CoStar™

Investors Are Already Trying To Get Ahead of Potential Federal Tax Changes

Biden Administration Proposals Help Spur Recent Sales Activity

Potenial tax law changes proposed by the Biden administration are already rippling through the real estate investment community. (iStock)

By Mark Heschmeyer
CoStar News

May 6, 2021 | 10:21 AM

(Corrected on May 6 to say Scott Merkle is managing partner at SLB Capital Advisors.)

Commercial real estate investors have wasted no time rethinking their strategies considering the Biden administration's intention, revealed last week, to rewrite capital gains tax rules, including the reduction of a benefit that has been available in some form for 100 years.

The number of properties put up for sale in the first seven days since the announcement — 4,067 — was 10% more compared to the weekly average of the preceding three weeks, CoStar data shows. That points to a likely surge in deals as investors race to beat the timing of any potential tax increases.

And such an outcome is just the beginning of how a revision of capital gains taxes, including a possible rate hike from 20% to 39.6% and weakening so-called 1031 deferrals, could affect the market now and in years to come.

Investors are already accelerating their acquisition targets to tax-friendly states such as Texas and Florida, according to industry brokers and attorneys. In addition, players have started considering moving their money to real estate investments that would still retain capital gain deferral and elimination benefits, notably the federal opportunity zone program, one accounting expert said.

"There's been a lot of 'skies falling' talk for over a year because nothing in this framework was not anticipated," Alex DuFour, a real estate and finance lawyer at Cozen O'Connor in Washington, D.C., told CoStar News. "But I think what was a little surprising is the amount of the rate increase. And then, effectively almost total elimination of 1031 exchanges," he said of the popular tax break that allows investors to roll profits from real estate sales into similar purchases.

Biden's Proposed Changes

New tax rules are at the core of Biden's ambitious economic American Families Plan that calls for $1.8 trillion in spending and tax credits for provisions, including two years of free public post-high school education and financial assistance to families with children. The cost of the program would be funded by altering elements of the 2017 Tax Cuts and Jobs Act signed by former President Donald Trump as well as other changes.

The most prominent impact of the plan on real estate is the treatment of capital gains, according to Cozen O'Connor. The present capital gains rate of 20%, the lowest in a decade, would rise to 39.6%.

Biden's plan would remove the ability to shield capital gains above $500,000 from taxes. Such moves are called like-kind or 1031 exchanges, referring to Section 1031 of the IRS tax code that has been in place since 1921.

As a result, investors have broken off into two camps, according to DuFour. "One is 'Let's see what actually gets passed,' and the other is 'We have to take action now.'"

The latter group consists mainly of investors who have held on to their properties for a few years and were thinking of selling this year or next, DuFour said. The other includes those that have acquired properties more recently and are planning to hold them for a while.

The assumption is that if Congress approves the proposals, any potential tax law changes would take effect in January 2022, DuFour said. And that is what is leading to the rush to get properties on the market and sold by year-end.

"From a broader market perspective, restricting 1031 exchanges could generate a short-term surge of activity as investors liquidate assets that have significant appreciation and/or deferred taxes," according to John Chang, senior vice president and national director of research services at real estate firm Marcus & Millichap in an analysis emailed to CoStar. "These investors would try to clear the books before the new tax rules are put in place."

Size of 1031 Exchange Market

Like-kind exchanges make up a huge volume of overall property sales but even a more significant portion of net-lease sales, where the tenant pays for most, if not all, of expenses such as property taxes, insurance and maintenance while the landlord collects rent.

"On a macro level, an estimated 10% to 20% of commercial real estate transactions leverage the 1031 exchange," Chang said.

Last year, that percentage would have amounted to 1031 exchange property sales ranging between $48.7 billion and $97.4 billion, according to CoStar data.

"I don't think it would be prudent to hazard a guess as to what net-lease transaction volume would be without a 1031 market, but I do feel like it would be quite a meaningful impact," Scott Merkle, managing partner of SLB Capital Advisors, said in an interview. SLB specializes in sale-leaseback deals.

"The negative impact on the sale-leaseback market would be a reduction in the buyer pool. There would be a lot fewer high-net-worth and other individuals playing in these transactions," he said.

