Volume 31, No. 4, January 26, 2018

QUARTERLY UPDATE

CWS CAPITAL PARTNERS LLC

CWS Capital Partners LLC

CWS

CALENDAR OF EVENTS

March 15, 2018
Year 2017 K-1's Mail by Date

March 30, 2018
Good Friday
CWS Offices Closed

April 17, 2018
2017 Fed & State Tax Filing Deadline
1st Qtr. 2018 Est. Tax Payments Due

April 27, 2018
1st Quarter 2018
Quarterly Packages Mailed

May 8, 2018
CWS Annual Partners Meeting
Hotel Irvine (Irvine, CA)

May 28, 2018
Memorial Day
CWS Offices Closed

June 15, 2018
2nd Quarter 2018
Est. Tax Payments Due

July 4, 2018
Independence Day
CWS Offices Closed

July 27, 2018
2nd Quarter 2018
Quarterly Packages Mailed

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TAX REFORM: VERY FAVORABLE FOR RENTERS

By Gary Carmell

Tax reform is a big deal and that is why it does not happen very frequently. It can also have some very large unintended consequences. The 1981 tax law sparked a tremendous wave of real estate investment and development because passive investors could write off their losses against ordinary income. It created a huge flurry of tax-focused investing versus supply and demand based decision making. It led to a terrible misallocation of capital.

Ahh, but what Congress giveth Congress can taketh away. The 1986 tax law changed this feature by only allowing passive losses to be taken against passive income unless you were an active real estate professional. This took a lot of capital out of the system at a time when there was way too much building. This helped lead to the S&L debacle and the collapse of real estate values led to the creation of the RTC. The tax reform of 1981 was designed to help get the United States economy out of a terrible recession while the 1986 act unintentionally helped put the country into one.

So what about the 2017 tax changes? My thoughts will be from the perspective of a company that invests in apartments with a

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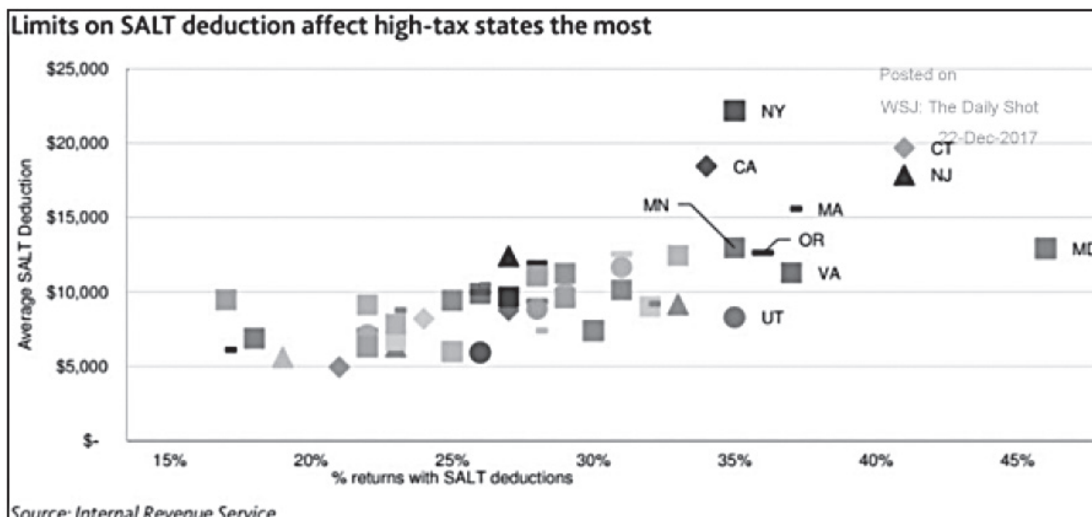
large presence in the major cities in Texas, Atlanta, Raleigh and Charlotte, and a growing portfolio in Denver, Phoenix, and Seattle.

