TAX REFORM AND WHAT IT MEANS FOR OUR REAL ESTATE MARKET

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Now that the Tax Cuts and Jobs Act (Act) have been passed, everyone is trying to figure out what it means for them personally and for our market. The anxiety leading up to the results caused a similar pause in activity as when consumers were awaiting the results of the election last year. In both events, we noticed an increase in activity the moment the results were released albeit unpopular amongst many in our marketplace. This is not an uncommon trend whenever a major change is taking place politically or economically. The biggest issue now is interpreting and predicting how the Act will impact the economy and our local New York City real estate market in a time when several items still await clarity.

Impact on the Residential Market

One of the biggest questions from the Act is how the loss of several tax deductions, which have long been viewed to increase demand in purchasing a home, will impact the local and national housing market. Historically, homeowners were able to deduct the interest on their mortgage on a primary residence up to one million, all of their state and local property taxes as well as deduct their state and local income taxes.

These tax breaks make the carrying cost of a property less burdensome when you are able to deduct your main expenses associated with owning a home (i.e. mortgage interest and property taxes). The Act has now reduced the mortgage interest deduction to $750,000 and has also capped the deduction for state and local property and income taxes (aggregate) to $10,000. For example, if you pay $18,000 a year in property taxes and $40,000 a year in city and state income taxes pre-tax reform, then you would have a $58,000 deduction. Now that deduction is capped at $10,000.00 which, under this scenario, would result in a $48,000 loss in deductions.

This portion of the Act is viewed quite negatively in affluent markets such as the tri-state area and California. While at face value it would appear detrimental to the residential market, we also have to look at what changes could be positive to the market. While the loss of the deduction above seems substantial, most high-income earners were phased out of the amount of deductions they were able to take due to their income levels. Thus, most people who paid such amounts in taxes were not able to take the full deduction regardless. It is still a loss for all, and you have to do an analysis on how this loss could be offset (and potentially then some) given the reduction in the federal tax rates and marginal brackets. Almost all of the tax rates were reduced as a result of the tax reform. The highest reduction was 4 percent and the top tax rate also declined from 39.6 percent to 37 percent. The tax brackets were also all adjusted, which, coupled with the decrease in rates, could result in a substantial reduction in income taxes. Any potential home buyer should consult their accountant to conduct an analysis on how these reductions compare and contrast to the loss of deductions indicated above.

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In many parts of the country, economists are speculating that these changes could result in a decline in home-building and could spark demand in the rental market. In New York City, it remains to be seen how the market reacts to these changes. Buyers will certainly use them as a negotiation tactic and it could result in a price correction in the first-time home buyer market. In all likelihood, the high-end and luxury markets will not be impacted by this as the demand in those markets is not as dependent on the deductions that have been lost. Also, we have to take into consideration other changes to the tax reform that are outlined below.

Impact on the Commercial Market and Investment Properties

The most sweeping change in the Act was the reduction of corporate tax rates from 35 percent to 21 percent. Some view that a substantial reduction such as this will result in creating jobs, reducing corporate debt, and increase in profits to shareholders.

As for investment properties, the biggest advantage to any real estate investor is that now you are permitted to deduct 20 percent of your domestic qualified business income (QBI) that comes from a partnership, LLP, LLC, S Corp., or sole proprietorship. This 20 percent deduction reduces your gross income, and then your tax calculation and deductions are based on the reduced sum. It should be noted that there is a phase out for this deduction based on the "wage limitation test," but regardless it does provide some form of a tax break for real estate investors. The maximum effective tax rate on QBI is thus reduced to 29.6 percent.

When the tax reform was first proposed, the elimination of the 1031 exchange was being considered. I.R.C. 1031 was in fact altered by eliminating personal property from the equation. Because of the Act, I.R.C. 1031 is now only limited to real estate, which was a big win for the real estate market.