

District Work Period Talking Points

DON'T RAISE TAXES ON REAL PROPERTY OWNERSHIP

- This spring, the Biden Administration unveiled an ambitious infrastructure and spending plan (the *American Families Plan*). In addition to ideas for spending and improvements came a set of proposed tax increases designed to partially offset their costs. Unfortunately, some of the proposals would negatively impact real estate investment.
- Three of the proposed tax increases could slow the recovery of an already struggling commercial real estate sector while increasing the tax burden for those who hope to pass on a family business and/or real property to their heirs:
 - **Limiting the amount of deferred gain from a 1031 like-kind exchange transaction**
 - **Doubling of the maximum long-term capital gains tax rate**
 - **Making death a taxable event for unrealized gains in capital assets such as real estate**
- While these proposals are only recommendations and have not progressed to the stage of active legislation, NAR is taking them very seriously and has already weighed in with the Biden Administration and Congress on why their enactment would be counterproductive to economic recovery during the ongoing pandemic and for future job and economic growth.
- The next pages provide detailed rationale for opposing these proposed tax increases.



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SECTION 1031 LIKE-KIND EXCHANGES

What's in the Proposal. In July 2020, the Biden campaign indicated that if elected, Mr. Biden would repeal or cap the ability of investors and business owners to take advantage of Section 1031 like-kind exchanges (LKEs). The White House subsequently proposed a \$500,000 cap on the amount of gain that can be deferred as part of the *American Families Plan*.

- Some in Congress believe that like-kind exchanges represent an unwarranted “loophole” that should be closed. However, in ongoing discussions with Capitol Hill, there is often a lack of understanding of how like-kind exchanges work and their benefits to communities and the economy.

NAR Position. NAR is strongly supportive of preserving like kind exchanges with no limitation on their use under the current law.

Effect on the Real Estate Industry. 61% of REALTORS® were involved in at least one 1031 transaction between 2016-21.

- 88% of the properties exchanged were held by small investors, and in 89% of the exchanges, clients invested significant additional capital into the property, creating jobs and increasing economic growth.
- LKEs are a principal tool for retirement savings for many REALTORS®. As independent contractors, REALTORS® typically do not have access to a traditional 401K or pension plan through an employer. LKEs provide similar deferral tax benefits as a traditional 401K, which helps build retirement wealth.

Effect on the Economy. Like-kind exchanges will accelerate economic recovery from the pandemic by preventing real properties from languishing, underutilized and underinvested. LKEs put real estate into the hands of new owners with the time, resources, and desire to restore and improve them, which invigorates the economy and creates jobs.

- Like-kind exchanges are an engine of job creation. New research estimates that LKEs support 568,000 jobs generating over \$55 billion of annual value added. Commercial REALTORS® report that five jobs were typically created in association with replacement property by their clients.



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- 1031 exchanges help small and minority-owned businesses expand and grow. These firms use LKEs to expand and build equity without having to rely on bank loans and other third-party lending that can be difficult to obtain. LKE's result in more investment. On average, commercial REALTORS® reported that an additional investment of 20% of the fair market value (FMV) of the replacement property was made by the investor of the replacement property.
- Farmers, ranchers, and forest owners rely on LKEs for various reasons, including to mitigate environmental impacts and to promote land conservation.

Effect on Taxpayers. Elimination of like-kind exchanges would generate little additional revenue. In fact, the Biden Administration's proposal to limit LKEs would raise less than 1% of the total proposed. Yet, 64% of relinquished properties reported by commercial REALTORS® had a gain on sale of at least \$500,000.

- State and localities rely on LKEs for much-needed tax revenue through transfer taxes and title fees.
- LKEs are a principal tool for retirement savings for many Americans and REALTORS®.
- Increasing the supply of affordable rental housing depends heavily on LKEs. Without them, rents would increase significantly.
- LKEs help stabilize property values and real estate markets during economic crises.



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INCREASING THE MAXIMUM CAPITAL GAINS TAX RATE

What's in the Proposal. The *American Families Plan* proposes to raise the top capital gains rate to 39.6%. Adding the 3.8% net investment income tax, which the White House proposes to expand, would push the tax rate on investment gains to 43.4%. In many states, the total tax burden would exceed 50%.

- In 105 of the 108 years since the creation of the federal income tax, the U.S. has taxed long-term capital gains at a lower rate than ordinary income. The only exception was a 3-year period following enactment of the *Tax Reform Act of 1986*.