While most parts of the country will not be significantly impacted by the mortgage interest deduction being reduced to loans not to exceed $750,000 for future home purchases, some will be hit pretty hard. While according to Attom Data Solutions only about 4% of purchase mortgages originated in 2017 exceeded $750,000, there are some high cost regions that will be significantly impacted. According to the *Wall Street Journal*:

> *In Manhattan, for example, 64% of purchase mortgages made this year were for more than $750,000, according to Attom. In San Francisco, that proportion is 58%, and the surrounding counties of San Mateo, Marin and Santa Clara register between 44% and 55%. Black Knight Inc., a mortgage data and technology firm, calculates there are about 684,000 active mortgages with current balances over $750,000. Black Knight estimates that about 107,000 loans expected to be made in 2018 would fall above the $750,000 cap.*

In addition to the mortgage deduction limitation disproportionately impacting high tax, high housing price states, particularly California, New York, and Connecticut, these states are also vulnerable because of the curtailment of write offs of state and local income taxes (SALT) and property taxes being limited to $10,000. This makes these states less competitive in some ways, although for high income earners who were paying the Alternative Minimum Tax, some of these deductions were limited already so they may not be hit as badly as one would initially think. The following chart shows the percentage of tax returns with SALT deductions and the average value of those deductions.



The above chart shows that the most exposed states are California, New York, Connecticut, New Jersey and to some extent Maryland. With the exception of Maryland, these states are very top

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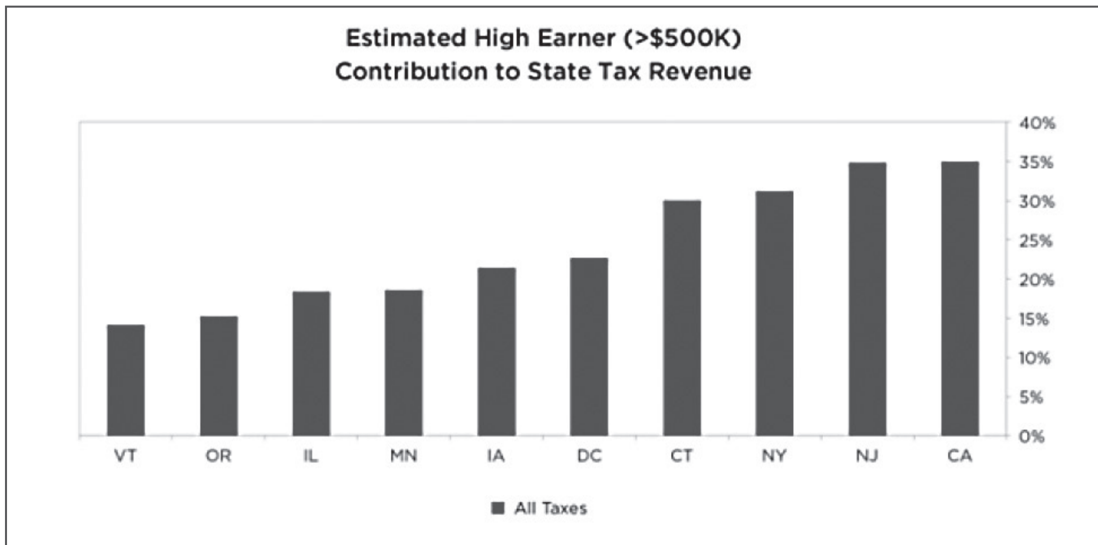
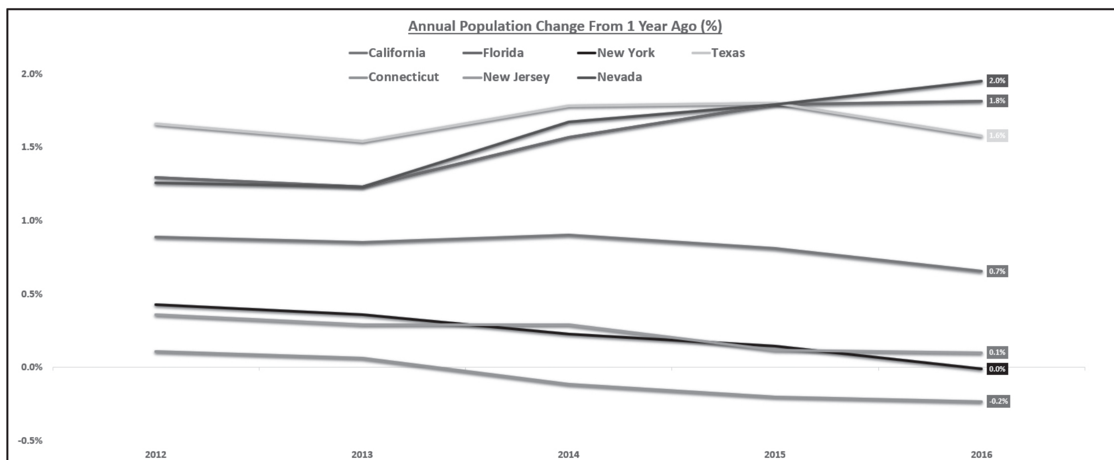
heavy in terms of high earners paying a very large percentage of state taxes. So the real question is will these changes result in high earners leaving these states for lower cost destinations? The following chart is from an interesting analysis done by Ray Dalio and shows why this question is so important.



