

Capital Gains and 1031 Exchanges – The Political Headwinds

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COVID-19 stimulus is likely to add at least \$5 trillion to the National Debt. At some point, Congress will need to address how to start paying for this increase. Two likely revenue raisers are changes to the capital gains rates and the elimination or curtailment of Section 1031 exchanges.

Let's review some of the current political implications on these two items.

Capital Gains

Joe Biden has indicated a plan to tax capital gains at a 39.6% tax rate for incomes over \$1 million. More problematic is the repeal of step-up in basis for assets passing through an estate. This could represent close to a 100% increase in capital gains taxes for wealthier taxpayers. Let's look at an example.

Mary sells farmland for a gain of \$2 million. Under current law, she is subject to a maximum capital gains tax rate of 23.8% (20% capital gains rate plus the 3.8% net investment income tax rate) or a total tax of \$476,000. Under Biden's plan, her capital gains tax rate would increase to 43.4% (39.6% capital gains rate plus the net investment tax) or \$868,000. This represents an 82% increase.

Mary's husband Joe passed away in 2021 leaving her grain with a value of \$2 million, cost of growing crop worth \$1.5 million and farm equipment with a value of \$2.5 million. Mary plans on selling all of these assets in 2021. Under current law, Mary would get a step-up in cost basis to \$6 million and owe no tax on the sale.

However, under Biden's proposal, Mary would owe ordinary income tax of at least 39.6% (assuming she is in the highest bracket) or \$2,376,000 of tax. None of these gains qualify for capital gains treatment.

Section 1031 changes

Biden also proposes curtailing Section 1031 tax-deferred exchanges for taxpayers with more than \$400,000 of taxable income. Current rules allows real estate investors to defer their capital gains by replacing the sale of real estate with other real estate of equal or greater value without incurring any tax.

Plus, if the taxpayer holds the real estate until they pass away, all of the capital gains tax is eliminated. However, if Joe Biden gets his way, all of the gain will be due at the time of sale (even if new real estate is purchased) and heirs will get no step-up in basis at death. We call this a double whammy.

Conclusion

As you can see, major changes to capital gains tax rates and Section 1031 exchange may be in the works. Since none of this will occur until at least 2021, you may want to try to lock in capital gains in 2020 while lower rates prevail. If not, be prepared to pay a lot more.