NAR Position. The return on risk capital is a much different type of income than wages and other forms of compensation. Treating the return on risk-taking the same as salary income would undermine a fundamental tenet of the American economic system. The lower tax rate on capital income reduces the cost of capital, drives patient, long-term investment, and encourages entrepreneurial activity. In the case of real estate, the reduced tax rate partially offsets the higher risk associated with illiquid, capital-intensive projects.

Effect on the Real Estate Industry. Two structural features of the tax code further penalize risk capital over wages:

- First, a significant share of long-term capital gains liability does not relate to actual economic income, but rather reflects the effects of inflation.
 - For example, assuming an asset is purchased for \$100 and sold five years later for \$110, but inflation rises 15 percent during the same five-year period, the taxpayer has actually lost money on his or her investment. He or she would need \$115 just to maintain their original purchasing power. Nonetheless, the taxpayer will still owe capital gains tax in year five on the \$10 of nominal appreciation. The individual is paying tax on “noneconomic” income.
 - The capital gains preference partially offsets this unfair taxation of noneconomic income.
- Second, unlike ordinary losses, such as casualty or net operating business losses, losses on capital assets are generally nondeductible and must be carried forward to future years (with a small \$3,000 exception). In other words, the government collects tax immediately on capital gains, but does not allow taxpayers to apply their capital losses against their ordinary income.



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Effect on Taxpayers. For most owners of capital assets such as real estate, the timing of their sale is discretionary and can wait until conditions, including prevailing tax rates, are more favorable. Thus, a doubling of capital gains tax rate will inhibit the sale of many assets, thus freezing the real estate market and locking in many properties. This would have a devastating impact on economic growth, job creation, and collection of federal, state and local revenue.

Effect on the Economy. High capital gains taxes on real property will also negatively impact the after-tax return of real estate investment projects, meaning that fewer will move forward, again reducing growth and jobs.



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TAXING UNREALIZED CAPITAL GAINS AT DEATH

What's in the Proposal. The *American Families Plan* proposes to tax unrealized capital gains at death for certain taxpayers. There would be an exclusion of up to \$1.25 million where part of the unrealized gain is on a principal residence. Additional rules would defer taxes to protect heirs who continue to run family-owned businesses and farms from having to sell them to pay the tax.

- If enacted, this proposal would have extremely negative consequences for taxpayers, the real estate industry, and the economy.

Effect on Taxpayers. At the taxpayer level, death would become a taxable event at \$1.25 million for single filers with a primary residence (assuming there is at least \$250,000 of unrealized gain in the home) and at \$2.5 million for married taxpayers with a primary residence (if there is at least \$500,000 of gain in the home).

- Contrast this to the far higher asset levels (\$11.7 million for single filers and \$23.4 million for married filers) at which the estate tax is currently imposed. The last year estate taxes were imposed at an asset level of less than \$1.25 million for a single filer or \$2.5 million for a married filer was 2003.
- There is little reason to make death a taxable event at the lower asset levels contemplated by the *American Families Plan*. Moreover, many who have substantial unrealized gains due to inflation or other factors may have incomes far below the \$400,000 figure targeted by President Biden for tax increases.

Effect on Real Estate Industry. By making death a taxable event at far lower asset levels than under current law, this proposal would impose tax before an asset is actually sold by the heir. This is a reversal of an income tax policy principle dating to the beginning of the modern tax law.

- If this tax is imposed, many estates will not have the cash to pay the tax due. This could force an estate to sell the property the decedent desired to be left to an heir. Even if the funds to pay the tax are available, little might be left over to improve and upgrade the property. This could have negative consequences for many commercial real estate assets, including affordable rental housing, office buildings, and shopping centers.



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- While the *American Families Plan* contemplates enabling family-owned businesses to defer the payment of tax until an inherited asset is sold, this approach would be problematic in many cases. An heir could inherit a property with little or no basis and sizeable debt. If it is sold, the heir could face significant depreciation recapture taxes and capital gains taxes. This could discourage heirs from investing further capital to maintain the property.
- Ultimately, housing and especially affordable housing, office buildings, and shopping centers could be lost from inventory due to obsolescence. Moreover, the tax deferral relief proposal may not cover situations where the heir may wish to diversify into other business assets or where there are multiple heirs who may wish to go their separate ways with business interests.

Effect on the Economy. On a macroeconomic level, an April 2021 EY study estimates that imposing tax on transferred assets at death would cost 80,000 jobs in each of the first 10 years and 100,000 jobs each year thereafter. Gross Domestic Product (GDP) relative to the U.S. economy would also fall by \$10 billion annually and \$100 billion over 10 years. Workers' wages would decline by \$32 for every \$100 collected in tax.

