

Three Issues for Real Estate

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The Three

- Tax policy and real estate
- Fed running off mortgage balance sheet
- Trade

Tax reform

- Good for broader economy, bad for real estate?
 - Interest deduction
 - Treatment of depreciation
 - Rates
 - Like kind exchanges

Example

- Debt cost of 4.5 percent, Interest Only
- LTV of 65 percent
- Depreciation eliminated—cost of acquisition frontloaded.
- Enough passive income to offset passive losses
- Rate moves from .35 to .2
- Buying cap .05; selling cap .055
- NOI growth of .02
- Ten year hold
- Like kind exchanges vanish

Before and After

- ROE before tax reform is 8.5 percent
- ROE after tax reform is 10.4 percent
- Reason? Ability to expense up front
- Interestingly, cut in rate doesn't help real estate—its all about expensing it.
- Essentially an interest free loan from government—works like gearing, only better (because if property loses value, government gets the downside kicker).
- Questions
 - Will investors have sufficient income to take losses all at once?
 - Will existing buildings get same treatment as new buildings? If not, tax reform would reduce ROE on existing buildings
 - How will current owners be treated?
 - Will tax policy affect interest rates?

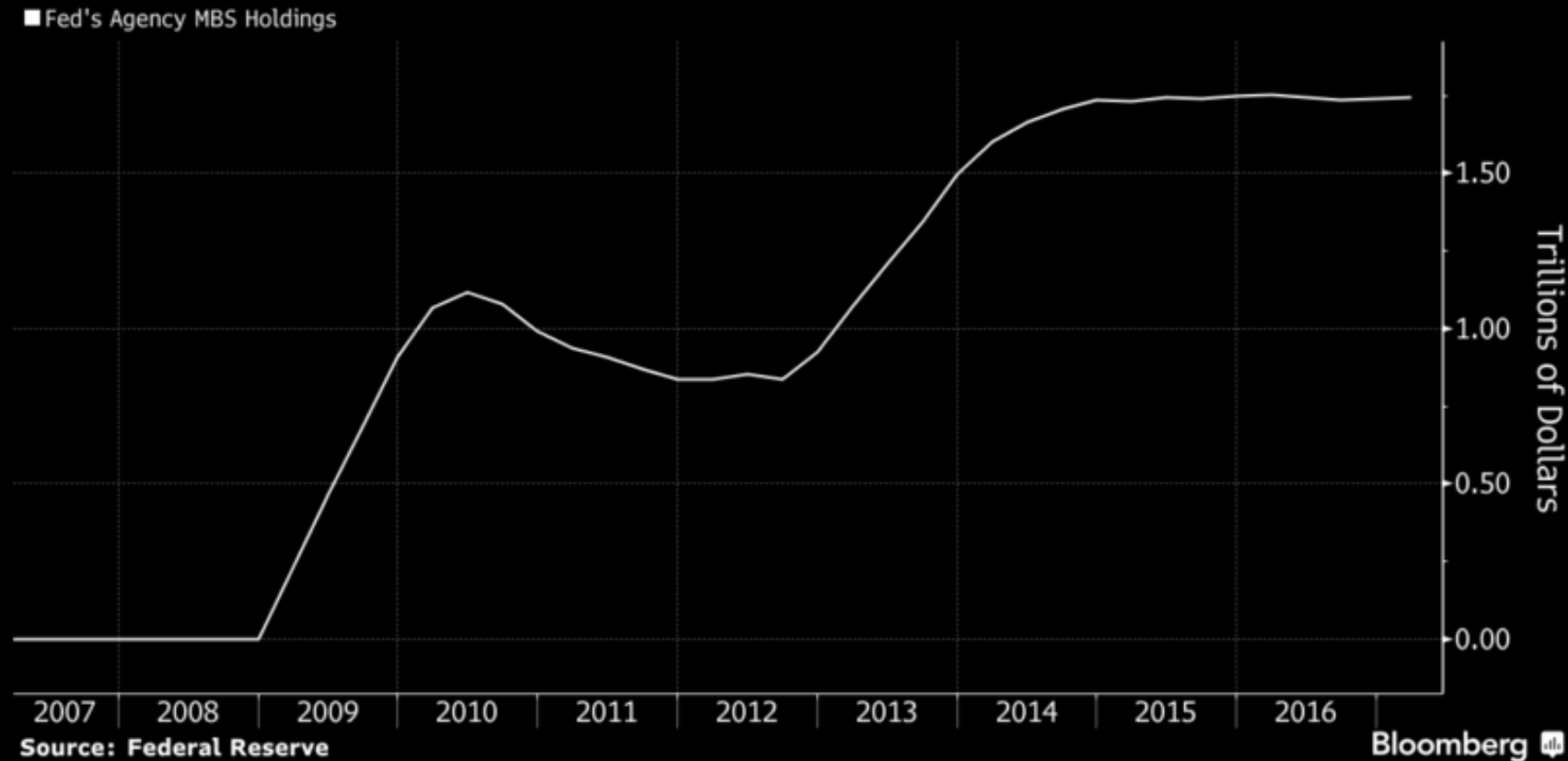
Funded with Border Adjustment Tax?

- Switch from origin based to destination based tax
- Current system taxes at point of production; BAT would more or less tax at point of consumption
- Exports would not be taxed at corporate level; imports would not be deductible.
- Econ theory says exchange rates should adjust to offset price effects, but...
- Retailers are lobbying heavily against the BAT

The Fed and Mortgages

Fed's Massive MBS Stash

Speculation rises that end of reinvestment is near



Why Do We Have Our Mortgage System at All?

- We are unique, in that our mortgages are:
 - Fixed term, fixed rate
 - Freely pre-payable
 - Often have low down-payments
- Without government backing, this goes away.
- Is it worth it?



Trade drives California

- 18 percent of imports into US come through California
- More than a billion square feet of filled industrial space happens because of trade
- The supply chain is becoming increasingly integrated across nations—hard to say what domestic content is anymore (think about last time you bought a car)

My controversial views on trade

- NAFTA was a good deal for the US
 - Mexico cut its tariffs far more than the US—and raised standards too.
 - Admitting China into WTO had far bigger impact on manufacturing employment
- The trade deficit is driven by capital account surpluses
 - Americans are not great savers
 - US investments are desirable to rest of world
 - We export capital in exchange for importing goods
- Trade is not the principal source of US manufacturing job loss (this is actually not controversial).

The big issue

