
- ✓ **No Pease**
- ✓ **No ACA (3.8% tax)***

*** Affordable Care Act *Individual Mandate Penalty:* reduced to $0 in 2019, effectively repealing the mandate****



TCJA – across the board tax rate cuts



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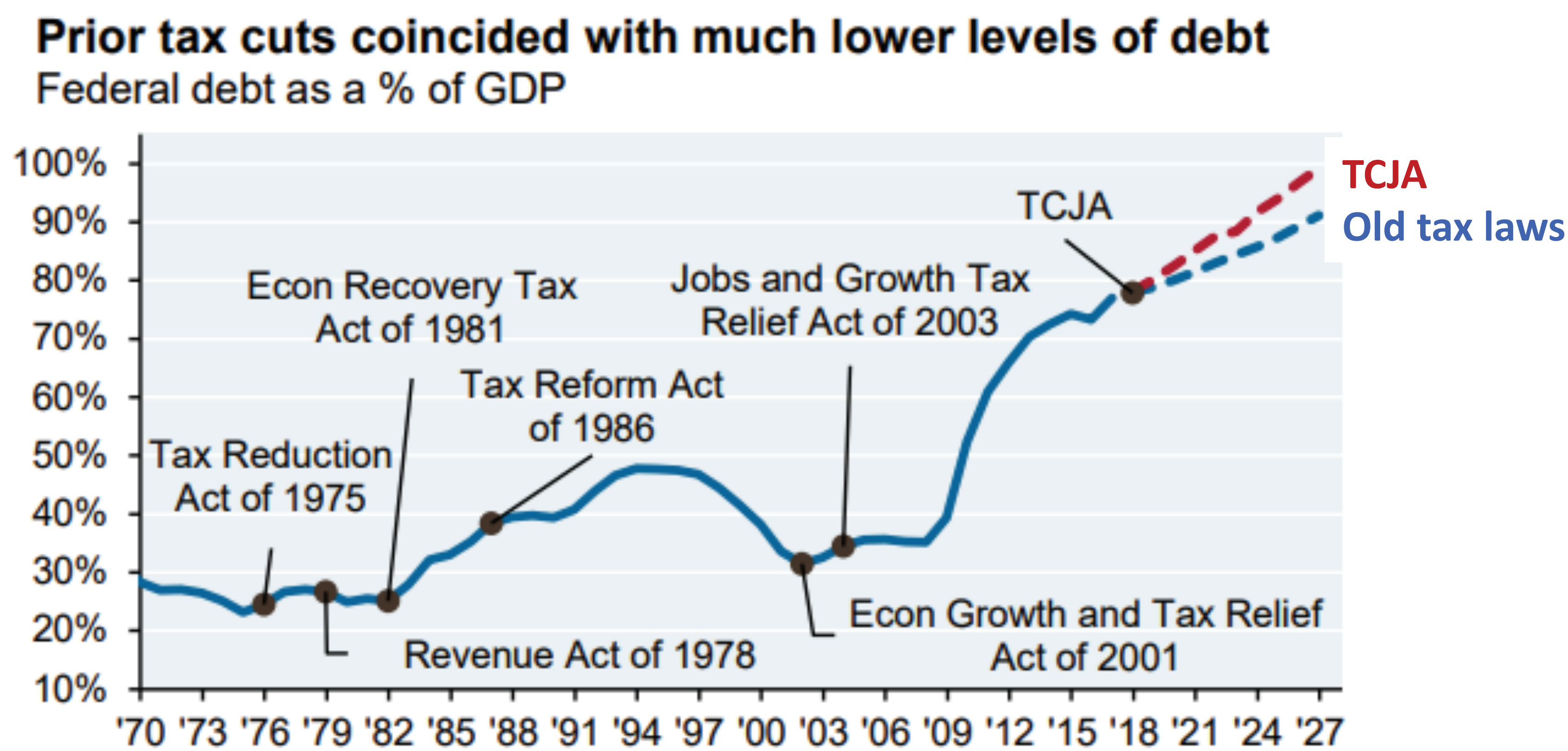
Will TCJA Explode Deficits?



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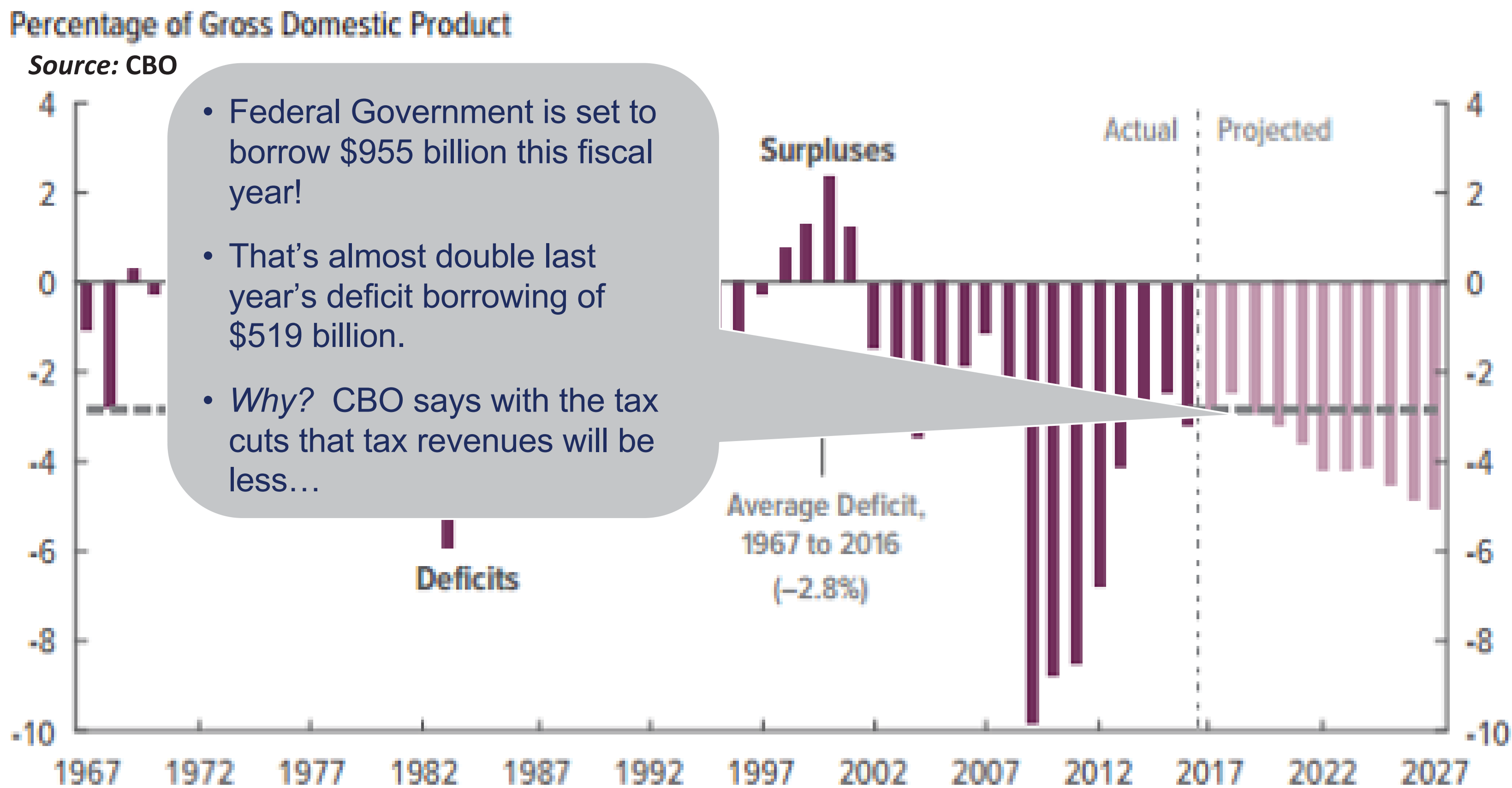
Budget Deficit Got Much Better but is Getting Worse:

Total Deficits and Surpluses



- Federal Government is set to borrow $955 billion this fiscal year!
- That's almost double last year's deficit borrowing of $519 billion.
- *Why?* CBO says with the tax cuts that tax revenues will be less…

But Cutting Taxes Can Actually Increase Tax Revenue

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%

Cutting Tax Rates…

let's people keep more of their own money

Increases Tax Revenues

more money flows to the government

$

Previous Administrations and Tax Cuts

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- President Calvin Coolidge cut tax rates:
  - Top marginal tax rate was 75% – reduced to 25%
  - Tax revenues increased 61% over 6 years from $719 million to $1.164 billion
- President John F. Kennedy cut tax rates:
  - Top marginal tax rate was 91% – and was cut down to 65%
    - (Tax rates ranged from 20% to 91% – cut down to a range of 14% to 65%)
  - Corporate tax rate was 52% – was cut down to 47%
  - Capital gains tax rate was 25% – held steady…
- President Ronald Reagan cut tax rates:
  - Top marginal tax rate was 70% – cut down to 28%
  - Corporate tax rate was 46% – cut down to 34%
  - Capital gains tax rate was 28% – cut down to 20%

