Tax Reform in High SALT States: Is the Whole Greater Than the Sum of the Parts for CRE?

March 2018

WHAT YOU NEED TO KNOW

- Tax reform reduces taxes even in those states and markets with the highest state and local taxes such as the San Francisco Bay Area and New York City Metro; however, they will fall more in lower tax markets such as Texas and Florida.
- The new tax law will help drive investment in knowledge-center markets such as the Bay Area, Seattle, Boston and Raleigh-Durham supporting office rent growth and having positive spillovers into other product types.
- The Bay Area economy and office market stand to benefit from increased investment following repatriation of tech companies' cash hoards. Rising housing costs and traffic congestion, however, may make occupiers more willing to look at burgeoning secondary tech markets.
- Tax reform provides tailwinds to the technology and financial services sectors which will have a positive effect on the economy and commercial real estate market (CRE) in the New York City Metro.
- The tax law reduces homeownership incentives and that will likely translate into slower single-family home-price growth in high-tax, high-cost markets. At the same time, renting will become more competitive, supporting demand in these same markets
- Investment Opportunities
  - Knowledge center markets (primarily office but other property types as well)
  - Multifamily (especially in high-tax, high-income markets)
  - Class A multifamily, "home substitute" units in suburbs

Tax reform – the whole is greater than the sum of the parts

The recently enacted tax reform legislation (the Tax Cuts and Jobs Act or "TCJA") was an attempt both to lower taxes and to broaden the tax base in a number of ways to compensate for tax cuts. There is a tendency to focus on the change in tax liability from a single provision in isolation rather than to look at the tax reform law as a whole, due in part to the complexity of the varied and countervailing provisions within the law. Nonetheless, it is absolutely necessary when examining tax reform to focus on the net effects. The best examples of this are the limitations of state and local tax (SALT) and mortgage interest deductions (MID) and their impact on taxpayers and communities, particularly in higher tax, higher income areas.

Under the TCJA, taxpayers' SALT and property tax deductions will be capped at a maximum of $10,000; previously these deductions were unlimited. Additionally, the TCJA reduces the mortgage balance on which taxpayers can deduct interest payments from $1 million to $750,000; however, this provision does not apply to existing mortgages or refinancing thereof.

These provisions are projected to generate substantial increases in revenue with the overwhelming majority of the tax being paid by higher income households. Limiting the SALT deductibility alone is projected to raise $650 billion over 10 years with 96% paid by the top quintile of earners. The incidence of these tax provisions is higher where incomes, property values and tax rates are relatively greater. Yet, we find that the other individual tax cuts under the law more than offset these marginal tax increases even in those states and markets most impacted, while the business provisions are unambiguously positive for the economies and CRE in these same markets. In this report we focus particularly on the high SALT states of California and New York.

