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President Biden's Tax Proposal and "The Perfect Storm" - What it means for real estate - by Robert Gilman

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In the movie, The Perfect Storm, based on a true story, the captain of the commercial fishing vessel, the Andrea Gail, made the fateful decision to head to the Flemish Cap where he expected his luck would improve. He was right—the catch was great—and wrong—there was a perfect storm straight ahead. He attempted to ride through it, however, two colliding weather fronts and a strong hurricane were more than the Andrea Gail could weather, and the entire crew was lost at sea.

President Biden's $1.8 trillion American Families Plan tax proposal is a perfect storm for the real estate industry. New York's real estate owners/investors would be particularly hard hit if certain changes in Biden's plan are enacted. Further, they would be coming during a challenging period for a nation still reeling under the effects of the pandemic, a recovering economy, and increasing public and private debt. For real estate owners and investors of all sizes, it is important to understand what may lie ahead to better prepare for imperative business decisions in the near future. The following are important proposed changes that will occur if Congress passes the American Families Plan:

Long-Term Capital Gains

Biden's tax plan would increase the tax on long-term capital gains for taxpayers with incomes over $1 million from 20% to 37% (the current ordinary rate) or to the proposed rate of 39.6% if the ordinary rates increase as proposed. In May, it was reported that this change could be applied retroactively to take effect as of April 2021, the month Biden introduced his tax plan. That means an asset sold after April 2021 would incur the capital gains tax increase.

Think of the proposed change to the long-term capital gains tax and ordinary tax rate increases as the weather fronts. Now for the hurricane – proposed 1031 exchange limits.

Changes for 1031 Exchanges

1031 exchanges have been used for decades in the sale and purchase of all property types. They enable a real estate investor to reinvest the sales proceeds from one property transaction to purchase another property and defer paying capital gains taxes.

Biden's proposal would limit the deferred gain for 1031 exchanges completed after December 31, 2021, to $500,000 per individual taxpayer and $1 million for married couples filing jointly. This change would not only impact the largest, wealthiest real estate investors, but many small investors. According to a National Association of Realtors (NAR) survey, from 2016 to 2019, an estimated 12% of real estate sales involved 1031 exchanges and 84% of the 1031 exchanges were by smaller investors (i.e., 47% sole proprietors and 37% S-corporation owners). Limiting deferred gain for 1031 exchanges will be the tidal wave to setting off the perfect storm, as the real estate industry would see an overall reduction of real estate transactions including a dramatic decrease of property sales. In return, this could potentially create a ripple effect for brokers, construction companies, subcontractors, etc. who benefit from real estate sales. In addition, state and local governments will lose transfer taxes which many, like New York State, depend on heavily. Rather than selling property, it may be financially beneficial to hold onto an existing property, as the 1031 benefit may shortly be unavailable.

Real estate investments made through limited partnerships might be less affected as the profit is divided among partners each of whose property gain could remain under the $500,000 threshold. An individual real estate investor, however, in a comparable transaction, would feel the full weight of the new $500,000 deferred gain limit.

As if these potential federal tax changes were not bad enough, New York State is increasing its tax rate for individuals earning between $1,077,550 to $5 million from 8.82% to 9.65%, and to 10.9% for earners making over $25 million.

Disrupting Multifamily Transactions

One sector expected to be significantly affected by the proposed 1031 exchange limits are multifamily properties. The sector performed well in 2020 despite rental income losses due to deferred rents during the pandemic. CBRE has forecasted multifamily properties to make a full market recovery in early 2022. A change in 1031 exchange tax provisions, however, could alter that, and coupled with the end of New York State's Affordable New York Program in June 2022, could have serious implications for the region's affordable housing market.

There are a variety of proposed changes in the American Families Plan that are not mentioned in this article, however, the changes noted above will greatly affect the real estate industry. The best words of wisdom for any real estate owner/investor are to proceed with caution and rely on trusted advisors for guidance. It is wise to run projections on any considered real estate transaction to see what the financial impacts would be under the proposed tax changes, especially relating to 1031 exchanges.

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