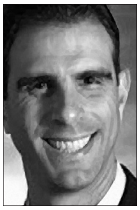
Washington's Current Musings and Their Effect on Real Estate Investing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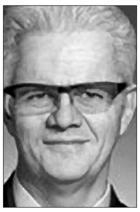
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In this article, we discuss some of the proposed changes coming out of Washington that may affect the real estate investment environment for PREA's domestic and foreign institutional investor members. This article was written in early January; by the time it is published, some of what we suggest might have happened and some might have bitten the dust.

Tax Policy

Although it appears the gridlock that has marked the past six years of federal tax policy may be about to end, the outcome of the 2016 presidential election may be a mixed blessing for real estate investors. Though dissimilar in many ways, the tax plans proposed by the Donald Trump administration and the House GOP overlap in meaningful areas, and it is possible that some of the most dramatic changes in tax law since the Tax Reform Act of 1986 may be enacted. Many hold as an article of faith that Republican control of the government must result in a better tax environment for real estate investment. However, as many veteran real estate investors will remember, the Tax Reform Act of 1986, which imposed the passive activity loss limitation rules, eliminated the tax rate differential between capital gains and ordinary income, and lengthened the depreciation period for real property, was a significant (if not the principal) contributor to the real estate recession of the late 1980s, in part because it caused certain then-traditional sources of real estate capital to dry up.

Among the key areas of potential change being bandied about are the following:

Reduce Tax Rates and Restrict Tax Deductions

Both the Trump administration and the House GOP propose consolidating tax rates into fewer brackets, capping the highest tax rates well below current rates (ordinary income taxed at 33% for individuals, 15% to 20% for corporations), and eliminating the individual and corporate alternative minimum tax and the surtaxes imposed to support the Affordable Care Act. Both also reduce taxation of investors in pass-through entities, such as partnerships, S corporations,

and limited liability companies to either a top rate of 25% (House GOP plan) or a rate of 15% on undistributed income plus a 15% tax rate on distributions (Trump administration's plan).

These tax reductions will not, however, come without a cost. Both the Trump administration and the House GOP also propose eliminating or restricting most individual and business deductions and most business credits other than the research and development credit. With respect to real estate, the most significant tax deductions that may be eliminated or modified are the deductions for state and local property taxes and deductions for business interest (including the possible restriction of the individual home mortgage interest deduction). In other words, although tax rates will likely be lowered and brackets simplified, the net impact of those lowered rates on the real estate industry will ultimately depend upon the impact of eliminated deductions and credits. From the institutional investor perspective, eliminating the interest deduction will likely tilt the capital stack toward increased equity investment relative to debt, possibly impacting capitalization rates and the promotes sought by the sponsors/developers as well as reducing risk capital available from high-net-worth individuals. It may also cause investors currently participating in capital stacks as mezzanine debt to, instead, participate as preferred equity.

Reform Cross-Border Taxation

Over the past several years, many tax reform advocates have argued that the US "worldwide" tax system and high nominal tax rates have made the US business environment increasingly noncompetitive compared with that of other developed nations. Under current US tax law, US citizens and businesses are taxed on all income earned anywhere in the world but are provided exceptions for certain business income of foreign corporate subsidiaries and are given credits for foreign taxes paid. Because of this complex system, multinational tax planners have long advised their clients to minimize their business footprints in the United States. A well-publicized symptom of the purported ill health of the US tax system has been that US multinationals are reluctant to repatriate the untaxed business income of their foreign corporate subsidiaries. The Joint Committee on Taxation estimates that roughly $2.6 trillion is "trapped" in offshore profits, which if repatriated to the US would generally be subject to a tax rate (less foreign tax credits) of up to 35%.

The Trump administration and the House GOP will likely make dramatic changes to US cross-border tax policy. First, both indicate they will propose a tax repatriation holiday, charging a tax of 10% or less, to encourage multinationals to bring their non-US cash earnings back to the US. Second, although Trump's view on the matter is not entirely clear, Congress will strongly push to move the United States from a worldwide tax system to a territorial or border-adjustable tax system. These efforts, combined with the overall reduction of US tax rates and business investment incentives, aim to make the tax environment in the United States friendlier for domestic and international investment. Under a more favorable environment, foreign investors may be more willing to invest directly in the United States rather than using offshore structures, and the impact of the Foreign Investment Real Property Tax Act in discouraging some foreign investors may be reduced.