History of Top Marginal Tax Rates

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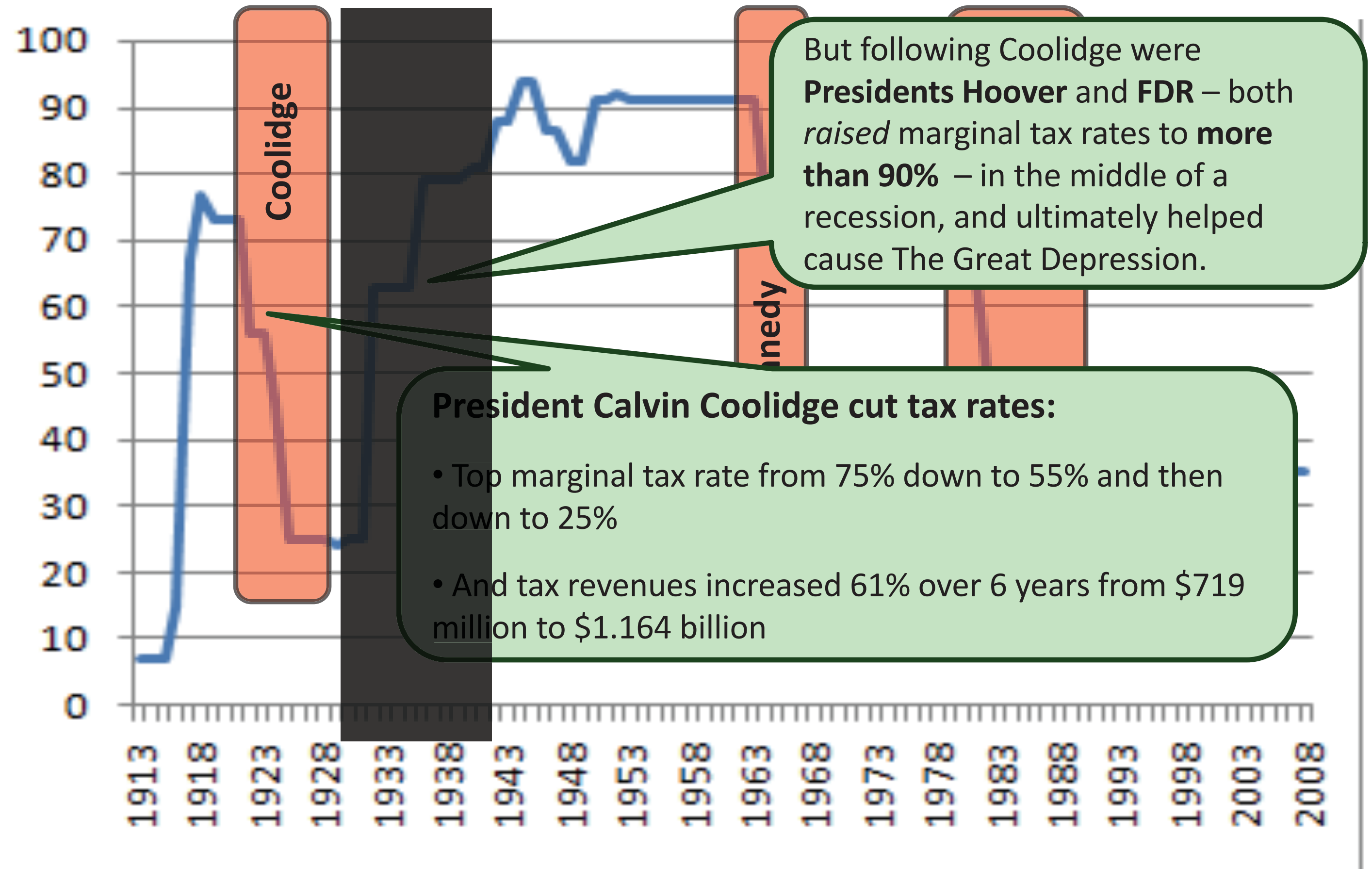
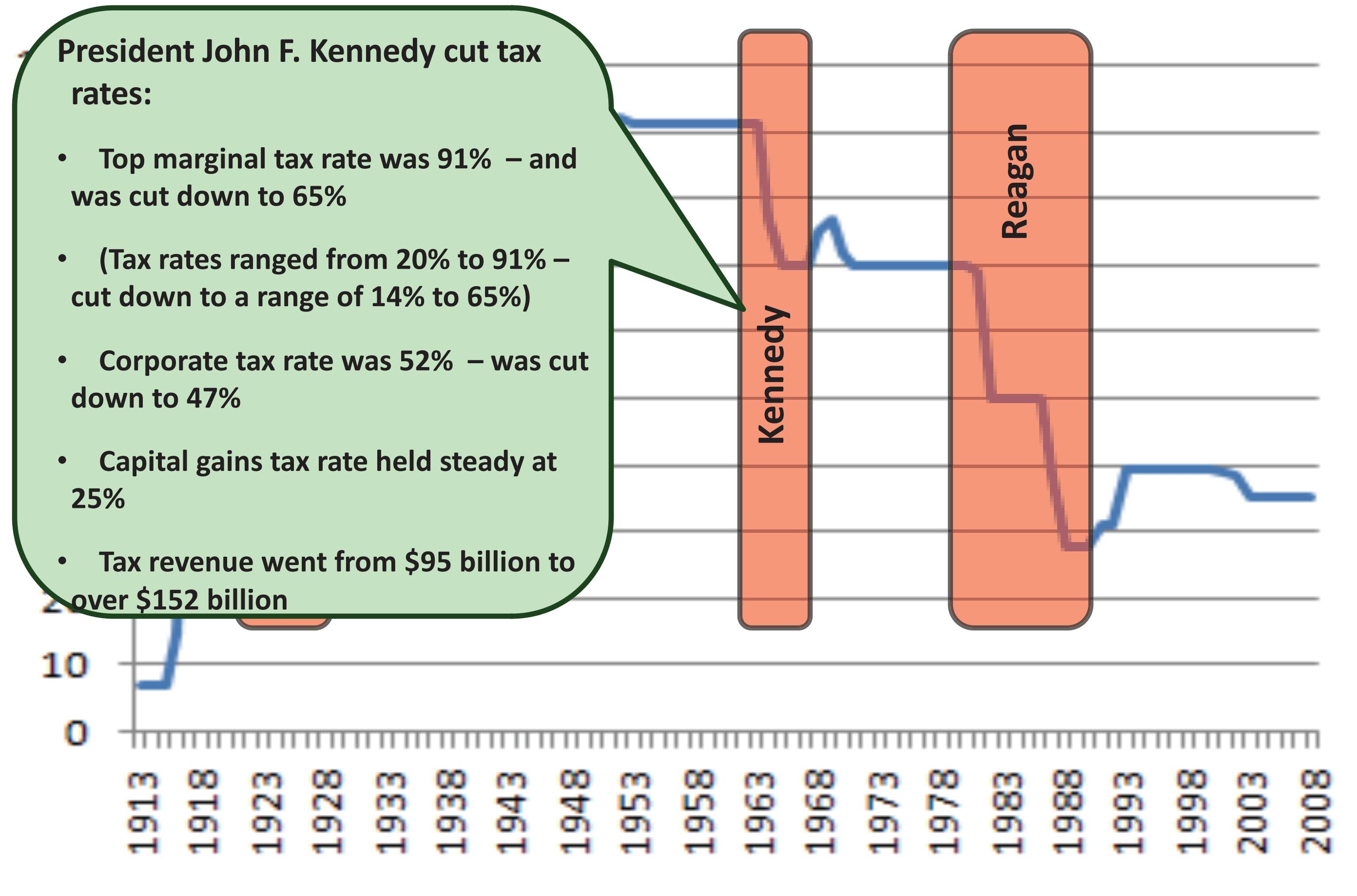
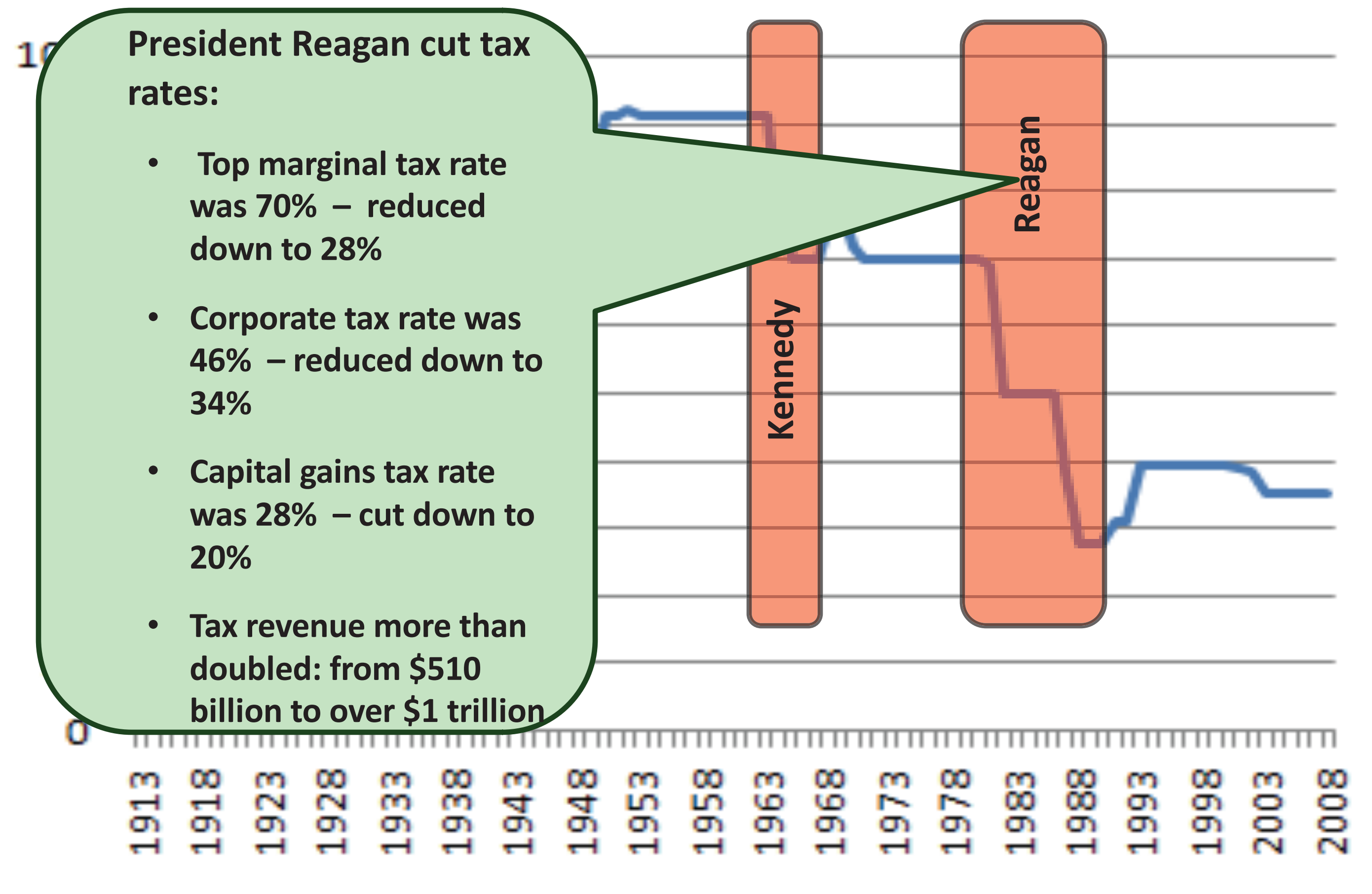