A Tax Cut is still a Tax Cut in California…

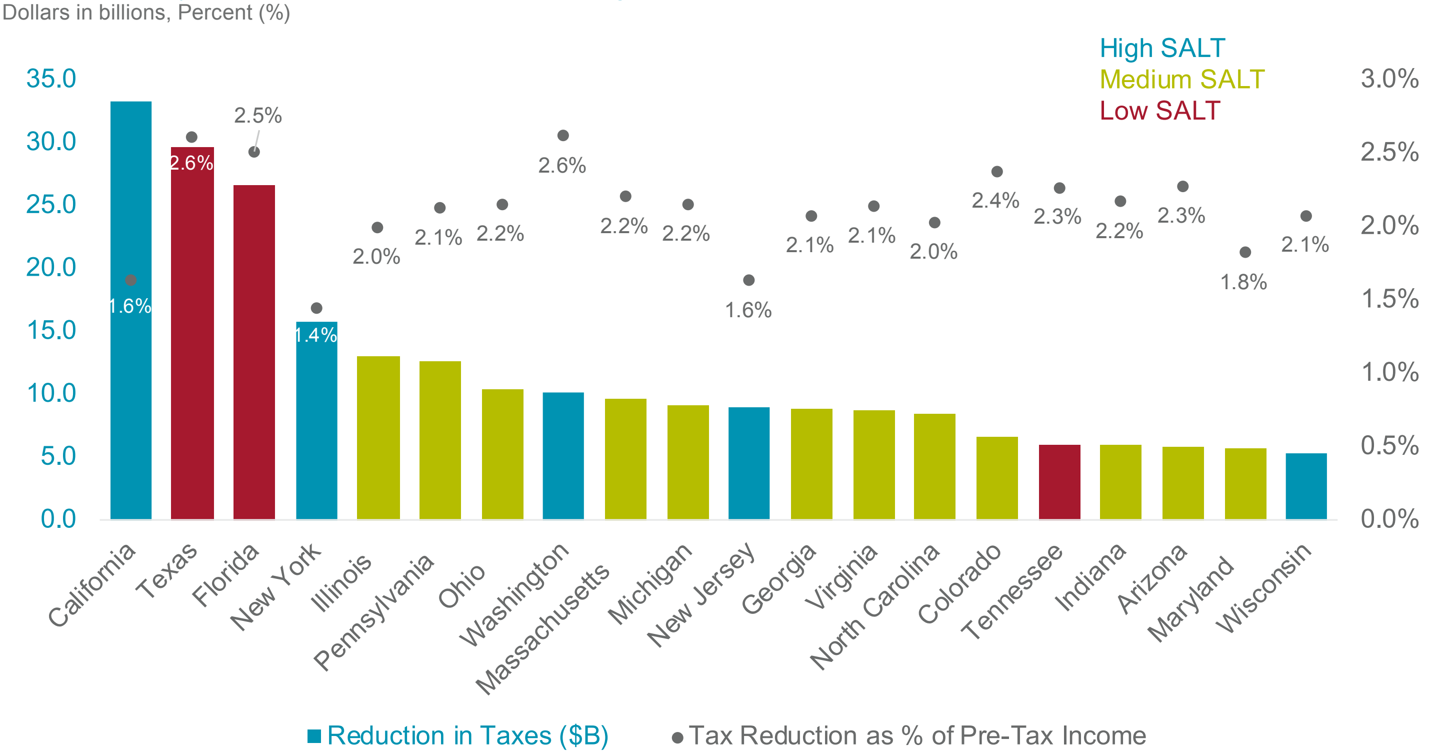
Taxpayers in every single state in the union (and the District of Columbia) will see their overall tax bill fall in 2019. Like children's soccer, everyone gets a trophy.

The TCJA reduces the aggregate tax liability of Californians more than residents of any other state in absolute terms: $33.3B in 2019. This means if one adds up the tax bills of all California households under the TCJA and then compares the total to what it would have been under the previous law the bill will be $33.3B lower. That's a tax cut. Texas, Florida and New York ($15.8B) will receive the next largest tax reductions. However, residents in the higher tax states will see a smaller reduction in their taxes relative to their incomes; consequently they will bear a larger share of the tax burden than they had previously. The decrease in taxes in 2019 is equivalent to 2.1% of pre-tax income for U.S. taxpayers overall while in California the difference is only 1.6%. In contrast, Texas and Florida taxpayers—with no state income taxes and therefore less impacted by SALT deductibility—will see taxes fall by 2.6% and 2.5% of pre-tax income, respectively. Washington, DC sits between these two extremes with taxes falling by 2.0% of pre-tax income.

At the individual level, 84% of taxpayers in the U.S. overall will see their tax liability decline in 2019, 9% will see it unchanged and a scant 7% will see an increase. Eighty-three percent of Californians and 76% of New Yorkers will

TCJA State-by-state Impact: 20 States with Largest Tax Reduction

Dollars in billions, Percent (%)



Source: ITEP, Cushman & Wakefield Research

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experience a tax cut while 11% and 13%, respectively, will see their tax liability increase.

