

How the Biden Administration's Proposed Tax Plan Could Affect Your Real Estate Business

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There's no telling what policies from President Biden's new tax plan will pass through Congress, but what we do know is that there are some key items you should be aware of if your business is in the real estate industry.

President Biden's \$1.8 trillion "American Families Plan" (AFP) proposal presents tax

policy changes that will greatly affect the real estate industry, including an increase in the capital gains tax rate and limits on the use of 1031 like-kind exchanges.

To understand the gravity of the impact these proposed tax changes will have on the real estate sector, it is important to understand the Tax Cuts and Jobs Act (TCJA). In 2017, the real estate industry caught a much-needed tax break when the TCJA was signed into law. The new bill unlocked various benefits and substantial savings for the real estate industry, including, but not limited to, a decrease in the corporate tax rate, a 20% income exclusion for owners of flow-through entities, a decrease in the highest personal marginal tax rate, and that income earned on carried interest held less than 3 years was taxed as short-term capital gains.

It is important to note that some of the changes instituted by TCJA were modified under the CARES Act. Nevertheless, the legislation produced positive outcomes for the real estate industry and enabled the sector to spur economic activity. This has proven to be a short-lived victory as the Biden administration's proposed tax plan could modify many of the favorable facets of TCJA.

For example, the AFP would make the TCJA-implemented excess loss limitation provision, or net losses a taxpayer can take on their personal return of \$250,000 for single filers and \$500,000 for married couples filing jointly, permanent. The new plan would also increase the maximum personal income tax rate to the pre-TCJA level of 39.6%. The AFP would also increase the tax on long-term capital gains and qualified dividends for taxpayers with income over \$1 million from 20% to 39.6%, beginning retroactively from April 2021 when the proposal was first introduced.

Beyond striking down many of TCJA's benefits, the AFP notably limits the deferred gain from a 1031 exchange completed after Dec. 31, 2021, to \$500,000 per taxpayer and \$1 million for married couples filing a joint income tax return.

For example, assume you have a partnership with five partners, each owning 20%, and the partnership does a 1031 exchange that generates a \$2.5 million gain, then each partner can defer their entire gain. However, assume the same facts, but that one partner owns 50% and the other partners own the remaining 50% in equal shares, and the gain allocable to the partner owning 50% would be \$1.25 million. If this partner files a joint return with their spouse, then \$250,000 of their gain would

be taxed; if this partner is single or files separately from their spouse, then \$750,000 of their gain would be taxable. The gain allocable to the remaining four partners would be deferred, as they each have a \$312,500 gain. The \$500,000 exclusion would be per annum and not per transaction.

The AFP would also build upon the net investment income tax created under the Obama administration.

Currently, net investment income is assessed as an additional tax of 3.8%. However, there is an exclusion for income from an active trade or business. The new proposal would eliminate this exclusion, therefore, subjecting virtually all income to the 3.8% additional tax. If the highest tax rate proposed was to pass and the tax rate on long-term capital gains was to increase also, then the effective tax rate on ordinary income and long-term capital gains would be 43.4%. Whereas, currently, a long-term gain from the sale of real estate in an active trade or business is taxed at 20%.

Finally, it is important for real estate businesses to track how the new proposal will tax unrealized appreciation on assets gifted or transferred upon death as a taxable event.

If changes proposed in the AFP are implemented, an income tax would be due on the excess of fair market value over the donor's basis. Some exclusions are suggested, such as the transfer of a farm that will continue to be farmed. Family businesses would be excluded and taxed only when either the property was sold or ceased to be owned and operated by the family.

In addition, each taxpayer would be entitled to a \$1 million lifetime exclusion. The tax on the unrealized gain would be a deduction on the taxpayer's estate tax return. The tax on transfers upon death would be able to be paid over 15 years at a fixed rate.

What does the future hold for the real estate Industry? There are many questions that will only be resolved in time. Although we do not know what changes will pass through Congress, it appears that there is a strong likelihood that capital gain rates will increase, as the Biden administration is focused on high-net-worth and high-income individuals.

To best prepare your business for the future, it is important to review the above proposed tax changes and plan ahead through opportunity zone investments, 1031 exchanges, or consider selling your property now, as it is possible the changes will not be retroactive.

In addition, reviewing your estate planning is crucial during this waiting period as values are currently depressed due to the pandemic, and in light of the proposed estate tax changes, this may be the time to transfer assets to the next generation.

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