History of Top Marginal Tax Rates



History of Top Marginal Tax Rates



List of Companies Giving Bonuses or Wage Increases (as of 1/4/18):

Stating Directly Because of TCJA

- AT&T
- AAON
- AccuWeather
- Aflac
- American Airlines
- American Bank
- American Savings Bank
- Americacollect
- Aquesta Financial Holdings
- Associated Bank
- Ball Ventures - T.B.A.
- Bank of America
- Bank of Hawaii
- Bank of the Ozarks
- BB&T
- Boeing
- Canary LLC – Increased hiring
- Central Pacific Bank
- Citizens Financial Group
- Colling Pest Solutions – T.B.A.
- Comcast
- Comerica Bank
- Commerce Bank
- Community Trust Bancorp
- Copperleaf Assisted Living
- Cornerstone Holdings – T.B.A.
- Dayton T. Brown Inc.
- Delaware Supermarkets Inc.
- DePatco, Inc. – T.B.A.
- Eagle Ridge Ranch – T.B.A.
- East Idaho News – T.B.A.
- Elite Roofing Systems – T.B.A.
- Elite Clinical Trials – T.B.A.
- Emkay, Inc.
- Ennis, Inc.
- Express Employment Professionals
- Fifth Third Bancorp
- First Farmers Bank & Trust
- First Hawaiian Bank
- First Horizon National Corp.
- Frank L. VanderSloot Foundation
- Fort Ranch – T.B.A.
- Gardner Company – T.B.A.
- Gate City Bank
- Get Found First – T.B.A.
- IAT Insurance Group
- INB Bank
- InUnison Inc. – T.B.A.
- Kansas City Southern
- Kauai Cattle LLC – T.B.A.
- Melaleuca
- Move It Or Lose It Moving LLC – T.B.A.
- National Bank Holdings Corporation
- Nationwide Insurance
- Natural Guardian – T.B.A.
- Navient
- Nelnet
- OceanFirst Financial Corp.
- Ohnward Bancshares
- Old Dominion Freight Line Inc.
- Pinnacle Bank
- PNC Financial Services Group, Inc.
- Regions Financial Corporation
- Resident Construction LLC – T.B.A.
- Riverbend Communications – T.B.A.
- Riverbend Management, Inc. – T.B.A..
- Riverbend Ranch – T.B.A
- Riverbend Services – T.B.A.
- Rush Enterprises
- Sheffer Corporation
- Sinclair Broadcast Group
- Smith Chevrolet – T.B.A.
- Smith Honda – T.B.A.
- Smith RV – T.B.A.
- Southwest Airlines
- Steel Design LLC – T.B.A.
- Stifel Financial Corporation
- TCF Financial Corporation
- The Flood Insurance Agency
- Territorial Savings Bank
- Tokio Marine HCC – T.B.A.
- Total System Services
- Turning Point Brands, Inc.
- Unity Bank
- U.S. Bancorp
- Washington Federal
- Wells Fargo
- Western Alliance – T.B.A.
- Willow Creek Woodworks
- Windsor Federal Savings

Size of TCJA cuts compared to other tax cuts

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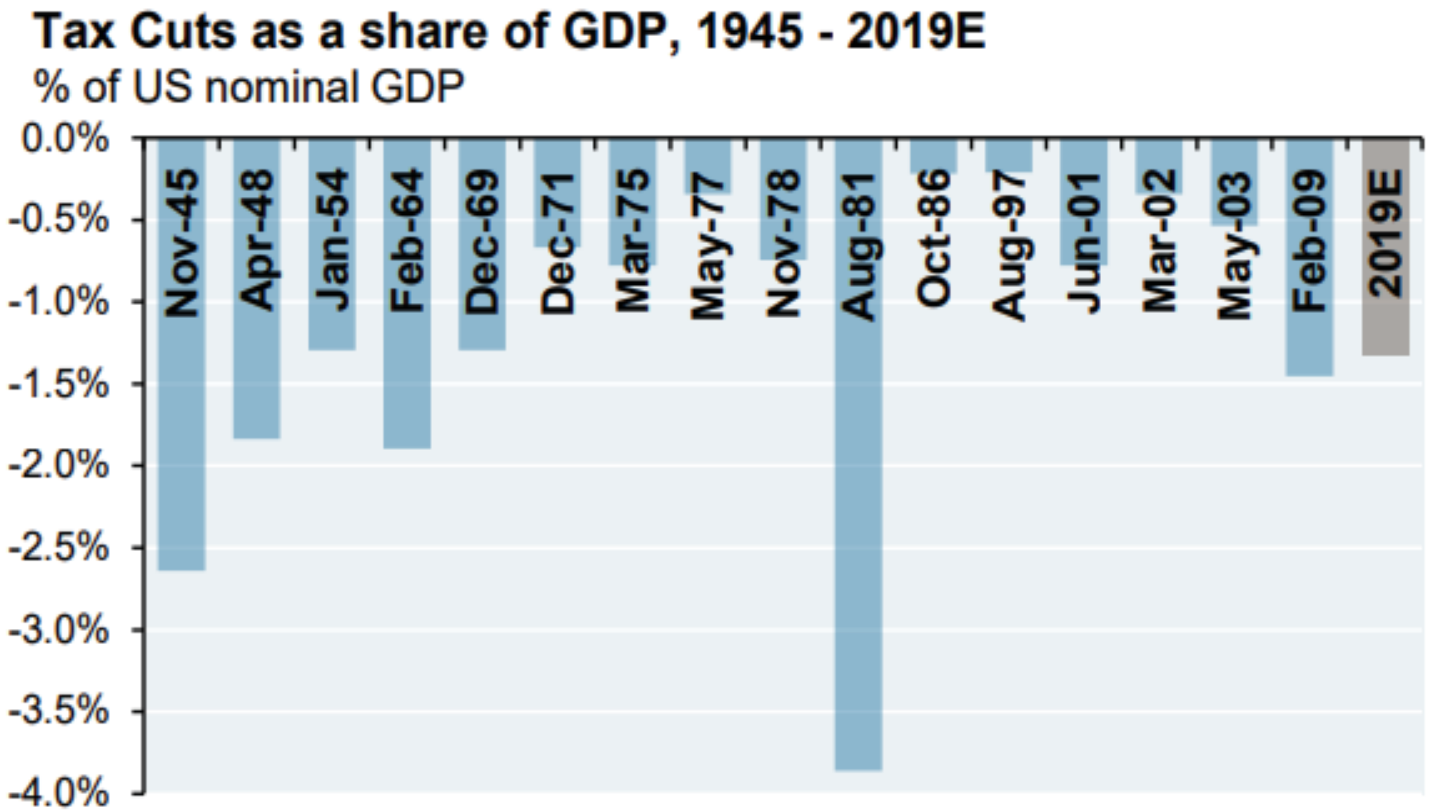