Immediately Expense Invested Capital

Under current law, capital investments are depreciated, which means that although they create tax deductions, those deductions must generally be spread over several years. In a dramatic departure from longstanding tax policy, both the Trump administration and the House GOP are expected to propose making capital investments, including acquisitions and improvements of real estate business and investment property, immediately deductible. Part of the quid pro quo for this benefit, as noted previously, is the elimination of (or significant limitation on) the deductibility of business interest paid for borrowed money. The up-front increase in the depreciation deduction may attract more taxable investors and postpone the entry of tax-exempt investors until the projects produce taxable income. Further, if the elimination of the interest deduction results in a shift in the capital stack toward equity investment, issues related to debt-financed income and unrelated business taxable income may disappear, thus affecting the structuring of joint ventures with pension funds and endowments.

The policy objectives behind these proposals are clear: to incentivize a substantial expansion of business investment but to discourage borrowing and instead encourage businesses to deploy their own capital into the economy. These policy proposals dovetail with the tax repatriation holiday described earlier. By turning longstanding tax policy regarding depreciation deductions and the deductibility of business interest upside down and by inviting the repatriation of non-US profits at a reduced tax rate, the Trump administration and the House GOP will attempt to unleash the cash of US multinationals "trapped" abroad into substantial new capital investment at home.

Restrict or Eliminate Section 1031 and Change Carried Interest

Two principal tools of tax planning for real estate investors will be under particular pressure in the upcoming environment of tax policy reform. Although the House GOP and Trump administration have been silent on the topic, there is concern that like-kind exchanges under Section 1031 may be significantly restricted or eliminated in the search for offsets to tax rate reductions and investment expensing benefits. In addition, Trump has specifically targeted carried interest (ownership interest in the appreciation of an investment's value), which under current law and practice is taxed at capital gains rates, for taxation at ordinary income tax rates. Because there is no overlap between the Trump administration and the House GOP on these two tax strategies, it is challenging to predict what, if anything, might happen with them in 2017. Although eliminating Section 1031 may not have a material impact on institutional investors, changes that affect carried interest could have significant impact on return rates because the sponsors may demand tax-adjusted returns to compensate for the risks they assume or more risk assumption by institutional investors.

Infrastructure Investment: Public-Private Partnership Expansion

In one of his bolder tax policy plans, Trump proposes funding $1 trillion of new infrastructure investment in the next ten years. The details have not been publicized, and Congress may resist the size of the investment, at least to the extent the cost increases the federal deficit, but the major aspects, as announced, involve using public-private partnerships (P3s) as sponsors of the projects and using tax credits rather than government outlays; in the latter case, the work performed might better match with the tax savings. Under traditional tax credit finance structures, tax credits are used to bridge the equity gap in funding for socially desirable (and politically favored) investments, including low-income housing, renewable energy, business in low-income communities, and the

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like. Complete details are not yet available, but initial indications are that the Trump administration's infrastructure plan will include an 82% tax credit for equity invested in certain infrastructure projects, which the government will recoup in the form of incremental tax revenue generated from such projects. The House GOP cites a lack of details and does not weigh in on Trump's infrastructure plan, but the cost of the tax credits has many in Washington, DC, doubting that the plan will come to fruition. Nevertheless, if it does, it could create a significant new pathway for real estate and project investment in the United States.

In certain circumstances and types of projects, P3s work well in developing new projects or rehabilitating existing projects, and major public pension funds show interest in investing in these types of projects because generally they are projected to provide a steady return, which may be higher than core returns. But for a P3 project to generate a return, it must charge a healthy toll or fee for usage, and not all infrastructure projects lend themselves to providing a direct financial return; the public's willingness to pay direct usage fees for common services used by all is limited. Thus, the use of P3s, even with tax credits, may not work financially for all infrastructure projects.

To date, P3 projects are often financed with tax-exempt municipal bonds, and the need for equity as a percentage of total capital investment has been small. With the concerns at the state level about the amount of debt required to be issued, especially if the income from a project is at high risk, the capital stack is likely to change, requiring greater amounts of equity to fund such projects. Further, the rise in interest rates may have an adverse impact. As we see it, the use of tax credits as a method of enticing equity investment in infrastructure may increase the interest of Wall Street and its stable of wealthy investors, large contractors seeking to get the work, and foreign capital that could structure investments to realize the direct or indirect benefit of the tax credits.

