CUSHMAN & WAKEFIELD

Biden Administration Tax Proposals:

Implications for Commercial Real Estate

May 2021

The Biden Administration has put forth two proposals—the American Jobs Plan (AJP) and the American Family Plan (AFP)—as part of its Build Back Better agenda. These proposals call for significant expansions in spending on infrastructure and social programs. In order to pay for this $4.5 trillion plan, the administration has also proposed a range of tax increases, mostly targeted at corporations, investors and the most affluent households.

The President's plan still needs to go through the legislative process and is likely to change from its current form. In this piece, we evaluate several provisions that could acutely impact commercial real estate investment including changes to capital gains tax rates, elimination of carried interest, limitations on like-kind exchanges, and an increase in corporate and marginal income tax rates.

Capital Gains

What's the proposal?

The Biden administration's American Families Plan proposes raising the long-term capital gains tax from 20% to 39.6% for households reporting income over $1 million (M) and taxing unrealized gains at death.

What's your best guess?

28%. Handicapping the politics is never easy, but we'll try. There are two significant factors that are likely to shape where the capital gains tax ultimately lands. First, the tax would fall heavily on democratic constituencies in urban, coastal metros, increasing the likelihood of opposition from both moderate democrats and representatives of affluent districts. Given the party's slim and slimmer margins in the House and Senate, it seems likely that these two in-party groups would be able to extract concessions. Second, there is considerable debate regarding how much tax revenue raising the capital gains tax would generate. Estimates range from as low as $113 billion (B) to as high as $448B over the 2022-2031 forecast period. The Tax Policy Center, a non-partisan think tank group, compared 15 different models to estimate the revenue maximizing top capital gains tax rate and found an average estimate of 28%.[1] Our best guess is that the final bill will end up somewhere around 28-32%; not 39.6%.

How should investors respond?

Some incentive to sell before the change occurs, but not for the majority. First, it should be noted that any increase could in theory be made retroactive to January 1, 2021, but it is more likely that the change will be made in the 2022 tax year. For an investor who was already considering selling an asset, the risk of increased capital gains should make a sale more attractive on the margin. Long-term holders of assets with large unrealized gains might also consider selling in this environment to the extent that they do not believe market conditions are distinctly unfavorable; this would naturally be case dependent. As an investor's situation departs from these conditions (want to sell anyways, large unrealized gain), the more they should conduct business as usual, perhaps building in a larger margin of safety into underwritings in expectation of adjustments in their investor's pre-tax return expectations.

[1]https://www.taxpolicycenter.org/taxvox/new-study-suggests-congress-could-raise-money-increasing-capital-gains-tax-rates-47-percent

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Carried Interest

What's the proposal?

Reform or eliminate the current tax treatment of carried interest. Presently, carried interest is taxed at the 20% capital gains rate rather than the 37% regular income tax rate. If Congress approves President Biden's proposal, carried interest would be taxed at the regular income tax rate, but only for those earning over $1M. Biden has simultaneously proposed increasing the ordinary income rate to 39.6% for those earning more than $1M.

What's your best guess?

Unlikely. Carried interest has repeatedly been rumored to be on the chopping block, most recently during the drafting of the Tax Cuts and Jobs Act. The reasons for this have more to do with perception and class politics than the fiscal needs of the state—Moody's Analytics estimates that taxing carried interest as ordinary income would only raise an additional $14B over a ten-year period.[2] Moreover, carried interest is favored by a concentrated and well-organized interest group with significant influence in both Republican and Democratic party politics. There are no certainties in politics, still less so today, but with little to gain and strong opposition, carried interest is likely to survive.

How should investors respond?

Don't lose sleep over it. If it happens (big if), closed-end funds might experience some internal pressure to accelerate realizations in 2021, but these are likely to be marginal given the gradual liquidation profile of most funds. Limited partners in these funds should be attuned to this principal-agent problem but shouldn't lose sleep. Fund managers should begin exploring alternative incentive structuring for future funds and potentially for existing fund vehicles, though this is likely to be more difficult.

Like-Kind (1031) Exchanges

What's the proposal?

Like-kind exchange rules allow taxpayers to defer tax when they exchange one property held for investment or business use for other property of a "like kind." The AFP proposes limiting gain deferral on exchanges to $500,000.

What's your best guess?

Coin toss. Similar to carried interest, 1031 exchanges were targeted during the 2017 tax reform debates and in fact had their remit narrowed. According to Moody's Analytics, this would generate $40.1B in revenue over ten years.[3] While this is large in comparison with the carried interest proposal, it would still only offset 2.0% of the cost of the AFP. Meanwhile, interest group support for like-kind exchanges is, if anything, stronger than that of carried interest, and there are generally stronger fundamental arguments that the tax provision supports greater economic activity jobs.