- President Trump says this is the biggest tax cut ever…
- TCJA is approximately the 6th largest tax cut (as a % of nominal GDP)

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1031 Tax Deferred Exchanges

- **Real estate (real property) exchanges** **NO CHANGE**
  - If repealed, PwC said GDP would drop by $165 billion
  - 45% of all commercial real estate sales are driven by 1031's
  - 20% of all residential real estate sales are driven by 1031's

- **Personal property exchanges** **REPEALED**

  This impacts:
  - Construction industry (trucks, equipment, materials)
  - Agricultural industry (farm equipment, irrigation equipment)
  - Intellectual property such as web designs, URL addresses, affecting "FAANG" stocks: Facebook, Amazon, Apple, Netflix, Google, etc.
  - Intangibles, such as: patents, copyrights, trademarks, art, collectibles, etc.

Itemized Deductions

- **Retains mortgage interest deduction (MID)**
  - For debt incurred starting in 12/15/17 limited to maximum of $750K of debt for new purchases
  - Interest on debt for second home (vacation home) still allowed
  - Eliminates mortgage interest deduction for equity debt (like HELOCs), including existing home equity loans

If you would like to see how this may affect you, visit Nerdwallet's Mortgage Interest Deduction Calculator link:

https://www.nerdwallet.com/blog/mortgages/mortgage-interest-deduction-changes/

Itemized Deductions

- **SALT: State And Local Tax deduction capped at $10,000**
  - Taxpayer's can choose any combination of property taxes, local income taxes, and/or sales taxes to satisfy their $10,000 capped limit.
  - $10,000 limit does not apply to taxes paid or accrued in carrying on a trade or business.
- **Retains credits for Wind, Solar, and Electric Vehicles**

Primary Home Exclusion

Same – NO CHANGES: (IRC Section 121)

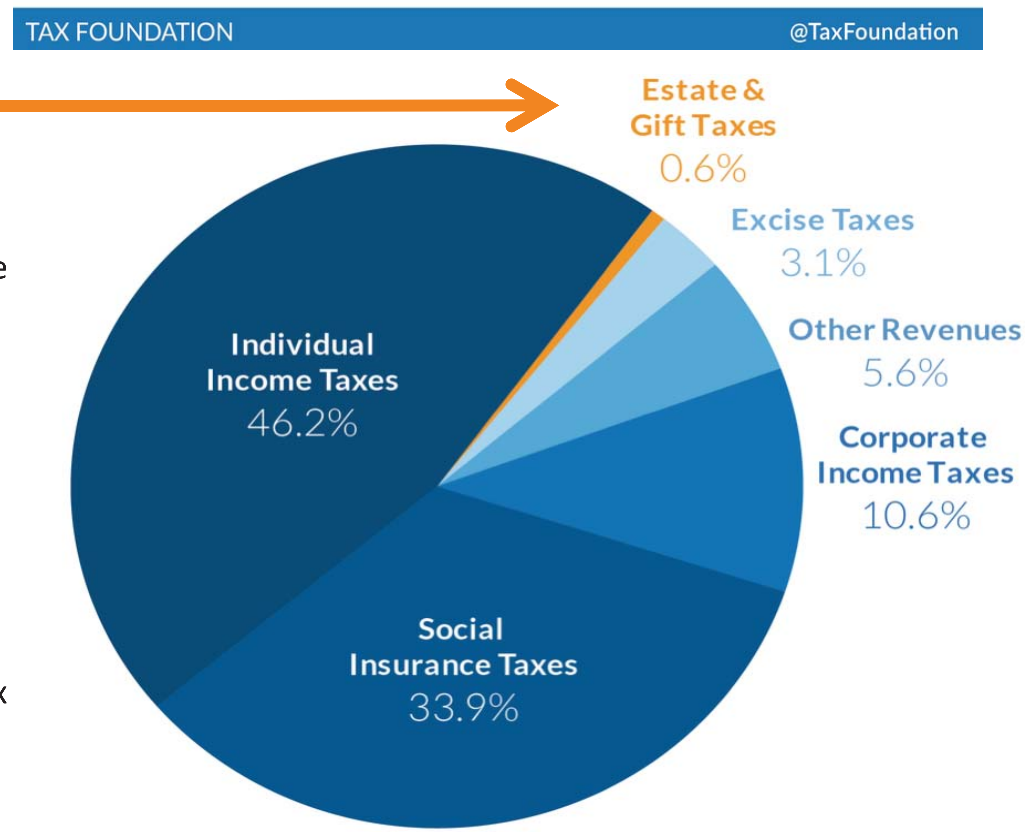
- **Live and treat as primary residence for 2 of the last 5 years**
- ***Dodged a bullet - Almost went to 5 of the last 8 years!***
- **Exclusions from capital gains:**
  - o $250,000 single filer
  - o $500,000 married, filing joint
- **Allowed to use once every two years**
- **Partial exclusions remain the same**
  - o IRS Pub. 523, Page 4

Estate Tax

Estate Tax – is a tax on the transfer of the estate of a deceased person.

- The Estate Tax starts at 18% and goes up to a maximum of 40% of the amount above the 2017 exemption of $5.45 million per person or $10.9 million joint married
- But next slide shows estate tax exemption doubles…!
  - Many states have inheritance tax as well
  - 99.8% of estates owe no estate tax – Only .2%, or 2 out of 1,000 estates are subject to estate tax.

Source: OMB, Historic Tables, Table 2.1 and Table 2.5.



Estate Tax

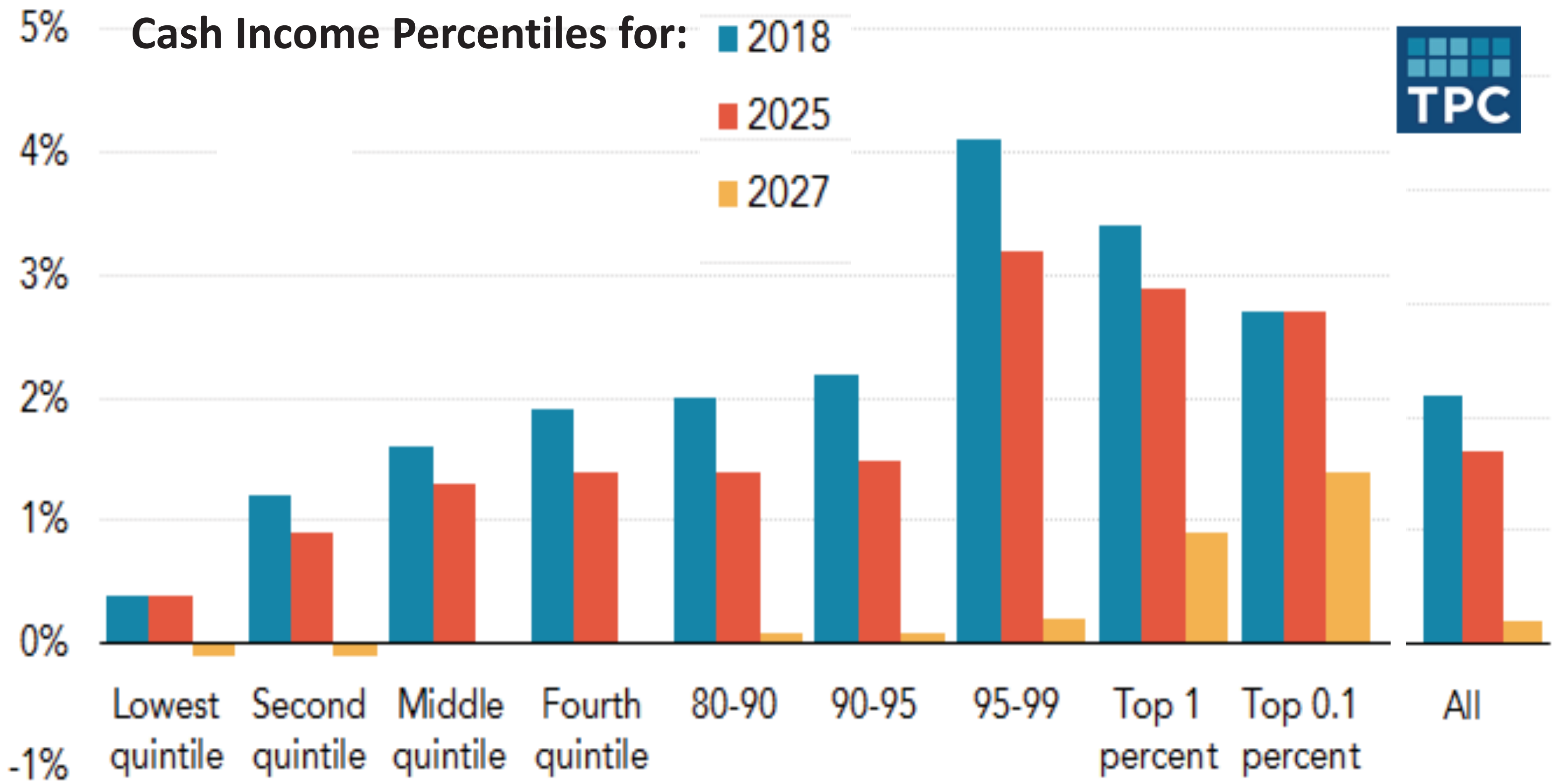
Estate Tax Exemption is *doubled:*

- From $5.6 million to $11.2 million per person
  - For married couple, $22.4 million
- This doubling of estate tax exemption expires at the end of 2025 and reverts back to $5.6 million per person
- §1014 Step Up in Basis ***retained***
- More incentive to never cash out
- Instead… *swap until you drop!*

