Market Perspectives

2017 TAX CUTS AND JOBS ACT
Implications for U.S. REITs

January 2018

The 2017 Tax Cuts and Jobs Act is a net positive for U.S. REITs and shareholders. The REIT structure will continue to be tax efficient and the tax burden for REIT shareholders on dividend distributions will be reduced by as much as 20%.

Legislation that stimulates economic growth, job creation, and corporate profitability is supportive of commercial real estate fundamentals as landlords may benefit from an increased demand for space. As investors digest the changes to the tax code, markets may oscillate short-term. Over the long-run, we expect U.S. REITs to benefit and any volatility associated with the 2017 tax reform to provide opportunities for active management to add value. Key provisions from the Act include:

TAX CUT ON REIT DIVIDENDS

REIT dividend distributions will be subject to a lower maximum "pass-through" income tax rate of 29.6%. Under current tax code, REIT dividends are taxed at an individual's tax rate and do not qualify for the lower qualified dividend tax rate that generally applies to dividends distributed by other equity securities. Under the new code, REIT investors in the highest income bracket which are subject to a 37% tax on dividend distributions would see a significant 20% decrease.

With the reduced tax burden, the REIT yield advantage relative to other income-producing investments improves. We expect this favorable tax regime to drive increased demand and capital flows to the asset class.

TENANTS CAN STILL DEDUCT THEIR RENTAL EXPENSE

A tenant's continued ability to deduct rental expenses supports the "Rent over Buy" mentality which benefits REIT landlords. With interest deductions limited to 30%, businesses will have less motivation to own real estate. Also, to the extent they own real estate, there could be a motivation to sell the real estate (potentially to a REIT) because of the limited ability to deduct interest expense above the cap while having no cap on the amount of "rent expense" to deduct.

NO LIMIT ON INTEREST EXPENSE DEDUCTION FOR REITS

Under the new tax code, corporations are limited to an interest rate deduction of no more than 30% of EBITDA. This limitation is designed to partially offset the benefit of the lower corporate tax rate of 21%. This limitation specifically excludes real estate companies, including REITs.

The exemption is an acknowledgment that REITs are capital-intensive businesses and require debt capital to adequately manage their portfolio of assets. While corporations may need to adjust their business models to account for this limitation, REITs will not.

REITS WILL CONTINUE TO BENEFIT FROM A 1031 EXCHANGE

The benefit of the Section 1031 exchange is that it allows REIT management teams to efficiently reposition their portfolios and recycle capital into potentially higher performing assets driving increased value for shareholders without the tax burden of paying capital gains from property sales.

Under the new tax code, Section 1031 exchanges will remain intact, allowing U.S. REITs the ability to defer capital gains tax on the sale of an existing property so long as the property be exchanged for a similar or "like kind" property.

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