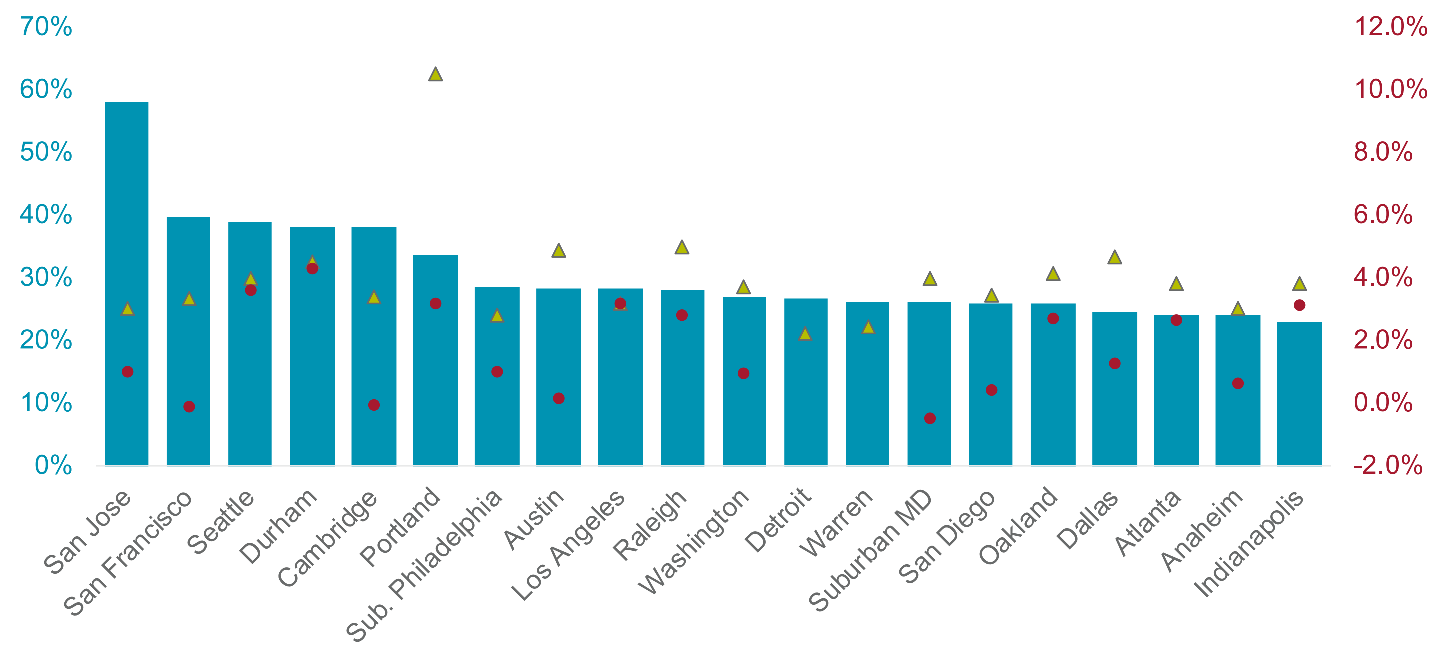
This begs the question: what kind of tax increases are we talking about and who will be affected? More importantly, will it cause taxpayers to change behaviors (i.e., migrate to states with lower SALT, defer/delay home purchases)?

Of the 11% of households that will see their taxes increase in California, the average increase ranges from 0.6% -1.7% of income depending on income quartile. The same holds true for New York and other higher tax, higher income states. In contrast, the overwhelming majority of households in California and New York are projected to see their tax liability decline by 1.3% -3.6%. Put simply, even in those states impacted most by the base-broadening provisions of the TCJA, the vast majority of households will see taxes decrease. For those relatively few whose taxes rise, the increase will be small both in absolute terms and relative to the average tax cut. There are more winners than losers, and the winners win more than the losers lose.

These are aggregate statistics, so the experience of individuals will vary. If you are reading this and are expecting your own personal tax liability to increase – perhaps even substantially—the above analysis does not invalidate your experience but should rather serve as a warning not to extrapolate your experience to the broader market. The data provide the best basis from which to consider tradeoffs that individuals will face in choosing where to live and work. Changing jobs and moving households are a costly process. Even if a change in job involved no other changes, it is unlikely that many households would be willing to do it for a 1% increase in income—the spread between the tax cuts for residents of California

Top 20 Metros by Intellectual Property Sector Share of Output

Percent of metro output (%), percent growth (%)



Source: BEA, Moody's, Cushman & Wakefield Research

Note: Intellectual property sectors defined as chemical, electronic, transportation, information and professional, scientific and technical services

and Texas. Add to that additional relocation costs and the incentive is lesser still. To the extent an individual was already considering relocating to a lower tax or lower cost-of-living state, however, the incremental tax benefits are an additional "plus." It should be exceedingly rare that the modest widening in the tax gap per se would be the motivator for individuals—and by extension businesses/commercial tenants—to relocate.

While academic research on the effects of tax increases on migration is limited, the research that is available supports the above conclusion. Goldman Sachs reviewed the literature on the link between taxes and mobility. It found limited impacts on low- and middle-income earners. The effect was greatest among top earners, but even for them the median estimate suggests only a 2%-4% emigration rate after 10 years following a 1% increase in the tax gap.