New Marginal Tax Brackets

- **Old: 10%, 15%, 25%, 28%, 33%, 35%, 39.6%**
- **New: 10%, 12%, 22%, 24%, 32%, 35%, 37% …still 7 brackets but mostly lowered**
  - Income levels associated with new brackets are mostly increased
  - Adjusted for chained inflation (old: CPI-U; new: C-CPI-U)
- **PEP and Pease both eliminated:** two provisions in the tax code that increased taxable income for high-income earners.
  - PEP is the Personal Exemption Phase-out
  - Pease (named after former Senator Donald Pease) reduces the value of most itemized deductions once a taxpayer's adjusted gross income reaches a certain amount.
- **Overall Effect:**
  - **Almost 80% of taxpayers will receive a tax cut**
  - **Across-the-board tax rate cuts are usually beneficial to the U.S. economy**
  - **Tax changes tend to impact more of the higher income tax brackets**

Percent Change in After-Tax Income from TCJA



Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0217-1).

Standard Deduction and Personal Exemptions

- **Standard Deduction *nearly* doubled:**
  - Single filers: **$12,000** (was $6350)
  - Head of Household (HoH): **$18,000** (was $9,300)
  - Married, filing joint: **$24,000** (was $12,600)
  - Additional Standard Deductions for single filers and the Blind &/or Elderly**: eliminated**
- **Personal Exemptions –** suspended for 2018 thru 2025; was $4,050 for 2017, and would have been $4,150 for 2018
  - Now the difference between Adjustable Gross Income (AGI) and Taxable Income is the amount of deductions (standard or itemized) only: AGI - Deductions = Taxable Income
- **Child Care Tax Credit –** increased from $1,000 to $2,000; refundable up to $1,400
- **AMT - Alternative Minimum Tax:** retained for *individuals,* but repealed for *corporations.* The exemption for the AMT increases from $86,200 to $109,400 for married filers. The exemption phases out starting at $1 million, up from $164,100. For non-married filers the new exemption is $70,300 and phases out beginning at $500,000.

Other Changes to Personal Income Taxes

- **Medical Expense** continued with floor reduced from 10% to 7.5%
  - Reduction in floor only for 2017 (retroactive) & 2018; goes back to 10% in 2019
- **Student Loan Debt interest** is still deductible up to a limit of $2,500
- **3.8%** Medicare surtax for ACA, the NIIT under Section 1411 retained in full for 2018 – it is *not repealed,* but the tax goes to $0 starting in 2019
- Entertainment expenses no longer deductible: event tickets (sports, shows, concerts, suites, etc.), golf, hunting…
- Meals: 50% deduction still in play, but 100% deduction no longer allowed – limited to 50% (**ALL** Meals). Office parties still 100% deductible – holiday parties, company outings/picnics
- NOL (Net Operating Losses): Carryforward only, can't use to offset current year income
  - Only 80% of taxable income in future years can be reduced by NOL
  - Insurance companies retain 2-year carryback and 20-year carryover provision

New Treatment of Pass-Through Income

- Creates a **20% deduction from income** for certain qualifying pass-through entities: sole proprietorships, partnerships, LLCs, and S-corps
- To discourage high earners from re-characterizing their regular wages as pass-through income, the deduction would be capped using a formula based on W-2 wages and qualified property values.
- The 20% deduction is limited to the **greater of:**

  (a) 50% of the W-2 wages paid by the business, *or*

  (b) 25% of the W-2 wages paid by the business **+** 2.5% of the cost of tangible depreciable property (the unadjusted basis, immediately after acquisition, of depreciable property). This includes structures, but not land.

- The limitations don't apply if their taxable income is below:
  - $157,500 for single filers, or $315,000 for married joint. There is a phase out over a range of $100,000.
- Certain industries are **excluded** from taking this 20% deduction, such as: **health, law,** and **financial services**. But **engineers, architects, real estate agents/brokers** and **investors** should be able to use… Estates and trusts are also eligible for the pass-through benefit.
- Distributions from publicly traded partnerships and REIT dividends are not be subject to the wage restriction

New Treatment of Pass-Through Income

Section 199A Deduction: Pass-Through Entity Deduction

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Generally for tax years beginning after Dec. 31, 2017 and before Jan. 1, 2026, the TCJA adds new Code Sec. 199A, *"Qualified Business Income",* under which **a non-corporate** taxpayer, including a trust or estate, who has <u>qualified business income</u> (<u>QBI</u>) from a *partnership*, *SMLLC, S corporation*, or sole proprietorship is allowed a deduction for pass-through income for the purpose of computing the taxpayer's income tax.

<u>Not an Adjustment to Gross Income</u> - The deduction is not allowed in computing AGI, but rather is allowed as a deduction reducing taxable income.

***<u>Self-Employment Tax</u>* –** Since the deduction is only used to offset taxable income, it does not reduce the net earning for self-employment used to compute self-employment (SE) tax. Thus, it will not be used to reduce SE tax.

New Treatment of Pass-Through Income

- 20% of Qualified Business Income or QBI deduction is governed and calculated with the following parameters:
  - W-2 limitations
  - Certain industries excluded from using
  - The new law was all contained within one brand new provision of the Code: Section 199A.
  - And now we have to layer *pieces of new law* onto an already exceedingly complicated body of provisions: Sections 168(e), 168(g), 168(k), 280F, and 179 to name a few – that interact with one another in ways that are hard to predict and even harder to understand.

Depreciation for Real Estate

- Real property depreciation schedules were **retained:**
  - 39 years nonresidential (commercial) real property,
  - 27 ½ years residential rental property, and
  - 15 years for qualified improvements
- However, taxpayers electing to take unlimited interest deductions (must have gross revenues > $25 million – *see next slide*) on real property will have **slightly longer** recovery periods:
  - **40** years for nonresidential or commercial property (previously 39 years)
  - **30** years for residential income property (previously 27.5 years)
  - Some land improvements (parking lots, drainage, etc.) and tangible, personal property used in a real property trade or business are eligible for 100% expensing for the next 5 years.
- *Which schedule to use?*
  - Debt will be a factor in determining which schedule to use. If a taxpayer has very little debt, they may opt to benefit from the existing, shorter schedules. If a taxpayer has a higher amount of debt, they may benefit from unlimited interest deductions and opt to take the longer schedules. For further clarification please seek the advice of your tax advisor.

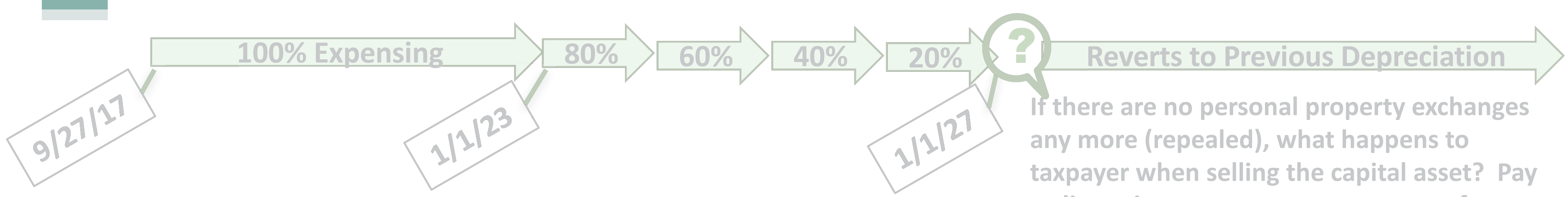
Business Interest Deduction – *and its relation to Depreciation*

