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Proposed Tax Law Changes Could Change Shape of Transactions, Real Estate Executives Say

Buyers Could Hold Properties Longer, Rely More on Debt, Experts Say

The effects of President Biden's proposal to raise the capital gains tax rate could be muted in the real estate industry by the need and desire to buy and sell properties. (Getty Images)

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The White House's plan to raise the capital gains tax rate and do away with deferred taxes on property exchanges, should it become law, would likely result in transactional changes next year and beyond, but any significant decline in the volume of deals may be muted, according to real estate executives and analysts.

In the short term, the proposals by the Biden administration as part of its American Families Plan are expected to generate a surge in real estate deals later this year as investors race to beat the timing of any potential tax increases.

However, determining the longer-term effect that could arise won't be possible until the ink dries on the fine print. And Washington is a long way from getting to that point.

A coalition of real estate groups has come out against the Biden plan. The industry's initial guesses are that it could, in time, slightly reduce sales transaction volume, and pricing could increase borrowing costs and hold times. However, brokerage firms say most deals are likely to still move forward.

The most prominent proposed tax changes include raising the capital gains rate from 20% to 39.6%. In addition, the White House 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.

"While 1031 exchanges play an important role in Marcus & Millichap's business, many of our predominantly private investor client base would need to transact even with restricted tax deferred exchanges," 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 News. "Investors generally fall into two categories: owners who 'must' sell a property and owners who 'desire' to sell a property. The 'must' sell investors will transact regardless of the rules on 1031 exchanges."

If the proposals end up becoming law, the client base Chang describes would still exist, and deals would still get done. Similar sentiments were echoed at other brokerages.

Protected From Impact

In his first-quarter earnings conference call, Bob Sulentic, president and CEO of CBRE Group, said the potential changes would "not have a material impact on our earnings prospects currently, or in the longer term as we've laid them out."

Even in the net-lease space, where 1031 exchanges are a preferred method of buying and selling property, the effect could be lessened, according to Alex Sharrin, managing director of capital markets for JLL in Chicago.

“The net-lease space is awash with record liquidity right now, and the investor base has expanded greatly in the last 12 months,” Sharrin told CoStar in an interview. “And I’m not just talking about your new investors in terms of private capital but new institutional investors that are looking for fixed income alternatives. Given the attractive fundamentals of net lease particularly in today’s market, I think JLL can confidently say that the market can absorb and adapt to the 1031 repeal if it ever materializes.”

At the same time, investors should be preparing for how the proposed changes could affect individual deals, according to brokers and real estate attorneys.

Alex DuFour, a real estate and finance lawyer at Cozen O’Connor in Washington, said that he thinks the buyer pool would shrink under the proposed changes. In a 1031 exchange, investors are purchasing a new property effectively to defer taxes and not necessarily because they want to own more real estate that they might have to buy at a higher cost.

If a capital gains tax rate increase goes through and the exchange deferral is eliminated, a seller would only have about 62% of their gain left to reinvest instead of 100%.

With less money to reinvest from a sale, the cost to buyers could increase, according to Sharrin.

“There would be a much greater reliance on debt financing,” Sharrin said. “JLL research suggests that the average loan to value on assets acquired via 1031 exchange are 13% lower than those that are not.”

So, the average loan-to-value ratio would go from about 30% to roughly 43%, he said.

The changes could also have a positive effect on the market, according to Chang.

"Restricting 1031 exchanges would also create investment opportunities," he said. "While many investors would step to the sidelines, others could deploy aggressive acquisition strategies with a longer-term hold parameter."

Past dramatic tax policy changes under previous presidential administrations or congressional makeups saw investors acquiring and holding assets with an expectation that at some point in the future, taxes could be significantly reduced again, he explained.

"These investors would help the market maintain some level of stability," Chang said.

Industry Voices Opposition

Congress began to take up President Biden's proposed spending and tax reform changes last week as it started hearings. And in doing so it heard from a coalition of 17 real estate associations urging lawmakers not to change long-standing tax rules that support the industry.

"Several of the tax proposals in the administration's infrastructure and human capital initiatives, unfortunately, would reduce real estate investment and diminish opportunities for startup businesses and those less advantaged," a letter from the coalition to House and Senate finance committee members said.

In addition, Jeffrey DeBoer, president and CEO of the Real Estate Roundtable, one of the 17 industry groups, had more to say on the topic in a webcast with Marcus & Millichap President and CEO Hassam Nadji.

"From our perspective, we're not afraid of revenue increases. … We're not shying away [from] taxes; however, we're highly concerned about targeting certain industries and … what I would call the unintended impact," DeBoer said.

Because they are just early proposals at this point, according to DeBoer and Nadji, the real impact cannot be known. However, DeBoer added, "This is a proposal from the

president of the United States to a Congress that is controlled by his party. So, it is a very, very serious proposal and should be taken that way."

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