Given the tax status of pension funds, however, allocating federal tax credits to them is not of any real benefit, and investing in municipal debt is not an attractive investment. Further, reallocating or transferring such credits by US pension funds to others creates glaring tax issues (even for those public funds that pay only lip service to unrelated business taxable income). Nevertheless, significant tax-exempt capital available for infrastructure projects appears to be "sitting on the sidelines" if a mutually beneficial arrangement can be reached, and the challenge is designing a financing scheme that works for the various constituencies.

Not all will be lost for pension funds if the tax credit scheme is adopted, because it is most likely that such a financing method will be directed only at new projects designed to create jobs and new capital investment. Thus, the door for equity investment in existing projects may open wider, and pension funds could well find a home for equity investment in these projects, thereby obtaining a higher return than is currently available in the marketplace.

High Volatility Commercial Real Estate

The High Volatility Commercial Real Estate (HVCRE) regulations within the Basel III capital requirements became effective January 1, 2015, and require that acquisition, construction, and development (i.e., non-permanent) bank loans be subject to a 150% risk weight requirement. For most commercial loans to avoid HVCRE status, the regulations require, among other things, a 15% equity infusion at loan closing, an 80% loan-to-value based on the estimated "as completed" value, and a prohibition against the withdrawal of internally generated capital throughout the term of the loan. To satisfy the equity requirement, any appreciation of land value (between the time of acquisition and the time of loan closing) is not included. The regulations apply not only to new loans but also to loans already on banks' books.

After the regulations became effective, the Office of Comptroller of the Currency issued a Frequently Asked Questions memorandum on HVCRE, but many questions remain unanswered, causing difficulty for lenders and borrowers.

Because of the regulations, banks have had to factor in the additional risk weight requirement in their pricing should a loan not be exempt from an HVCRE designation. In some cases, the change in pricing caused transactions not to move forward or borrowers to seek similar loans from non-banking institutions.

Under the Trump administration, certain clarifications and changes to the regulations may be possible. For example, the prohibition against the distribution of internally generated capital may be revised, or new legislation may allow the inclusion of appreciated property value to meet the 15% equity contribution requirement.

Unless and until clarifications and changes to the regulations are implemented, borrowers may continue to look to alternative lending sources not subject to the HVCRE regulations for acquisition, construction, and development loans.

Risk Retention

The Dodd-Frank Wall Street Reform and Consumer Protection Act included provisions for risk retention in securitizations, which require generally that sponsors of securitizations retain 5% of the securities issued. A special rule for commercial mortgage-backed securities (CMBS) permits the 5% retention requirement to be satisfied by a third party that purchases the junior tranches of the securitization (a B-piece holder). Final regulations implementing the risk retention requirement took effect on December 24, 2016. Many industry participants suggest that these regulations will increase interest rates on future securitized mortgage loans by about 30 basis points.

The risk retention regulations contain several provisions the industry has criticized. It will be possible for new administration appointees to revisit those issues and revise the regulations, but that process may be slow and uncertain. Alternatively, a bill proposed last year may resurface; the Preserving Access to Commercial Real Estate Capital Act of 2016, H.R. 4620, moderates the current regulations in three major respects.

- The first such provision of H.R. 4620 exempts securitizations involving a loan or group of cross-collateralized loans to a single borrower from risk retention. The industry has argued that such single-borrower transactions do not generally feature the sort of aggressive underwriting that has resulted in problems for CMBS securitizations.
- The bill expands the current exemption for "qualifying CRE loans," loans exempt from risk retention because they satisfy specified conservative underwriting criteria. The current regulations exclude interest-only loans from the qualifying-CRE-loan category, no matter how conservatively the loan is underwritten. H.R. 4620 reverses this categorical exclusion and also softens the applicable rules regarding loan terms, amortization terms, and appraisal requirements, all of which the industry has criticized as unduly onerous.
- The bill affords greater flexibility to B-piece holders by permitting them to divide the 5% junior tranche into senior and subordinate interests to be held by different parties.

Regulatory Changes Affecting Interest Rate Risk Management

Risk Management and Legal Compliance After the Zero Rate Era

Federal Reserve rate hikes increase borrowing costs and necessitate the use of fixed-for-floating interest rate swaps and other instruments at a time when these ubiquitous risk management products are subject to a comprehensive and still relatively new body of law and regulation worldwide.