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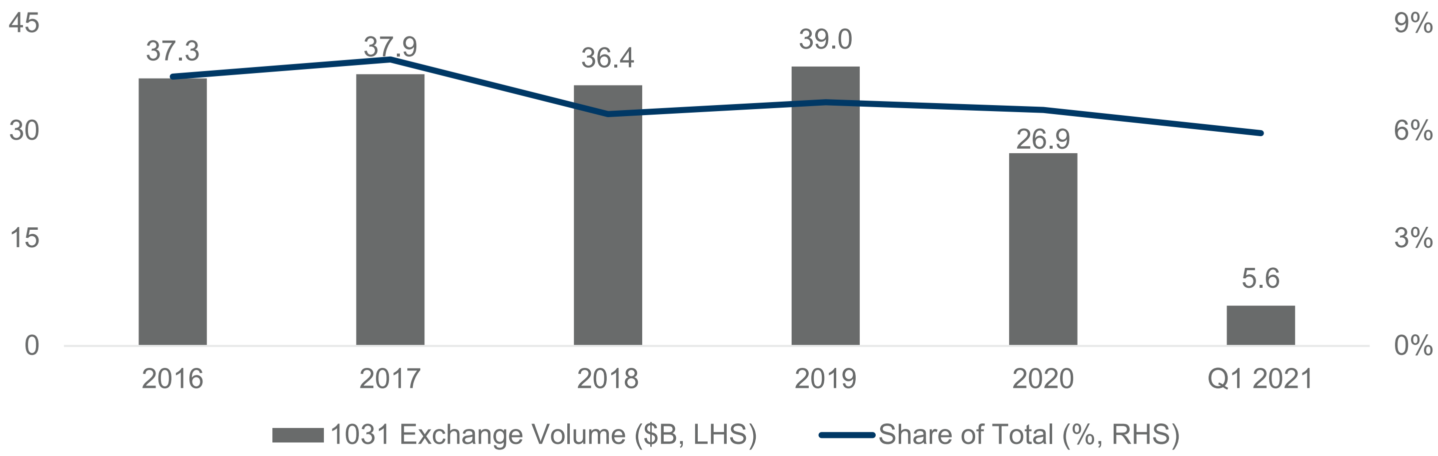
[2] https://www.moodysanalytics.com/-/media/article/2021/american-families-plan-build-back-better-agenda.pdf
[3] *Ibid.*

Like-Kind (1031) Exchanges cont.

All of the above point in favor of the proposal failing or being further diluted in a final bill. The Biden administration has proposed continuing to allow deferral of up to $500,000 in gain with the intention of reducing the impact on smaller investors/property owners. Should the proposal survive, it would likely be with a further increase in the gain limit (e.g., to the $2M to $5M range). By doing so, negotiators could weaken opposition from the residential real estate industry, leaving commercial real estate investors exposed. Were this to happen then we would put 50/50 odds on 1031 exchange limits being in the final bill with the odds in favor of limitation increasing with the gain cap.

1031 Exchange Market Size



Source: CoStar, Cushman & Wakefield Research

How should investors respond?

1031 impacts a small segment of the market, but the possibility of a change does create incentive to close deals in advance. From 2016 to Q1 2020, 1031 exchanges totaled $183B or 7.0% of commercial real estate transaction volume during the period. The vast majority of exchanges are under $5M in value with only 6.3% of transactions over $15M. The relative importance of exchanges varies across markets and property types. While a 1031 exchange curtailment could in principle be backdated to January 1, 2021, it is more likely that the change would be made effective to the time of the bill signing or beginning 2022. As such, exchange investors should consider taking advantage of the unrestricted provision one last time in 2021. This is particularly true for investors who: 1) have larger investments and/or 2) intended to exchange in the next several years even absent tax incentives. There is little downside to this strategy. Investors will be glad of having done so if exchanges are limited, and if exchanges continue as before, then they should not be too sorry, having gone through their usual due diligence in selecting the new exchange investment.

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Corporate Taxes & High-Income Households

What's the proposal?

The American Jobs Plan proposes increasing the top marginal rate on corporations from its current 21% to 28% and the AFP increasing the top marginal income tax rate from 37% to 39.6%.

What's your best guess?

25% and 39.6%. Some members of Congress have already expressed unease with increasing corporate tax rates to 28%. In response, the President has stated that the exact number could be flexible. The primary criticism of raising the corporate tax rate is that it would make the United States less competitive compared to other nations. The OECD average corporate tax rate was 23.5% in 2020, 27.2% for the G7 economies. Given this backdrop, a compromise at 25% seems feasible or even likely, given the magnetism of round numbers. Increasing the top marginal income tax rate to 39.6% would simply be to reverse the effect of the 2017 Tax Cuts and Jobs Act. It's a fairly small change for a highly affluent group and is unlikely to be the hill anyone will want to die on. It passes.

How should investors respond?

Stay put. These changes are unlikely to have significant effects on the strategic behavior of firms and individuals, let alone in a way that its specifically applicable to commercial real estate markets.

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