The Business of the TCJA is Business

In contrast to the relatively modest impact of the TCJA on individuals, most corporations will benefit significantly with an overall tax benefit of $330 billion over 10 years. The net impact of these changes should spur new business formation, greater investment by existing enterprises and attract more capital spending to the United States from abroad. All of these effects should support demand for CRE. The degree of the impact, however, will depend on how the majority of corporations spend their tax windfall. Oxford Economics estimates that business investment will increase 140 basis points (bps) in 2018 as a result of the tax changes, compared to only a 30-bps boost to consumption. Business investment is increasingly geared towards the production of new intellectual property (IP), a trend that is likely to continue in the foreseeable future. IP production tends to be concentrated in high-skilled, often higher tax knowledge-center markets. These markets will likely experience an increase in business activity that is highly correlated with CRE market performance.

From 2010-2017, IP sector growth and its share of a metro's real gross domestic product (GDP) combined to contribute 40% of the variation in rent growth across markets. In other words, the IP concentration of a metro's economy and the growth of IP sectors have been highly predictive of rent growth. This correlation will continue and tax reform will add further impetus to those markets already well-positioned to benefit from this dynamic.

Bay Area Continues to Thrive

The Bay Area economy is highly dependent on the technology sector. In the U.S. overall, just 4.8% of workers are employed in technology-related firms or jobs. In the San Francisco metro area, which includes San Mateo County and the East Bay, that figure is 11.9%. In the San Jose submarket, nearly one in three workers is employed in the tech sector.

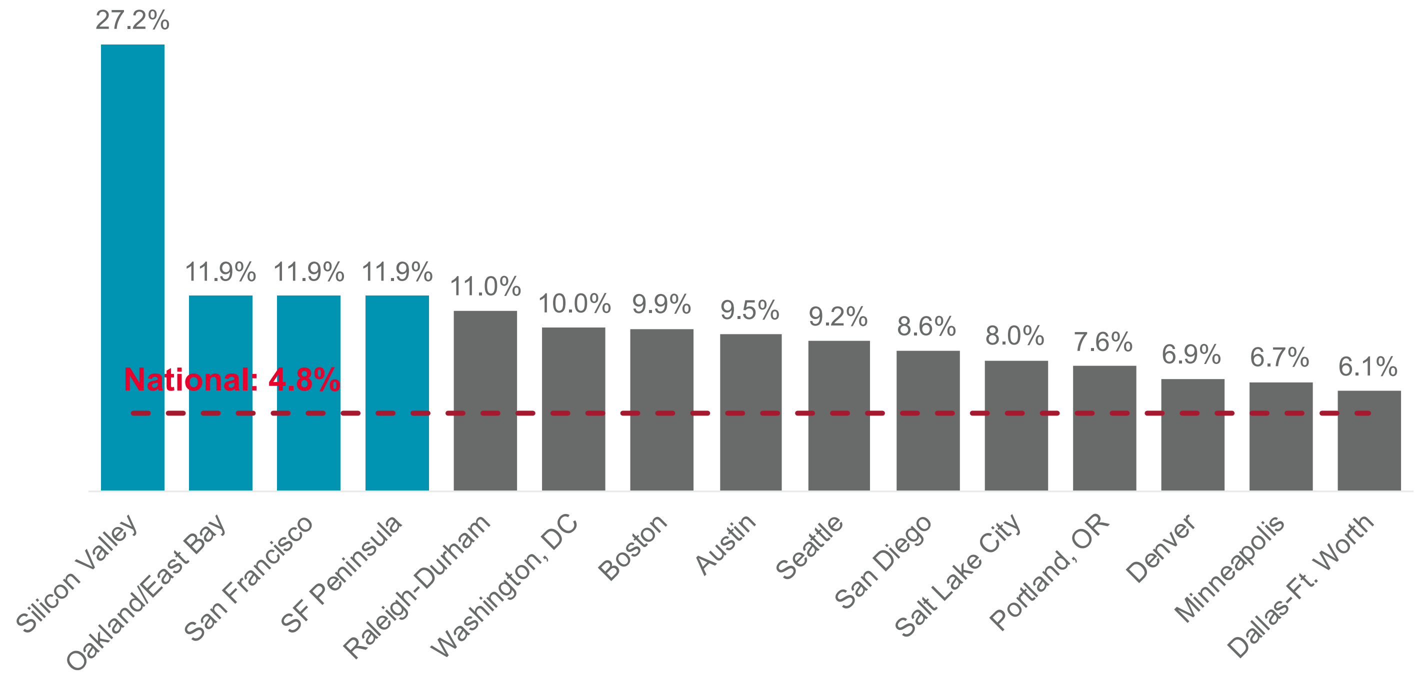
As a result, the Bay Area's office market is highly levered to the technology sector. The sector accounted for 50% of overall office leases in 2017 with even higher percentages in San Francisco and Silicon Valley. The lowest tech share is in Oakland, but this is likely to change in the next few years as the Bay Area continues to be the technology capital of the world and somewhat lower rents in Oakland—both for multifamily and office product—attract workers and tenants.