Six years before Trump was elected president, the primary derivatives regulator in the United States, the Commodity Futures Trading Commission (CFTC), was itself subject to a statutory mandate to comprehensively regulate over-the-counter (OTC) derivatives that included interest rate swaps pursuant to Title VII of the Dodd-Frank Act. Thus, the CFTC subjected many interest rate swaps to a "clearing mandate." Market conditions and policy changes in 2016 and 2017 require new focus on applicable laws and regulations, such as the clearing mandate as well as the legal documentation needed to come into compliance with dealer and legal requirements.

The Clearing Mandate for Interest Rate Swaps

With the CFTC's September 28, 2016—under Dodd-Frank Section 723(a)(3)—inclusion of several additional classes of interest rate swaps as subject to the clearing mandate, as of today, the vast majority of OTC interest rate swaps with a US person must now be executed on a regulated exchange and cleared or settled by an approved clearinghouse. Otherwise, interest rate swaps that are subject to the clearing mandate are unlawful under Section 2(h)(1)(A) of the U.S. Commodity Exchange Act.

What is the clearing mandate? If the CFTC identifies one or more derivatives (as was the case when the CFTC designated certain interest rate swaps years ago and most recently on September 28, 2016) as subject to the clearing mandate, then market participants in institutional real estate and other industries are required to execute and settle the derivatives in much the same way that futures are executed and settled (by means of a regulated exchange and clearinghouse) unless an exception applies. Generally, an exception to the clearing mandate is available to certain entities hedging commercial risk so long as those entities are not deemed "financial entities"—a term that includes certain benefit plans as defined in paragraphs (3) and (32) of Section 3 of the Employee Retirement Income Security Act of 1974—and other conditions are satisfied.

The statutory intent and regulatory design of the clearing mandate are to reduce systemic risk within the global financial system and to make the system more transparent. Perhaps ironically, the clearing mandate concentrates risk in clearinghouses typically owned by many of the global investment banks and affiliates that experienced financial difficulties eight years ago.

The CFTC's implementation of its most recent clearing mandate and designation of interest rate swaps denominated in nine additional currencies (including Canadian and Australian currencies) took effect on December 13, 2016, around the time that the Federal Open Market Committee announced its rate increase.

These regulatory mandates and Federal Reserve policy announcements necessitate new focus in 2017 on interest rate risk management, regulatory compliance, and legal documentation to bring about compliance with the clearing mandate and other Dodd-Frank requirements.

Reconsideration of Regulatory Mandates In the New Administration

The White House Office of the Press Secretary issued a January 20, 2017, Memorandum for the Heads of Executive Departments and Agencies imposing a regulatory freeze on regulations that have not yet been published in the Federal Register, as well as a 60-day delay on regulations that have been published in the Federal Register but have not yet taken effect. Aside from this development, we forecast no immediate change in the US regulation of products to manage interest rate risk. Market participants seeking relief from regulatory burdens connected with the announced regulatory rethink promised by the Trump administration will need to be patient at least with respect to interest rate–related risk management.

Over the past six years, massive efforts to comply with the completely new and comprehensive law of derivatives make regulatory adjustment unlikely in 2017—especially concerning the clearing mandate. This mandate is but one of hundreds of new rules proposed and finalized since 2010 and before January 20, 2017, to implement Dodd-Frank by the CFTC and the Securities and Exchange Commission (SEC). There is no indication from either commission that the clearing mandate will be effectively undone by the Trump administration.

The CFTC, which regulates interest rate swaps in the US will, at least in the short term, be led by J. Christopher Giancarlo, an existing commissioner in line to be chairman of the CFTC in the Trump administration at the time of this writing. The other primary US regulator of derivatives is the SEC; Trump has nominated securities attorney Jay Clayton to chair the SEC. The CFTC has generally completed its derivatives regulations and the vast majority of CFTC risk management and hedging regulations were published and finalized well before January 20, 2017. The SEC will finalize new rules that pertain to security-based swap execution facilities (exchanges for credit default swaps and derivatives based on SEC-regulated instruments), and the SEC will set capital and margin requirements for security-based swap dealers and other market participants.

As interest rates move higher over time, it is unlikely that either CFTC or SEC regulations in the areas of interest rate management or security-based swaps will substantially change, at least in the short term, given widespread industry acceptance of the vast majority of rules now in effect. ■

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