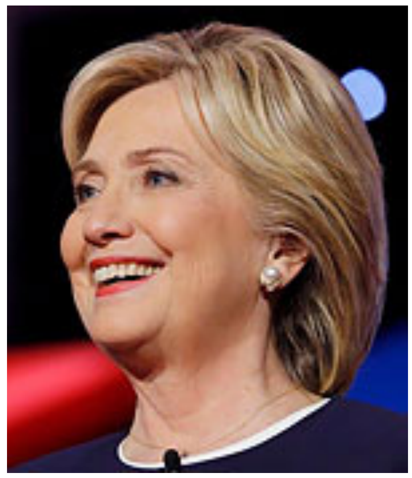
Clinton tax proposal worries real estate pros

Presidential candidate Hillary Clinton's plan to raise taxes on wealthy Americans has gained much attention on the campaign trail this year, but a lesser-known tax proposal could have more impact on the commercial real estate market — and not in a good way, according to industry watchers.

Clinton has proposed putting limitations on so-called Section 1031 like-kind exchanges, which allow sellers of commercial real estate to defer federal taxes on capital gains on a property sale if they purchase a similar investment property, typically of equal or greater value.



Critics of like-kind exchanges say it is a tax loophole that has been exploited by wealthy investors — like billionaire presidential candidate Donald Trump — to build their real estate empires and avoid paying federal taxes. Capital gains on real estate sales can be deferred indefinitely using like-kind exchanges, until the owner cashes out with a final sale.

Last year, the Obama administration proposed limiting like-kind exchanges to $1 million per taxpayer per year. Clinton didn't spell out in the latest update on her tax plan to what extend she would limit the deferral. Market watchers assume, however, that her plan will follow the lines of Obama's plan, which would close the perceived loophole on big property deals, but continue the deferral for smaller deals. Some Democrats have called on Congress to eliminate like-kind exchanges entirely.

Like-kind exchanges have been around for about 90 years, however. Small and large investors commonly use the like-kind exchange provision to avoid paying what can be as much as a 23.8 percent federal tax on the gain from a property sale. Industry participants say if like-kind exchanges are significantly restricted, it could grind commercial asset sales to a halt.

“If you eliminated the 1031 deferral, you are not going to get many sellers,” said Daniel Goodwin, chairman and chief executive officer of the Illinois-based The Inland Real Estate Group of Companies. Inland is one of the largest commercial real estate and finance companies in the U.S.

Goodwin noted that property owners must depreciate the value of the properties. He provided the theoretical example where a property owner buys a building for $10 million, its value is depreciated for tax purposes to $5 million, then sold for $12 million. In that scenario, he said, the tax liability will exceed the $2 million gain on the sale, and so the property owner will have no incentive to ever sell.

“There will be some [sales],” Goodwin told Scotsman Guide News during a telephone interview this week. “Some people like to sell, and have to sell, but the majority of investors take into account the tax ramifications.”

David Wieland, chief executive officer of Realized, said most sellers of commercial assets that do like-kind exchanges are smaller investors. Wieland's Austin, Texas-based company functions as a conduit for investors to sell their property and then invest in a corporation that manages a pool of properties. The sellers can still take a like-kind exchange tax deferral by purchasing a stake in the corporation. According to IRS data for the 2013 tax year, there were 357,000 like-kind exchanges, of which more than 235,000 involved individuals. Wieland said the average capital gain deferred by individuals was around $45,000 per deal.

“The 1031 exchange comes up with politicians about every three or four years,” Wieland said. “Most politicians frankly don’t understand how important it is to the real estate industry. The concern that I have, frankly, is that in Clinton’s most recent update on her tax plan, she doesn’t specifically mention this $1 million exemption [that had been proposed by Obama].”

Goodwin said he believes the majority of members in Congress from both parties privately oppose eliminating the provision, but the issue has become election-year fodder for politicians to come out against perceived tax loopholes. A battery of industry groups, including the National Association of Realtors and Real Estate Roundtable, are lobbying against restrictions to like-kind exchanges.

"It is still going to be contentious but, to be honest with you, we have talked to the people in Congress and the majority of people in Congress understand it," Goodwin said. "When you politicize something, sometimes people say something that they don't really believe, and I believe that is where this is getting caught."

Goodwin also said a slowdown in commercial sales would be a job killer because numerous professionals, like lawyers, engineers and title companies, are involved in the transactions. He also said commercial sales generate tremendous fees and taxes for local and state governments. The buildings are also usually upgraded prior to a sale, and so property sales are a source of construction jobs.

"It is not a real loophole," Goodwin said. "It is actually a stimulant to the economy, but if you are trying to get elected, you can blame the current elected officials for allowing loopholes."

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