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Opinions on how laws are affecting CRE

CRE Professionals and the New Tax Law

Understanding cost segregation and increased depreciation deductions

BY MARK BRIDGE

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As property owners and CPAs become more familiar with the benefits of the new tax law — including utilizing cost segregation, accelerated depreciation and expense rules, bonus depreciation, and Section 179 expensing — I believe real estate professionals should see two significant benefits.

The first benefit should be an increase in 1031 exchanges and sales velocity in the marketplace. I see purchases, sales, and 1031 exchanges increasing due to the benefits of cost segregation and increased depreciation deductions. Cost segregation has been around for over 30 years, but now using it to identify eligible tangible personal property and land improvements has more benefits than it did prior to the recent tax-law changes. Owners with larger cash flows and little write-offs, who have been quiet on the sidelines prior to the new tax advantages, may now see opportunities for larger tax savings by purchasing or doing a 1031 exchange. After speaking to their CPAs and agents, these owners could become active in the market again, increasing velocity, pricing, and broker commissions in 2019.

The second benefit is additional potential income write-offs against owners' own investment and brokerage incomes. Identifying the five- and seven-year personal property along with the 15-year land improvements in a cost-segregation study has the potential to be used then as write-offs against other passive income such as brokerage commissions or other building income. Also, real estate professionals can decide which category to utilize, if any, in year one. So, depending on the category amount and your commission income, you may only want to deduct the 15-year land improvements in year one, but if you are having a great year you may want to deduct all three categories in year one. Brokers who buy real estate this year have the wonderful potential to significantly reduce the taxable income they will owe by using these benefits.

Since personal property can no longer be exchanged, gain on personal property sold is subject to tax, so if accelerated depreciation was taken in the past, sellers may have recapture issues. Sellers who are reinvesting need to make sure that their upleg has enough personal property to depreciate and cover the gain on sale and ideally more to depreciate in an amount in excess of the gain on sale. Not all real estate agents have the funds to purchase a property, but you can see how the advantages of paying less tax on your commissions is motivation to purchase one. If needed, you could even partner up with trusted colleagues that share your same investment strategies.

I have heard from some agents and investors that they are seeing a low amount of inventory of available single-tenant net-lease retail properties for sale. Although I personally see a decent supply of these in the market, there could be two contributing factors to their view.

The first factor is that there are increasingly more buyers entering the marketplace for this investment type. Since this product type is easier to manage than some other product types like multifamily, we see certain investors doing 1031 exchanges out of multifamily and other more management-intensive investments into these single-tenant net-leased retail investments.

The second factor I see is that rising interest rates have contributed to an increase in cap rates. The second quarter of 2018 saw a 10-basis-point increase, which was the largest quarterly increase since 2011. This pushback in pricing could have prevented some sellers from listing or removing their property from the market, rather than lower their pricing expectations.

One way that buyers can overcome the problem of scarce inventory is picking and working with a good agent at each of the larger firms. This way, they would have multiple pools of inventory to search from with their agents. And since a lot of listings will sell before they become visible to competing firm agents, they will also see better opportunities. The better listings sell in-house prior to going onto public listing websites, where a competing firm agent might be searching for available listings. Buyers could be missing out on a lot of good inventory by only searching these public listing websites.

Mark Bridge is first VP investments and a national multi-housing group director with The Bridge Group at Marcus & Millichap. He is also a multifamily owner who has operated, managed, and syndicated multifamily purchases and completed many of his own 1031 exchanges.

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