PLANNING AHEAD: EXPECTED CHANGES FOR THE REAL ESTATE INDUSTRY

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This article discusses tax changes that President Biden proposed during his campaign that real estate professionals should be keeping their eye on.

The Trump Administration enacted one of the largest changes to the tax code when it passed the Tax Cuts and Jobs of 2017 ("TCJA"), which contained various provisions that resulted in significant benefits to the real estate industry, such as the pass-through deduction and the extension of bonus depreciation, to name a few. The question now is, how will this, and other long-standing federal policy norms that the real estate industry relies on to do business, all change under the Biden Administration?

President Biden ("Biden") has started his term in office with a much bigger concern than the TCJA. Due to the COVID-19 pandemic, the U.S. is under immense pressure to mass distribute vaccines efficiently, promote non-essential employees to return to the workplace, and ultimately reverse the economic deficit. Will these important tasks take priority over alterations to tax law? Will there be tax law changes in 2021? 2022? In the first 100 days of the Trump Administration, it became clear that enforcing changes to tax law was a top priority; however, this may become a later-term goal for Biden. As Democrats now have control of the Senate, House, and the White House, it may be easier for President Biden to pass a sweeping change to the tax code when the time comes.

The following outlines some of the tax changes President Biden proposed during his campaign that real estate professionals should be keeping their eye on. Practitioners should consider taking steps in anticipation of some, or all, of these changes in the months and years to come.

Like-Kind Exchanges

Like-kind exchanges have long been an important tool that the real estate industry has used when

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selling a property and acquiring another one. Having the ability to reinvest the gain from a sale into a new property, while not having to reduce the amount of capital available for investment (deferring tax on the gain), has been critical to many real estate owners. Previous administrations have threatened to eliminate like-kind exchanges completely and, most recently, the TCJA made changes to this section of the Code. As a result, under the TCJA like-kind exchanges are limited to real property exchanges only.

Prior to the election, Biden proposed to eliminate or limit the use of like-kind exchanges. Enacting this would result in deterring owners and investors from selling properties. In addition, the outcome would destroy businesses that rely solely on the concept of like-kind exchanges, such as exchange intermediaries, companies that warehouse properties for like-kind exchanges, triple net lease property brokers, and more. Changes to like-kind exchanges can indirectly impact the construction industry as well as other industries, since when a property changes hands, improvements to the property are often made by the new owner.

Step-Up in Tax Basis at Death

Under current law, assets transferred upon death receive a step-up in basis to the recipient of the asset, equal to the fair market value of the asset at the date of the decedent's death. Therefore, if an owner of a property dies, and at his or her death the property has a fair market value of $1 million, if the beneficiary of the property sold it for $1 million, the beneficiary would have no gain or loss on the sale. The rationale behind this is that the estate will be taxed (assuming it's a taxable estate) on the fair market value of the net assets in the estate, and taxing the recipient would be a double tax. Biden has proposed to eliminate the step-up in basis upon death, creating a double tax on any taxable estate. The difficulty with this change is then determining the decedent's tax basis in the asset bequeathed. The asset could have been held for many years, or in the family for many generations. It is likely that the decedent may have had improvements made to it throughout the years and is no longer available to answer any of these questions.

Lifetime Exemption

The lifetime exemption is the amount any given person can give away to another individual during his or her lifetime or upon death, in excess of the annual gift exclusion, without creating an estate or gift tax. The TCJA doubled the lifetime exclusion to $11.58 million per person, which is portable. This means that under the current law, any person can give away $11.58 million ($23.16 million per married couple) during their lifetime, or upon their death, without paying any federal gift or estate tax. If one spouse dies and does not use all of their allowed lifetime exemption, the balance will be added to the surviving spouse's balance. Biden has proposed to reduce this amount to as low as $3.5 million per person. Many taxpayers are making gifts of real property, as well as other assets, post-election in anticipation of the lifetime exclusion being reduced.

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This proposed reduction to the lifetime exclusion, coupled with the elimination of the basis step-up upon death, would create the need for many property owners to look at their current estate plans, as well as the liquidity of their estate in order to pay estate taxes that they may not have anticipated owing.

Qualified Opportunity Zones

Biden has proposed changes to the Qualified Opportunity Zone Program, including requiring the Treasury to review the Opportunity Zone regulations to ensure that the project located in the Opportunity Zone has a meaningful social impact on the community. This is in response to some concerns that the new developments are displacing people that live in the zone and are creating properties for individuals at much higher income levels. Biden's proposal intends to make sure that opportunity zone investments have clear social, economic, and environmental benefits. Additionally, Biden has proposed additional reporting requirements for those investing in opportunity zones to allow the Treasury to better monitor these investments and verify that they are proper Qualified Opportunity Zone investments.

In addition to disclosing the investments' impacts on local residents, Biden is also considering giving incentives to opportunity zone investments that partner with a non-profit or a community-oriented organization and that together focus on creating jobs for low-income residents and provide other direct financial benefits to the community. The selection of the census tracts designated to be considered to be Qualified Opportunity Zones has also come under attack. Although Biden has not directly addressed this in his proposals, practitioners should keep an eye on possible changes to the selection of tracts. A Qualified Opportunity Zone investor who has deferred the payment of tax on their gain until 2026 should keep a close watch on any change in the tax rates, since the tax they will pay in 2026 on such deferred gain will be the tax rate in place in 2026.