- **Disallow deductions for net interest expense**
- Only applies to businesses, partnerships, and individuals with over $25 million in revenues.
  - Unspecified special rules would apply to financial services companies such as banks, insurance companies, and leasing companies.
- Eliminates net interest expense in excess of 30% of EBITDA (adjusted taxable income) for first four years
  - Any interest expense disallowed would be carried forward five years
- After the first four years, then the net interest expense is eliminated in excess of 30% EBIT
- So when you borrow money to **buy investment real estate**, the cost of borrowing – your interest payment – may no longer be a tax deductible item – *if your Gross Business Receipts are greater than $25 million*
- This is linked conceptually to the elimination of depreciation…
- One motivation for doing this is to *equalize the tax treatment between debt and equity financing.*

https://taxfoundation.org/conference-report-limits-interest-deductions

Immediate Expensing: **Change in Personal Property Depreciation**

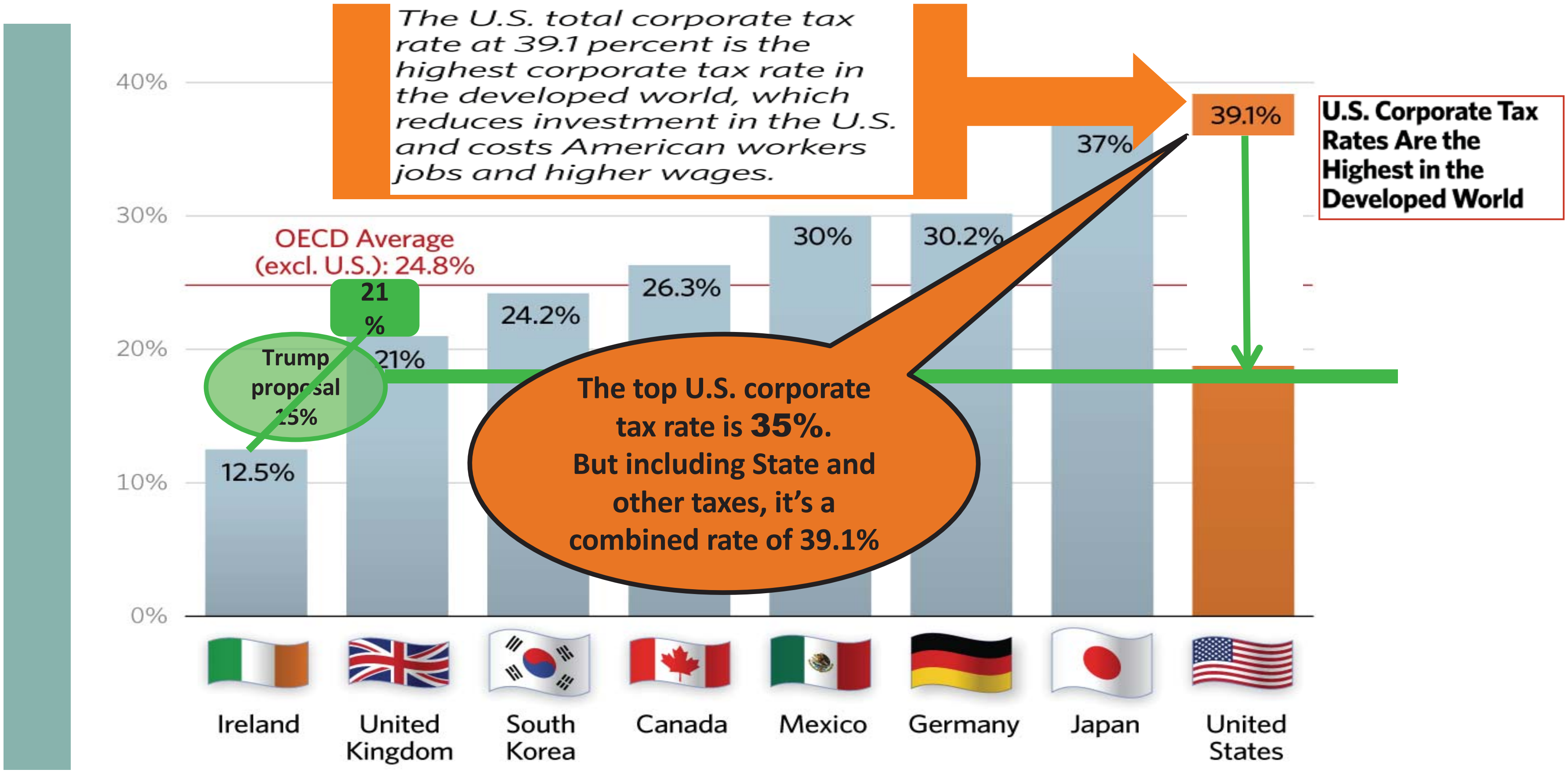
- Companies can expense 100% of the cost of qualified asset in the first year of acquisition, up to the company's income that year, so long as the asset is placed in service after September 27, 2017 and before January 1, 2023 – a 5 year timeframe
- Applies to any asset that has a useful life of 20 years or less – *so it does __not__ apply to land or other investment real estate*
- Excess expenses above that year's income would be carried forward and adjusted for inflation until exhausted
- The 100% expense provision is phased down by 20% per calendar year beginning in 2023 (i.e., 80%, 60%, 40%, and 20% for calendar years 2023 through 2026, respectively).   Normal depreciation rules apply after that.



If there are no personal property exchanges any more (repealed), what happens to taxpayer when selling the capital asset? Pay ordinary income taxes on recapture of depreciation!

Read: https://slate.com/business/2017/09/immediate-expensing-would-radically-undermine-our-tax-system.html

Corporate Income Tax Rates Comparison



Source: Organization for Economic Co-operation and Development (OECD).

Reduce the Tax Burden Chart 5 • Federal Budget in Pictures 2015 heritage.org

Cash Held by Corporations Overseas

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Between 2008 and 20~~13~~, 17
American firms held more than

