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2021 Proposed U.S. Tax Policy and its Effects on CRE

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United States government debt has ballooned as a result of COVID-19 related economic hardships and government intervention to provide financial assistance to businesses and citizens. With a change in administration after the 2020 election, public opinion on policy for personal, corporate and property taxes have pivoted with an intention to raise taxes to assist with repayment of the pandemic stimulus debt.

As a result, the current administration is proposing several changes. The American Families Plan will directly affect business owners, commercial real estate holdings and personal income taxes. If enacted, the policies will impact commercial property yields and likely how properties are traded and held in the future. It will also likely have an impact on new development and new investment in existing properties as well as the markets in which investors choose to invest.

On May 18, 2021, Marcus & Millichap presented a tax reform webcast to discuss proposed changes and potential impact of these actions. No one knows the exact timing of the proposed changes, should they pass Congress. Experts speculate the changes could be effective upon passing in the legislature or implemented at the beginning of 2022. It is unlikely the taxes will be retroactive to January 2021, but it is not without precedent. Jeffrey DeBoer, President and CEO of The Real Estate Roundtable, and Lisa Knee, Partner with EisnerAmper, provided insight as to how and when policies could be implemented, noting the following proposed changes:

1. **Top Tier Tax increase.** The top tax rate was lowered from 39.6% to 37% in 2017. The new proposal reverts the top tier to 39.6%. (Plus an added 3.8% Healthcare tax for an effective rate of 43.4%.) Earnings thresholds for single filers is $524,000; for joint filers: $628,000. Projected revenue over the next 10 years is $116 billion.
2. **Doubling of capital gains tax.** Existing capital gains rates are 20%. The proposed capital gains rate could rise to 39.6% on gains over $1 million. The potential unintended consequence is to discourage investment in properties (especially past the point of diminishing return—properties held for an extended time).
3. **Limiting the availability of 1031 Exchanges.** Approximately 10% to 20% of commercial transactions use a 1031 Exchange to reinvest equity and debt into a new property investment and defer taxes on gains on the property sold—a like kind property. Like kind exchanges allow for liquidity in the market and reinvestment in both new and existing properties after the sale which in turn creates jobs and adds local sales revenue and taxes to the local economy. The potential unintended consequence is a reduction in transaction activity and a reduction in capital investment and development.
4. **Eliminating the Step Up in Basis.** Taxpayers receive a basis step-up to current market value of real estate inherited from an estate. It wipes depreciation upon inheritance; reduces complex record keeping; and reduces the risk of severe estate taxes. Unlike a securities holding of 1000 shares of stock where the heir can sell 100-200 shares to pay the capital gains tax, an heir of CRE is likely to have to sell the real estate asset to pay the taxes on the inherited property. Rarely can properties be subdivided and sold. The proposed changes eliminate the step-up basis for gains of $1 million (or $2 million or more for joint holding), as this becomes an estate "death tax" obligation of total gain at time of death.
5. **Taxing Carried Interest as Ordinary Income.** Carried interest is the value creation by managing partners based on "sweat equity," a non-capital investment. At the time of disposition of an asset, it is currently taxed as a capital gain. In addition to direct capital contributions to an investment, managing partners often provide expertise and time, and assume other risks/ responsibilities for the investment. General partners of real estate investments, developments, investment partnerships such as private equity and hedge funds can all be affected. Projected revenue by this policy is $7.4 to $14 billion over the next 10 years. The unintended consequence is disincentivizing risk taking and entrepreneurship, especially on real estate development, reuse, and value-add projects. The impact could be felt by supply-short property types.

A coalition of 18 commercial real estate organizations is advocating for Law Makers' education, raising awareness of tax law implications on real estate from these proposed changes. Meanwhile, as investors, take heed of the proposed changes and understand how they could affect your portfolio value, financing and timing of acquisition, disposition and hold times.

Economic recovery is underway. From April 2020 through April 2021, total employment added 14 million jobs after a loss of 22 million jobs from February 2020 through April 2020. From July 2020 through April 2021, core retail sales increased 14.7%. Mutual fund and savings deposits grew by $4.3 trillion through April 2021.*

Will the proposed tax changes be taxing on CRE and a speed bump to economic recovery? Or will the taxes be absorbed as a cost of doing business and continued CRE investment will aid and accelerate the recovery?

Hear more from leading policy experts from The Real Estate Roundtable on Aug. 10 as CREW Network hosts a complimentary webinar, How the Build Back Better Plan Will Impact CRE. Learn more about what this means for you, your company and commercial real estate.

**Core retail sales excludes auto and gasoline sales. Includes investment in prime, government and tax-exempt funds for retail and institutional accounts. Sources: Marcus & Millichap Research Services, BLS, U.S. Census Bureau, Office of Financial Research, Board of Governors of the Federal Reserve System.*