Individual Income Tax Rates

Biden has proposed to revert the highest tax rate back to what it was pre-TCJA, to 39.6%. Throughout his campaign, Biden stated clearly, and often, that he will only increase taxes on those with income greater than $400,000. In addition to increasing the maximum individual tax rate on taxpayers making over $400,000, he has proposed to increase the capital gain tax from what is now 20% to 39.6% for anyone with income over $1 million. *The increase in capital gain rates to 39.6%, coupled with the elimination of like-kind exchanges, could cripple the real estate industry in eliminating incentives to sell properties that real estate businesses rely on.*

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Furthermore, it is important to note that if an owner passes away while owning a property, the owner's heirs will not receive a step-up in basis and the estate may not have the liquidity needed to pay the estate tax, leaving owners to wonder, "will my family be forced to sell the property?"

Itemized Deductions

Since the passing of the TCJA limited the deduction of state, local, and real estate taxes (SALT) to $10,000, many states have attempted to find workarounds. Biden has proposed to end the SALT limitation but put a cap on itemized deductions to 28% and restore Pease limitations for taxpayers with income over $400,000. The Pease provision reduced itemized deduction by 3% for every dollar of adjusted gross income over a set threshold. This threshold, per Biden's proposal, would be $400,000. Therefore, if your adjusted gross income was $500,000, you would reduce your itemized deduction by $3,000 ($500,000-$400,000=$100,000 x 3% = $3,000).

Carried Interest

As many real estate investors know, a sponsor/promoter of a real estate investment often receives an interest in the earnings and future appreciation (proceeds upon a sale), without having to make a capital contribution, or not making a capital contribution in proportion to their ownership percentage. This is known as a carried interest.

Under current law, real estate assets used in a trade or business are not subject to the current carried interest legislation, which states that an interest held for at least three years will be taxed at the long-term capital gain tax rate, which is currently at 20%. Biden proposes to eliminate carried interests from receiving long-term capital gain treatment, with the result being that any gain from a sale attributable to a carried interest would be taxed at ordinary income tax rates, currently up to 37%, and proposed to be up to 39.6%.

Social Security Taxes

Under current law, an employee has 6.2% (excluding Medicare tax) withheld from the first $137,700 of their salary, and an employer pays an equivalent amount. Self-employed taxpayers, including managers of limited liability companies taxed as partnerships – which many real estate owners qualify as – are subject to self-employment taxes equal to 12.4% (excluding Medicare tax) on their self-employed taxable income, up to $137,700.

Biden has proposed to increase the social security wage limit to tax individuals whose income is greater than $400,000, on their earnings above $400,000. This would cost an employee making $500,000 (as well as their employer) an additional $6,200 and would cost a self-employed individual an additional $12,400.

Bonus Depreciation

Prior to the passing of the TCJA, a taxpayer could take, as depreciation, 50% of the cost of qualified capital expenditures the taxpayer made in their business in the year the expenditure was made. To qualify for the 50% depreciation deduction known as bonus depreciation, the asset had to be used in the trade or business, be placed in service, be a new asset, and have depreciable life of no more than 20 years.

The TCJA made changes to these provisions by increasing the 50% to 100% and eliminating the requirement that it be a new asset. Therefore, if a taxpayer purchased a used machine for their business, they could depreciate, or write-off, the entire cost in the year it is placed in service.

Per TCJA, the 100% will be reduced by 20%, per year, beginning in 2023. The limits will be as follows: 80% in 2023, 60% in 2024, 40% in 2025 and 20% in 2026 and thereafter. Biden has proposed to reverse the TCJA provisions and therefore go back to 50% and disallow used assets.

Qualified Business Income Deduction

One of the most beneficial provisions of the TCJA for real estate professionals is the Qualified Business Income Deduction, commonly referred to as the 20% deduction, or the pass-through deduction.

Under the TCJA, a taxpayer can reduce up to 20% of the taxable income he or she receives from a flow-through entity, such as an S corporation, partnership, sole proprietorship, or a limited liability company taxed as a partnership.

The 20% deduction is limited to, first, the greater of 50% of the wages of the entity allocated to the taxpayer, or 25% of the allocable wages, plus 2.5% of the allocable share of unadjusted basis of the property. This result is then compared to 20% of the allocable share of Qualified Business income, and the lower of the two amounts is the allowable deduction – so long as it does not exceed 20% of the total taxable income of the taxpayer.

Biden has proposed two changes to this provision of the TCJA, including eliminating special qualifying rules – such as those for real estate investors. The second proposed change would be the elimination of the 25% wage and 2.5% of unadjusted basis computation, and to limit the qualified business income deduction for taxpayers making over $400,000.

Home Buyers and Renters

Biden has also proposed to give first-time homebuyers a tax credit of $15,000, and a tax credit to renters to ensure that their rent and utility bills do not exceed 30% of their monthly income. If this does pass, it could be a boost for single-family home developers and help multi-family property owners with collecting their rents, which is much needed since the onset of the pandemic.

Conclusions

As you can see from the proposed changes to the tax law outlined above, if enacted these changes could have significant impacts on the real estate industry and how business is conducted.

Now is the time to look at the potential changes, to see what impact they can have on your real estate business and family, and to possibly make some changes in anticipation of a change in the tax law. ■