For Connecticut, New York, New Jersey, and California, the top earners pay approximately 35% of the taxes. If these people stay put then these states should be able to absorb the higher costs of living there. If they leave, then real problems can arise. The first three states do not have the weather of California and as much foreign appeal so I see them as being far more vulnerable. They also have poor population growth characteristics as compared to higher growth states with lower taxes such as Texas, Florida, and Nevada as the following chart shows.



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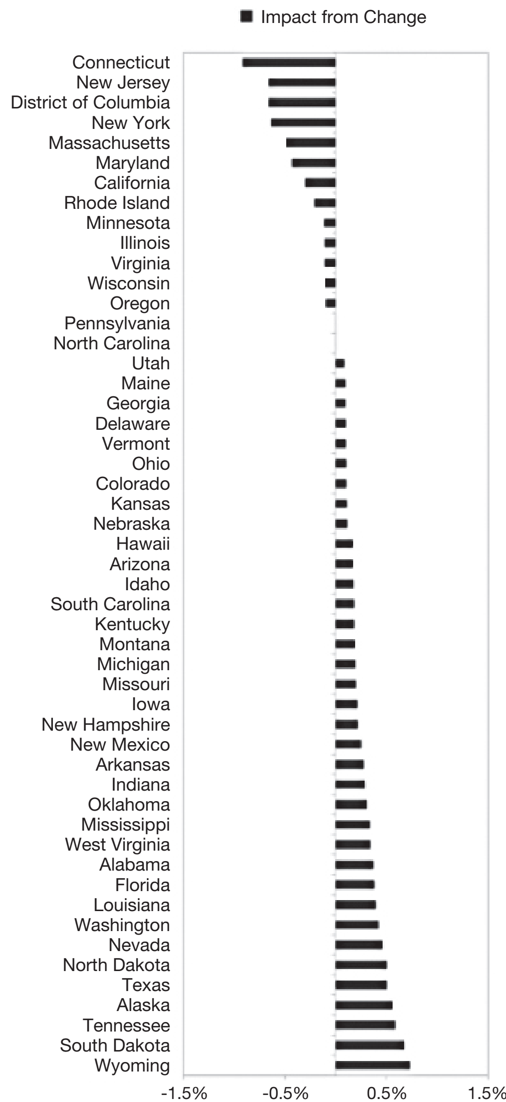
Clearly the latter three are growing at meaningfully higher rates than the first four. Here is how Ray Dalio sees the winners and losers from tax reform.



With the exception of North Carolina, which is neutral, all of CWS' primary investment markets are theoretical beneficiaries from the changes in the tax laws. We shall see how reality plays out. Dalio is pessimistic about the prospects for the most negatively impacted states because of the disproportionate impact that high earners can have on state finances and the overall economy if they pack up and leave.

For example, according to Dalio, in California 1.7% of the households make more than $500,000 per year. So the state is incredibly dependent on what these high income households do since, as mentioned previously, they generate approximately 35% of state tax revenue. And if they decide to leave and this ripples through to housing values and lower property taxes then the problems compound. After presenting some other information regarding population flows Dalio concludes the following:

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> *As you can see, everything points toward states like New York, Connecticut, New Jersey, California, and Illinois being the most vulnerable, and states like Florida, Texas, Nevada, Washington, and Arizona benefiting the most from this shift.*

CWS happens to be invested in all of those states expected to benefit with the exception of Nevada and Florida so from a CWS perspective this is encouraging.