Fourteen of the top 20 tenants that took the most space in 2017 were technology companies. In San Francisco alone, the most active of these were Dropbox (736,000 square feet [sf]), Facebook (436,000 sf), Airbnb (two leases of 370,000 sf) and Uber (289,000 sf). These companies; in general, were adding to their already extensive footprints in the Bay Area. There are 20 technology companies that each occupy over a million square feet. Google and Apple occupy 21.5 million square feet (msf) and 14.4 msf, respectively.

As mentioned earlier, the TCJA should provide a modest boost to Bay Area after-tax incomes. The more significant impact on the area's economy and the CRE market will result from the business provisions of the Act on technology companies. Prior to the TCJA's passage, the technology sector's effective tax rate was only 18.5%, well below the statutory 35% rate, according to S&P Global data. Only the energy and real estate sectors faced lower effective tax rates, the latter because it consists mostly of pass-through entities. Accordingly, tech-

Technology Sector Employment: Top 15 Markets

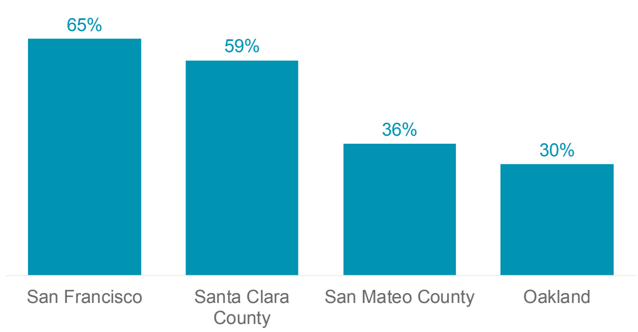
Percent of total employment (%)



Source: BLS, Cushman & Wakefield Research

2017 Overall Technology Leasing: Bay Area Submarkets

Percent of total (%)



Source : Cushman & Wakefield Research

nology companies will likely benefit relatively less from the reduction in corporate tax rates under the TCJA than those that facing higher rates, including financial (29.0%) and industrial (29.7%) firms.

However, technology companies—and by extension the Bay Area as a whole—will likely be prime beneficiaries of the movement from a global to a territorial taxation system that will facilitate the repatriation of overseas profits. Technology companies have some of the highest levels of unrepatriated cash: Apple, Cisco and Google had over $372 billion alone according to their most recent filings. These three companies together occupy 41.1 msf in the Bay Area—a total greater than the entire occupancy of many markets, including Oakland, Orlando and Nashville. As funds are repatriated, they will become available for new investment projects, wage increases, bonuses and for returning capital to shareholders. Those shareholders can then use the proceeds to make new investments. All of these outcomes are favorable for the continued expansion and vibrancy of the technology sector broadly and in the San Francisco metro specifically.

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The challenge for the Bay Area is not from tax reform. The Bay Area needs to address its ongoing housing affordability and congestion issues. Net migration has already been slowing for the past several years because of these issues, despite the area's having one of the nation's most robust labor markets. Occupiers that might otherwise have expanded their presence in the Bay Area may be tempted to invest instead in one of the growing number of secondary tech markets—markets where tax incentives may be available and where, in many cases, taxes for a company's employees would be lower as well.