$2.9
~~$2.1~~ trillion

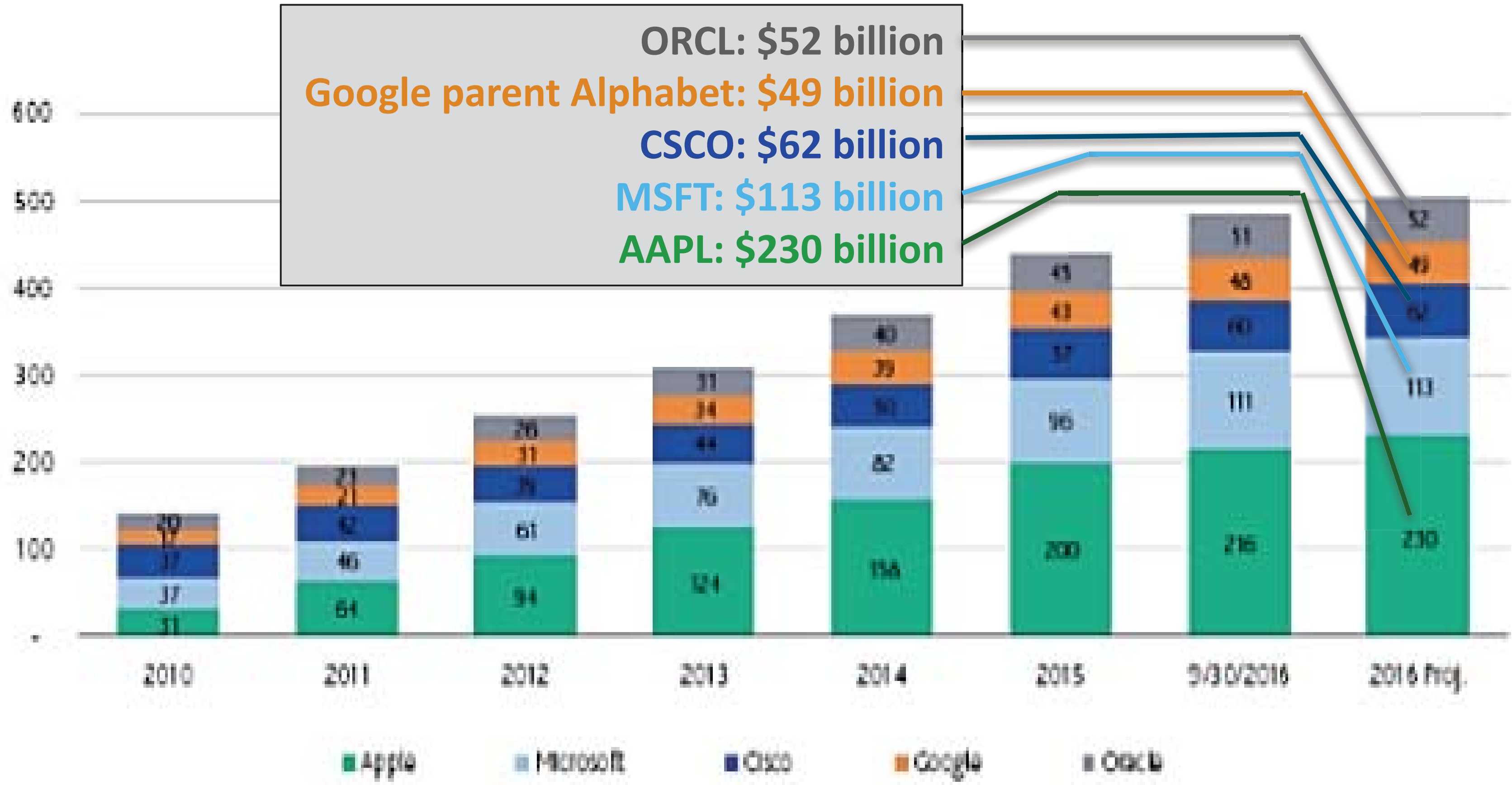
in profits overseas

That's as much as

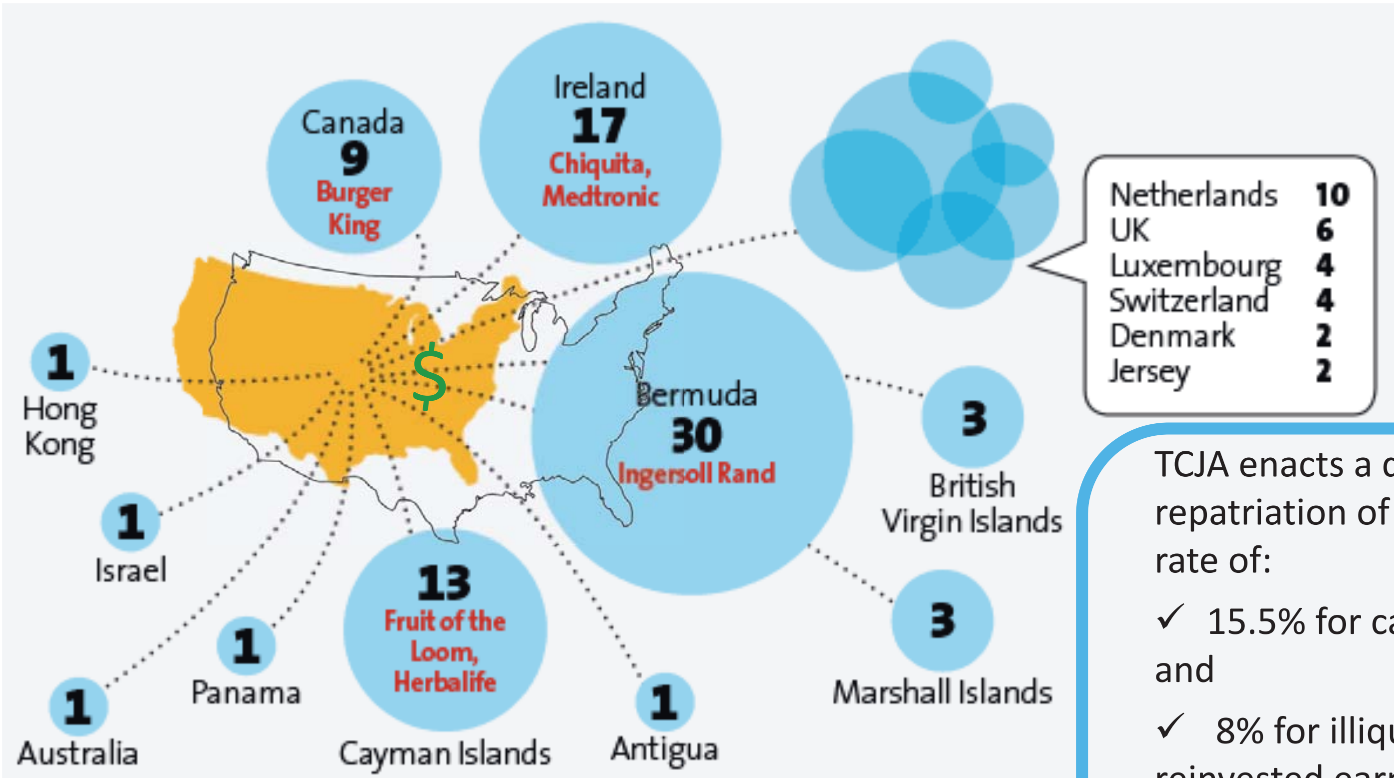
$900
~~$500~~ billion

in unpaid taxes

Top Five Corporations Cash Held Overseas



Deemed Repatriation under TCJA



TCJA enacts a deemed* repatriation of overseas profits at a rate of:

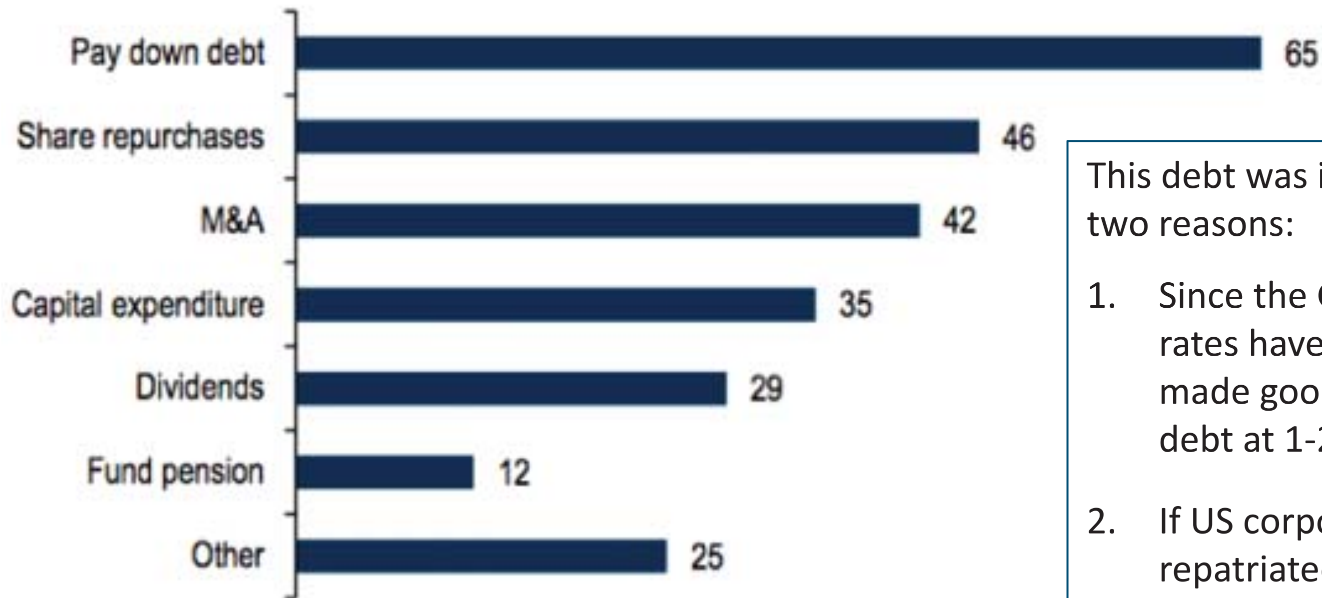
✓ 15.5% for cash and equivalents, and

✓ 8% for illiquid assets or reinvested earnings

** Taxed regardless of whether they dividend their deferred foreign earnings*

Source: http://fortune.com/2017/11/02/gop-tax-plan-business-wins/
And https://www.forbes.com/sites/anthonynitti/2017/11/10/senate-releases-its-tax-bill-how-does-it-compare-to-current-law-and-the-house-proposal/#578146784425

How would the proceeds of repatriated earnings be used?



Source: **BoA survey of 300 S&P companies**

This debt was issued largely because of two reasons:

1. Since the Great Recession, interest rates have been rock bottom. It made good financial sense to issue debt at 1-2%.

2. If US corporations would have repatriated their foreign cash prior to this new tax plan, they would have had to pay a 35% rate. So a bit of a no-brainer, whatever your opinion on tax avoidance.

Capital Gains Taxes for Investment Real Estate

IPX 1031

No Changes to Capital Gains Taxes

Tax rates for real estate investments:

- Appreciation: **15%** and/or **20%**
  - Old law: $400,000 - single; and $450,000 - married filing joint
  - New law: $425,800 - single; and $479,000 - married filing joint
- Depreciation Recapture: **25%**
- NIIT tax §1411: **3.8%**

  (this goes to zero in 2019)
- State of **CA : 13.3%**
- TOTAL effective or blended average rate: **30%**

Still a significant need to use a 1031 exchange!

Carried Interest

– required hold time extended

- The previous 1-year holding period was ***extended to a minimum 3-year holding period*** *for long-term capital gain treatment* with respect to carried interests received in certain types of partnerships, including hedge funds, private equity funds, and real estate.
- The 3-year holding period applies to the assets held by the partnership, as well as the partnership interest itself.
- The 3-year requirement applies to dispositions of assets and interests beginning in 2018
- In real estate a "**carried interest**" is a financial interest in the long-term capital gain of an investment asset. Carried interest is income flowing to the general partner(s) of a partnership or private investment fund. But the "**carried interest**" is given to a general partner (GP), by the limited partners (LPs), the investors in the partnership and can be treated as a capital gain rather than ordinary income.
- Carried interest is classified under the tax code as capital gains, which are taxed at the more favorable capital gains tax rate (20%) than if it was treated as ordinary income.