With that being said there is a lot of talk among blue states about workarounds to preserve similar deductions so these states do not lose out from the tax law changes. As an aside, I was at a lunch and was talking to a partner in an accounting firm who said that they have already been told by their Washington tax experts that they have currently come up with 35 loopholes to help their clients, almost all of whom are in California. These changes will create enormous incentives for those negatively impacted by them to find loopholes to lessen the impact.

Let me turn again to housing as I think the new tax laws will benefit renting. According to Zillow, under the prior tax laws, approximately 44% of U.S. homes are worth enough to carry a mortgage with interest payments that would have been large enough to exceed the old standard deduction. This previously created an incentive for these taxpayers to itemize their deduction to take advantage of the interest deduction that exceeds the standard deduction. Now that the standard deduction will be doubled, this percentage drops to 14.4%

This clearly creates a more level playing field between renting and owning. While it may not change a number of people's decisions to purchase a home, what it does do is take away an incentive to buy a home as one can get just as big of a write off via the standard deduction by renting as they can if they are buying. In addition, renting comes without the capital intensity of homeownership and the illiquidity and immobility this sometimes engenders. At the margin, I can't see how it won't lead to more people staying as renters for longer, but time will tell.

According to Zillow, at least 23 million fewer households will be motivated to buy a new home under the new law. This seems quite high to me but if it's anywhere near that number, it will be beneficial for landlords.

Another impact on housing and the economy is that there will now be less incentive to take out home equity loans and tap into existing ones as interest will no longer be deductible.

Overall I think that landlords should benefit as well as lower cost, lower tax states that should see an economic boost due to more in migration from high tax, higher cost states. On the surface this would appear to be beneficial to CWS and other apartment owners invested in states like Texas, Washington, Arizona, Georgia, and Colorado.

I did an analysis of a new home purchaser in California buying a $1.0 million home and one in Texas buying one for $400,000 with both being married couples making $150,000 per year. They both borrow 80% of the purchase price at a 4.00% interest with interest-only payments. The California property tax rate is assumed to be 1.2% and 2.7% for Texas. The analysis is interesting in that it

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shows that home buyers using these price points and income levels are virtually break even on an after-tax, cash flow basis when factoring in property taxes, interest, and federal and state taxes. The analysis excludes loan amortization, foregone interest or interest earned on the down payment, and maintenance and insurance for home buyers. Renters, on the other hand come out much better. My rent assumptions are of course up for debate but it doesn't change the fact that the new tax laws are much more favorable to renters than the old one. Here is the analysis for each:

New Home Buyer

	Old California	New California		Old Texas	New Texas
Income	$150,000	$150,000		$150,000	$150,000
Federal Taxes	(16,728)	(16,079)		(22,978)	(19,599)
State Taxes	(4,705)	(4,705)		0	0
Interest	(32,000)	(32,000)		(12,800)	(12,800)
Property Taxes	(12,000)	(12,000)		(10,800)	(10,800)
Net	$84,567	$85,216		$103,423	$106,801

Renter

	Old California	New California		Old Texas	New Texas
Income	$150,000	$150,000		$150,000	$150,000
Federal Taxes	(25,728)	(19,599)		(25,728)	(19,599)
State Taxes	(8,053)	(8,053)		0	0
Rent	(48,000)	(48,000)		(36,000)	(36,000)
Property Taxes	0	0		0	0
Net	$68,219	$74,348		$88,273	$94,401

Diff. Buying/Renting	$16,348	$10,868		$15,150	$12,400

Renting is definitely on a much more even footing as it has become more cost competitive with owning and after maintenance expenses it is probably a push. Of course one gives up the opportunity for appreciation potential (and risk of loss) when one rents, but one also gains great flexibility. One can also see that Texas homeowners and renters bring home quite a bit more after taxes and housing costs compared to California. In addition, if one increases the home price by 50% for a California and Texas buyer, the advantages accrue much more to renting as home buyers lose more deductions that were previously available to them.

One never knows exactly what the consequences will be of such sweeping and comprehensive legislation like the 2017 tax reform, but it does seem like it has made renting an even more financially competitive option on an after-tax basis and should be beneficial to CWS over the long-term.