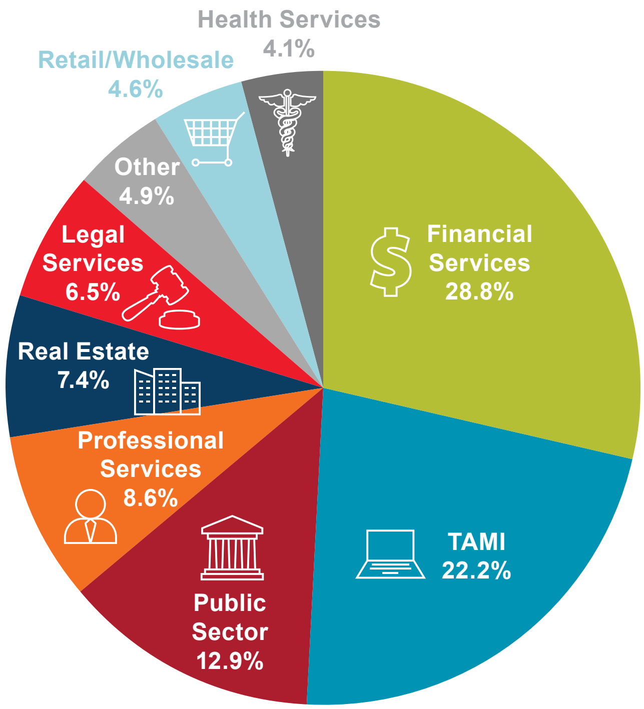
New York FIRE(D) Up

Financial services and TAMI (technology, advertising, media and information) firms are as central to the New York City metro economy as tech firms are to the Bay Area. Together these sectors accounted for 51% of new leasing activity in Manhattan during 2017. Since 2011, these two industries combined leased an average of more than 9.1 msf per year in New York City.

The financial services industry added 13,000 jobs in New York City during 2017—the largest one-year total since 2006—and this sector boasted the highest year-end employment level since 2000. The increase in financial employment led to a 60% increase in leasing activity compared to 2016.

Similar to the San Francisco Metro, the New York City Metro should experience a small boost in after-tax incomes as a result of the TCJA. Technology and information firms will tend to benefit disproportionately from tax repatriation and somewhat less from lower corporate taxes. The number of technology jobs in the New York City market has increased by 30% in the last 10 years and still has room to grow relative to overall employment. Meanwhile, the New York City Metro attracted $11.5 billion in start-up capital in 2017 (according to research by PwC), ranking it second only to the entire Bay Area and ahead of Silicon Valley in terms of start-up investment. These trends will likely continue to drive tech sector expansion and occupancy in the New York City Metro. Higher after-tax returns and newly available capital only make such investments more attractive.

2017 Manhattan New Leasing Activity
Percent of total (%)



Source : Cushman & Wakefield Research

Company	Employment	Space Occupied (SF)
JP Morgan	37,400	5,200,000
Citibank	24,990	4,400,000
Bank of America	19,500	3,600,000
Morgan Stanley	12,500	3,500,000
Barclays Capital	10,000	1,500,000

Source: Crain's NY Business, Cushman & Wakefield Research

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The financial services sector is also a significant beneficiary of the TCJA. The sector faced average effective tax rates of 29.0%, under the previous tax law--among the highest for any sector. Financial services firms should, therefore, expect some of the largest increases in their after-tax earnings and, correspondingly, the greatest increase to after-tax returns on potential projects and acquisitions. According to research by CB Insights, growth in the number of major bank acquisitions of fintech start-ups has accelerated in recent months. The environment is primed for continued M&A and new start-up activity in the sector, with much of it centered in Manhattan.

The broader positive national and global economic trajectories continue to support capital markets activity broadly and the expansion and profitability of the asset management universe. Even the recent revival in equity market volatility cannot be seen as unambiguously negative for the financial services sector: while index ETFs experienced outflows, a more volatile market has made both private asset classes and hedge fund strategies more attractive.

Overall, the TCJA will add to an already positive environment for the asset management and broader financial services sector globally and in Manhattan.

Housing Harried

While the overall economies and CRE markets of both high and low SALT states and markets will benefit from the TCJA, the impact on single-family housing is a different story. The deductibility of mortgage interest and property taxes are significant incentives for homeownership. This is reflected both in the proportion of households choosing to own rather than rent and ultimately in the values of homes.

