What a New Administration in DC Means for Investment Sales in NYC

A popular topic on Zoom calls has been what the implications will be for the New York City investment sales market of a Biden administration with a House and a Senate controlled by Democrats. The two main impacts that policymakers can have on the commercial real estate market are on the stimulus and tax policy sides.

President Biden said during the campaign that he would raise the capital gains rate and would modify 1031 exchanges. Both of these things, if enacted, could have profoundly negative impacts on CRE, particularly on the sales side. Our hope is that this was just campaign rhetoric.

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History has demonstrated that the actions of commercial real estate market participants are highly correlated to tax policy changes. Some economists and some business leaders do not believe that changes in tax policy impact behavior. When it comes to commercial real estate sales, that couldn't be further from the truth. In New York City, three of the five top years, in terms of investment sales volume over the past 36 years, (I began my career in 1984) were catalyzed by changes in tax policy, illustrating the close relationship between tax policy and sales volumes.

To demonstrate this relationship, we will use the Manhattan investment sales market as a microcosm to demonstrate this undeniable correlation. South of 96th Street on the East Side and south of 110th Street on the West Side, there are 27,649 investment properties. Of this stock, we have tracked all sales, and, in an average year, there have been 719 properties sold, or a 2.6 percent turnover ratio. The turnover ratio has been as high as 4.3 percent (1,200 sales), which occurred in 2012, and as low as 1.2 percent (331 sales), which occurred in 2009 and was caused by the global financial crisis. (We will know within the next week or so whether the turnover ratio in 2020 will be lower than the 1.2 percent low — it very well could be.)

We saw a spike in New York City investment sales volume in 1986 because of the Tax Reform Act that year. With increases in capital gains taxes (20 percent up to 28 percent) and changes to deductibility rules scheduled to kick in during 1987, participants rushed to sell in 1986 before the capital gains tax increased, which effectively "stole" activity that would have naturally occurred in 1987 and accelerated that activity into 1986. The cyclical peak in that market occurred in 1988. In 1986, the turnover ratio was 3.4 percent, up from 2.8 percent the year before. Turnover fell back to 2.8 percent in 1987, and then hit its natural cyclical peak of 3.5 percent in 1988.

In 1998, the Clinton administration dropped the capital gains tax rate from 28 percent to 20 percent. For long-time holders of assets with a low-cost basis, this effectively increased the value of their properties by 8 percent overnight and caused a significant spike in sales volume. To illustrate the spike the tax policy change spurred at this time, we see a turnover ratio of 2.8 percent in 1997, 3.9 percent in 1998 and down to 2.6 percent in 1999.

The third spike catalyzed by tax policy occurred in 2012. A relatively small 3.8 percent increase in capital gains taxes was covertly imbedded in the Affordable Care Act and was scheduled to become effective in 2013. On top of this increase, the campaign rhetoric during the 2012 elections was peppered with talk of further capital gains tax increases. It has historically been a target for politicians as studies have shown that 70 percent of capital gains go to the top 1 percent of taxpayers. The actual increase, plus the threatened increase, had investors heading for the exits in droves.

If 1031 exchanges are modified, it would also have a negative impact on sales. Modifications would make it more expensive to sell and, as Economics 101 teaches us, when an activity costs more to do, you get less of that activity.

The other impact tax policy will have on commercial real estate revolves around income taxes and migration patterns. One of the most troubling trends we have seen in New York over the past few years is the attraction that low-income-tax states is having on traditional New York investors and residents. If income taxes are increased significantly it could exacerbate the shifts of capital and people toward friendlier tax environments.

Generally, it seems that states with state income taxes below 3 percent to 4 percent have economies that are thriving and populations that are growing.

We remain hopeful that capital gains taxes won't be increased, as our broader economy needs to be stimulated in the post-pandemic world and, historically, capital gains tax policy has not been a completely partisan issue. The 1998 cut was implemented by President Clinton, a Democrat; and in the early 1960s, John F. Kennedy, also a Democrat, fought Congress, which wanted an increase, to keep the rate at 25 percent, as he feared an increase would slow the economy.

Again, hopefully, these changes will not be enacted. But, if they are, it actually could be good news for transaction volume. Historically, if tax policy changes go against the taxpayer, they kick in during the following year. If policy changes benefit the taxpayer, they have been implemented retroactively to the beginning of the calendar year in which they are passed. Increases could cause a whirlwind of sales activity in the second half of this year. We won't mention what sales activity would be like in the following couple of years, but you can only imagine.