Tax Advantage for Wealthy

High-net-worth investors have been projected to be hit harder by the proposed changes than corporations. An estimate of federal tax expenditures for 2020 through 2024 from Congress' Joint Committee on Taxation reported that the benefit to individuals from 1031 exchange deferrals will amount to $29.4 billion versus a benefit to corporations of only $12 billion.

The 1031 exchanges are the "preferred method for net-lease deals because you've got a bunch of normally high-net-worth individuals wanting to defer their capital gains tax," Alex Sharrin, managing director of capital markets for real estate firm JLL in Chicago, told CoStar. "So, you're really talking about somebody's huge retirement nut. They're using the tax advantage to shelter wealth, to grow wealth and to maintain wealth."

Such investors are still going to try to maximize their returns by paying as little tax as they can on their real estate transactions, Sharrin and Cozen O'Connor's DuFour said. One way they are now seeking to accomplish that is to shift their buying to tax-friendly states.

The share of 1031 transactions has always varied by state depending on local tax levels, according to Marcus & Millichap's Chang. States with higher tax rates have tended to have a greater share of 1031 exchange transactions.

Now if they cannot defer capital gains taxes, more investments will shift to states with lower or no capital gains.

"I get asked by my clients every day: 'Hey Alex, what do you have in Texas?' and 'Hey Alex, what have you got in Florida?' … Those are probably the two most popular words from a capital perspective," Sharrin said.

Florida and Texas are among those states that have no additional capital gains taxes along with Alaska, Nevada, New Hampshire, South Dakota, Tennessee, Washington and Wyoming, according to data compiled by Realized, a web-based platform that lets investors exchange 1031-eligible properties.

Then there are a few cities such as New York where sellers must pay separate federal, state and city capital gains taxes. Under Biden's proposed increase, sellers in New York would pay out 58.1% of their gains to taxes, according to DuFour. That could reduce the number deals in the largest U.S. commercial real estate market.

Another shift in strategy investors are considering is qualified opportunity zone funds, and it is an option that has been overlooked in the initial clamor since the Biden announcement, according to Michael Novogradac, principal of San Francisco-based Novogradac, a real estate public accounting, valuation and consulting firm.

The White House's plans do not include any changes to the federal government's capital gains tax benefits for investing in nearly 8,800 federally designated low-income census tracts.

Current law allows investors to defer through 2026 paying tax if gains are invested in qualified opportunity funds. And if the gains are held by a fund for the next five years, the amount that would be taxed would be reduced by 10%, according to Novogradac.

As an additional incentive, investors holding opportunity fund investments for a period of at least 10 years are exempt from any additional gains beyond that which was previously deferred.

“We found that in most cases, if you were to defer the gain now [in an opportunity fund] at lower rate and pay a higher rate 2026, that the benefit of the 10-year step-up more than outweighs any additional tax you might pay in 2026 due to higher rate,” Novogradac told CoStar.

Novogradac’s clients are taking different approaches.

“There are definitely investors that are saying, ‘I’m just going to pay my tax now.’ And there are definitely investors that are saying, ‘Boy, this is all the more reason to be investing [in an opportunity zone],’” he said.

TRENDING

1. Growing 3D Printing Company Signs Full-Building Lease for New Headquarters

2. Cryptocurrency Platform To Shut Down San Francisco Headquarters as Remote Work Plans Outlast Pandemic

3. Meal Kit Firm HelloFresh Plans Expansion Into Phoenix

4. Sale Shows Demand for Southern California Industrial Space

5. Los Angeles Investment Firm Acquires Apartments in Tempe, Arizona

6. Cleveland Hotels Score with NFL Draft, Pizza Chain Adds Stores, Fewer

6. Cleveland Hotels Score with NFL Draft, Pizza Chain Adds Stores, Fewer Company Layoffs

7. AMC Theatres Looks Beyond Another Quarterly Loss to Prospect of Market Recovery

8. Hudson Pacific Properties Anticipates Tech, Media Tenants Bolstering Office Sector Growth

9. A Year After Pandemic's First Big Retail Bankruptcy, Department Stores Set New Industry Direction

10. Cushman & Wakefield Points to Higher Transaction Income in Traversing 'Uneven' Recovery