As mentioned earlier, the TCJA reduces the mortgage principle balance on which interest can be deducted. It also caps the deductibility of combined SALT and property taxes at $10,000. The TCJA also doubles the standard exemption. The result is the percentage of households itemizing will decline from 26% to 11%, according to analysis by the Tax Policy Center. The same analysis finds

Market	Marginal State Income Tax Rate	Proportion of high earners ($150k HHI)	2016 Share of mortgages by number with balances over $750k	% Listings about $833k	% Property taxes above $10,000 p.a.	Risk Score (Average = 0)
1. Long Island, NY	9%	18%	1%	36%	46%	7.6
2. San Francisco, CA	13%	24%	10%	84%	20%	7.1
3. San Jose, CA	13%	30%	8%	63%	18%	6.6
4. Newark, NJ	9%	18%	1%	15%	34%	5.4
5. Fairfield County, CT	7%	27%	5%	37%	21%	5.1
6. New York, NY	13%	18%	2%	30%	23%	4.8
7. Oakland, CA	13%	24%	4%	38%	10%	4.0
8. Orange County, CA	13%	15%	4%	56%	9%	3.2
9. Los Angeles, CA	13%	15%	4%	45%	8%	2.8
10. Ventura County, CA	13%	19%	3%	44%	5%	2.7
11. San Diego, CA	13%	15%	3%	40%	6%	2.4
12. Boston, MA	5%	20%	2%	28%	12%	2.4
13. Suburban Maryland	6%	26%	3%	21%	7%	2.3
14. Washington, DC	9%	26%	3%	15%	4%	2.1
15. Cambridge, MA	5%	20%	2%	28%	11%	2.1
16. Camden, NJ	9%	14%	0%	2%	9%	1.2
17. Honolulu, HI	8%	16%	3%	36%	1%	1.1
18. Chicago, IL	4%	14%	1%	11%	12%	1.0
19. Hartford, CT	7%	16%	0%	4%	8%	0.9
20. Sacramento, CA	13%	12%	1%	16%	2%	0.7

Source: Trulia, Federation of Tax Administrators, U.S. Census, Cushman & Wakefield Research

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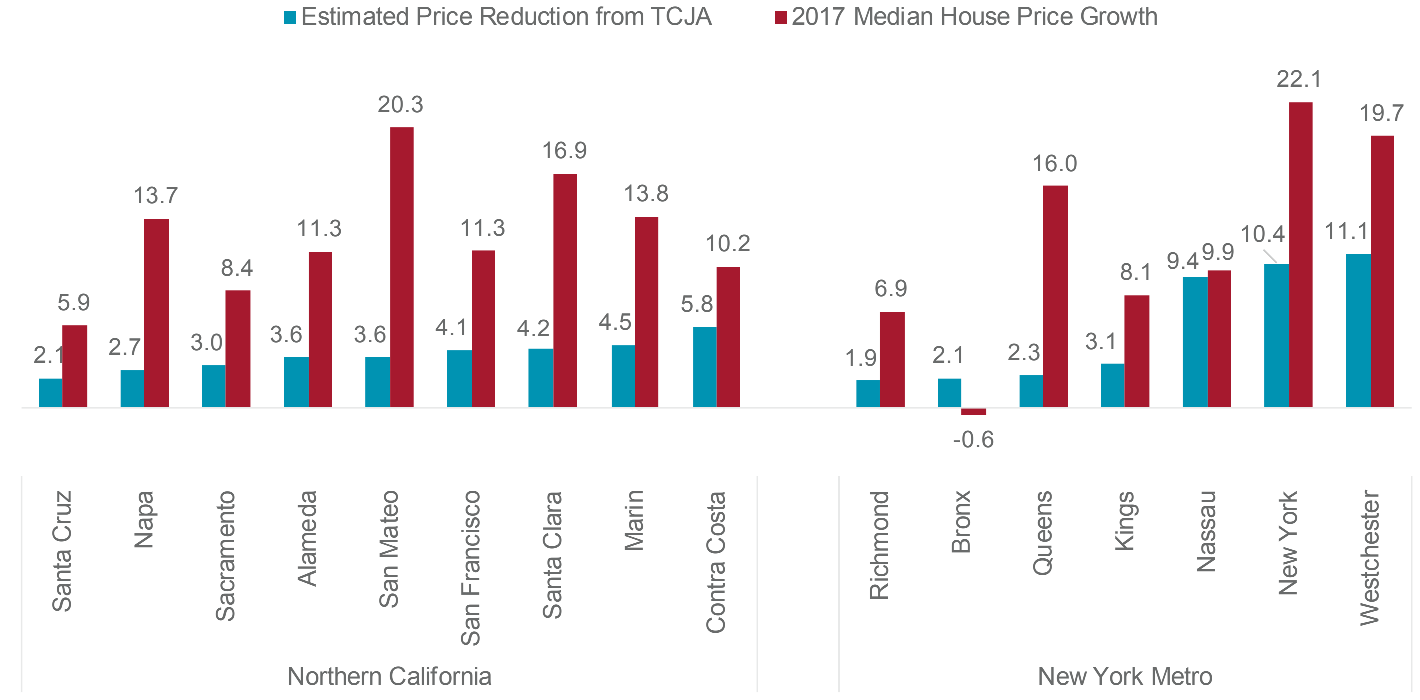
Impact of TCJA on House Prices vs. 2017 Price Growth: Bay Area and New York Metro