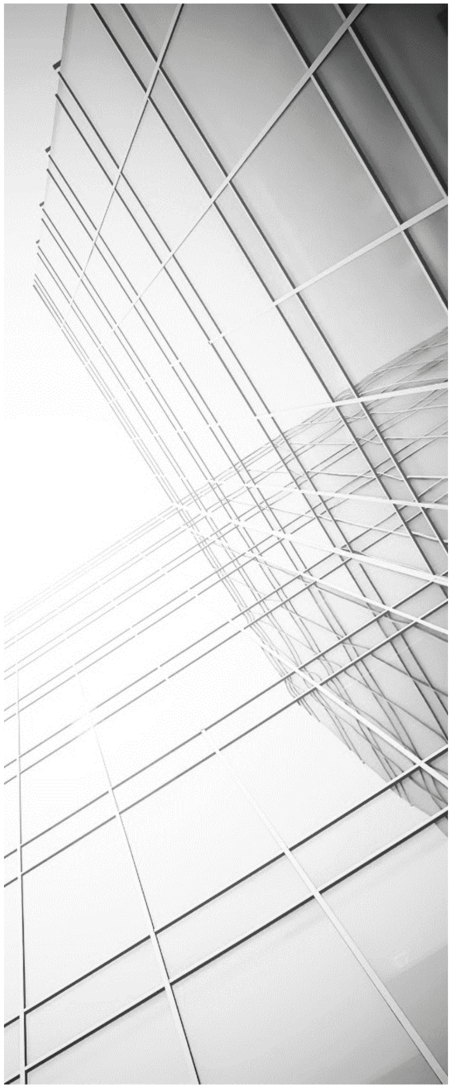
Remaining Provisions

Summary of Impact on Real Estate

Here are the remaining, less common, provisions not previously discussed that impact real estate:

- **Historic preservation and rehabilitation tax credits:** Preserves the 20% tax credit for the rehabilitation of historically certified structures, but taxpayers must claim the credit ratably over a 5-year period. The bill repeals the 10% credit for the rehabilitation of pre-1936 structures.
- **Low-income housing tax credit:** Retains the low-income housing tax credit without changes.
- **Contributions to capital:** Limits the ability of corporations to receive certain state and local subsidies on a tax-free basis, including contributions in aid of construction and contributions from a governmental entity or civic group. For example, the legislative history clarifies that a contribution of land by a municipality would be taxable, whereas a municipal tax abatement would not.

Summary of Impact on Real Estate



- According to the Washington based non-profit public policy organization, *The Real Estate Roundtable*, under the new tax system, commercial real estate will continue to be taxed on a sound, economic basis.

- The broad-based incentives for capital formation and investment should lift demand throughout the economy and allow real estate to continue its role as a principal driver of economic growth and job creation.

Summary of Impact
to Upper Income Brackets

- **This bill has an impact on high income earners** (over $200K/$250K) and especially for those in high tax states such as CA, NJ, and NY. The upper tax brackets will be paying more in income taxes due to less deductions allowed to them in previous years – property tax deductions above $10K, mortgage interest above $750K, etc.

- The top metro areas that utilize the mortgage interest deduction the most according to 2015 and 2016 data analyzed by Lending Tree include 13 CA metro areas and Honolulu. Even in these 14 metro areas only 20%-32% of all tax filers took the mortgage interest deduction.

TAX CUTS & JOBS ACT:

How it Effects Real Estate & the Economy

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877-775-1031

- https://www.jpmorgan.com/jpmpdf/1320744529831.pdf
- Get and use video from IBD: “Do tax cuts really work?”
- http://www.rclco.com/advisory-tax-jobs-act-2017-12-22
- https://piie.com/system/files/documents/furman20180106ppt.pdf
- https://seekingalpha.com/article/4064527-flattening-yield-curve-good-sign-equities-economy
- https://commercial.jpmorganchase.com/pages/commercial-banking/executive-connect/tax-cuts-jobs-act

- Investopia
- Read: http://www.businessinsider.com/charts-that-shed-light-on-the-feds-mysterious-45-trillion-portfolio-2017-5
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- http://www.businessinsider.com/every-interest-rate-cycle-since-1970s-2015-12/#march-1972-to-late-august-1973-1

Sources of Data and Information

- Yahoo! Finance: Complete Guide to 2018 Tax Changes
- Tax Center Policy
- Tax Foundation
- http://www.macrotrends.net/charts/economy
- https://www.kitces.com/blog/final-gop-tax-plan-summary-tcja-2017-individual-tax-brackets-pass-through-strategies/

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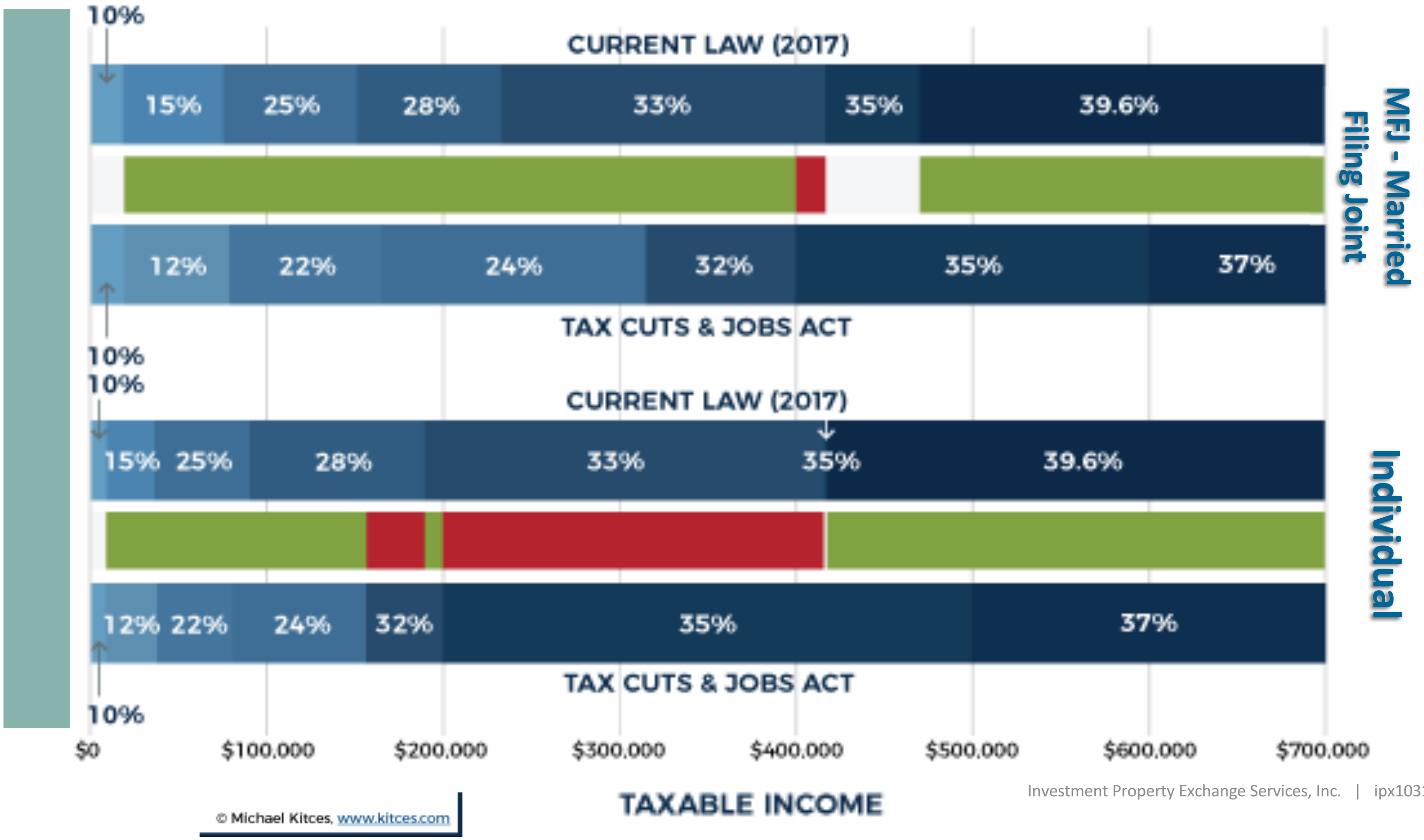
Comparison of Individual & MFJ Tax Brackets



- Notes


John Lynch's Presentatio
LPL_Financial_Outlook_2(
Debt to GDP Ratio Histor
www.macrotrends.net/1381/debt-to-gdp-ratio-historical-chart
Stock Screener
Stock Research
Top Dividend Stocks
ETFs
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Exchange Rates
Interest Rates
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Debt to GDP Ratio
110.00%
100.00%
90.00%
80.00%
70.00%
60.00%
50.00%
40.00%
30.00%
1970
1980
1990
2000
2010
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2/4/2018