Percent %



Source: Moody's, S&P Corelogic, Cushman & Wakefield Research
Note: Latest home price values from November 2017, figures reflect year-over-year change in price

that for those tax filers who continue to claim the mortgage interest deduction, the tax benefit will decline by 21% on average. In other words, only one in ten households will have any sort of tax incentive to buy a home rather than rent one. For those that do have an incentive, the tax benefits will tend to be smaller.

In the vast majority of housing markets, these tax provisions are likely to have little to no effect. The impact on higher income, higher tax, and higher priced markets, however, could be meaningful. Cushman & Wakefield analyzed the 100 largest housing markets across several tax policy risk factors. The markets most at-risk for impact are concentrated in urban centers of the northeast and west. Among the top ten, six are in California (including three Bay Area markets) and the remaining four are in the New York City metro area.

What will all this mean for home prices? An analysis by Moody's projects home prices will decline by just 4.0% in the San Francisco Bay Area overall and by 8.7% in the New York City Metro, with significantly larger price declines in the relatively more affluent Nassau, New York and Westchester counties. This downward pressure on prices, however, comes at a time when home prices have been skyrocketing in many of these same markets. The expected decline in prices as a result of the TCJA is less—often significantly less—than the price gains recorded in 2017 alone in every significant market in the Bay Area and New York Metro, with the lone exception of the Bronx. Rather than think of the TCJA as lowering home prices in highly affluent, high-tax areas, the TCJA could temporarily slow the meteoric rise of home prices in these areas.

Even this impact is not certain since the TCJA permits borrowers of existing mortgages to continue to deduct interest on up to $1 million of a mortgage principle balance. This creates a disincentive for these households to sell their properties for two reasons. First, it creates a valuation gap between the tax benefits that the current owner is able to claim from financing the property and that which any prospective buyer would be able to claim. Second, if as is often the case, the prospective seller is selling pursuant to purchasing a new home, the financing on any subsequent purchase would be less attractive from the standpoint of tax. This would be particularly impactful for owners who might be looking to upgrade their housing and less impactful for downsizing households. The result: there could be an acute decrease in housing market liquidity further exacerbating housing shortages that have been major drivers of the recent increases in home prices in high-price markets—with the Bay Area and New York serving as perfect examples. In this scenario, tax reform could lead to higher home prices in the near-term.

From a multifamily investor's perspective, this is all good news. The broader, positive economic effects of the TCJA support incomes, jobs and ultimately owners' ability to raise rents. At the same time, reduced tax benefits for homeownership suggest that even as incomes rise, more households will continue to rent, supporting occupancy and rent growth. Just as the impact on home prices is more significant in higher income, higher tax, higher priced markets, multifamily owners/investors in these same markets will benefit the most. The Urban Institute estimates that the break-even rent (compared to owning) for a three-person household making $150,000 a year would increase 25% as a result of the TCJA—and this assumes only moderate local tax levels.

This does not mean that rents will rise 25% overnight. It does suggest that current renters will transition to homeownership at a lower rate, a trend that will be especially prevalent among the affluent in higher tax markets. As these renters' incomes increase, they will be more likely to move to a more luxurious (i.e., higher priced) apartment than to purchase a home. Similarly, renter households that might otherwise have considered buying a home in a suburban location to support a growing family are likely to be more attracted on the margin to two- or three-bedroom multifamily units in such a location. These trends are not new, but the effect of tax reform provides further impetus. The recent tax reform is particularly supportive of multifamily in high cost-of-living, high-tax, mostly coastal multifamily markets where it will benefit primarily Class A product. It will also tend to support demand for larger, suburban units—and single-family rentals—particularly in neighborhoods with strong school systems. For value-add investors, increasing income and increasing break-even rents will translate into greater ability to achieve higher rents through redevelopment and repositioning strategies.

For more insight on tax reform and its impact on commercial real estate access The Great Tax Race report.

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