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FEATURED ARTICLE
Winter-2021

# PRESERVING THE 1031 NOW AND FOR THE FUTURE

By: Michael Hoban

The commercial real estate industry breathed a sigh of relief in September when the proposal to implement caps on 1031 like-kind exchanges (LKEs) was excluded from the House Ways and Means Committee's list of potential tax provisions earmarked to pay for the "Build Back Better" agenda in the multi-trillion-dollar reconciliation bill. Although a final bill had not yet come to a vote at press time, industry insiders were cautiously optimistic that Section 1031 would remain intact—at least for now.

Exhaustive lobbying efforts by the National Association of REALTORS®, the Federation of Exchange Accommodators (FEA) and nearly 40 other organizations, including SIOR, making up the Section 1031 Like-Kind Exchange Coalition appear to have played a major role in preserving Section 1031 as is. The Coalition argued that the elimination of the caps would have had far-reaching negative impacts for not only the CRE industry, but the economy as a whole.

"To offer capping 1031 as a pay-for is a misguided policy, because it's a misunderstanding of what 1031 actually does," says Suzanne Baker, former general counsel for Investment Property Exchange Services (IPX1031) and former co-chairperson of the Government Affairs Committee of the Federation of Exchange Accommodators. "It's not an abusive tax loophole for the rich. It's broadly used by taxpayers of modest means as well as larger businesses. It's not even a tax savings vehicle. It's merely a timing device, a tax deferral that allows taxpayers to better manage their cash flow."

LKEs have been a valuable real estate investment tool for a century, dating back to the Revenue Act of 1921. The rules have changed over time, but the intent has remained the same: to allow real estate investors to defer—not exempt—capital gains taxes on a property they sold if they acquire a new property of equal or greater value within the prescribed time period (180 days). The Biden proposal would have limited eligibility for Section 1031 exchanges by permitting each taxpayer to defer only up to $500,000 ($1 million for married taxpayers filing jointly) of real property gain each year as one of the mechanisms to pay for the cost of the American Families Plan.

This is not the first proposal that has sought to curtail or eliminate 1031 exchanges, and the idea has not been limited to Democrats. The proposals made early on by House Republicans in 2017 would have effectively ended Section 1031 in what eventually became President Trump's Tax Cuts and Jobs Act, but instead the legislation did away with exchanges for every asset class except real estate. In 2014, President Obama's budget proposal suggested that 1031 exchanges should be limited to a maximum deferred amount of $1 million per taxpayer per year. But earlier that same year, Republican House Ways and Means Committee Chairman Dave Camp released a discussion draft of the proposed Tax Reform Act that stated that Section 1031 should be repealed, effective January 1, 2015. The Senate Finance Committee, led by Democrat Max Baucus, came to the same conclusion in their discussion draft, but the proposals were not adopted. The Tax Relief Act of 1997 under President Clinton (with Republican Newt Gingrich as Speaker of the House) attempted to place significant restrictions on Section 1031, but it also failed.

The intended purpose of the various proposals to limit or eliminate LKEs has always been to generate additional tax revenue, purportedly from the wealthiest of taxpayers. The Biden administration estimated that their plan would generate $19.55 billion over 10 years, but according to industry analysts, it ignored the additional economic—and taxable—activity created by the exchanges.

"Some people refer to the 1031 exchange as a loophole, but it's anything but a loophole," says Gabriel Silverstein, SIOR, national Chair of Institutional Capital Markets at SVN in Austin, Texas, who adds that it's important to emphasize that it's not a tax exemption but a tax deferral on which taxes will be paid at a later date. "It's part of the tax code that people plan around, and it's something that generates more economic activity, not less."

A study that estimated the economic activity supported by the like-kind exchange rules within the U.S. economy in 2021 was conducted by EY (formerly known as Ernst & Young Global) for the Like-Kind Exchange Coalition. It concluded that "Like-kind exchanges reduce the cost of capital and, consequently, increase the amount of investment in the U.S. economy. This investment, in turn, supports jobs, labor income, and value added in the U.S. economy." The report found that LKEs directly or indirectly supported 568,000 jobs, $27.5 billion in labor income, and $55.3 billion in value-added, if one includes the suppliers to businesses that make use of LKEs and the related consumer spending that is generated from that activity.

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“The value of the 1031 exchange from a larger market point of view is that it creates a lot of liquidity and transactional activity in the market that would not exist if the tax deferral benefit to one participant in the transaction wasn’t still part of the tax code,” stresses Silverstein. Without the 1031 exchange, he explains, long-term private owners of properties that have been significantly depreciated but are now greatly appreciated may be hesitant to sell, due to the enormous tax burden generated by the divergent paths of the tax basis of the asset versus the current market value. “If there wasn’t the ability to defer those taxes to the future by replacing that property that you sell with a like-kind property, then a lot of people just wouldn’t sell,” says Silverstein.

In their 2020 report, “The Tax and Economic Impacts of Section 1031 Like-Kind Exchanges in Real Estate”, professors David C. Ling of the University of Florida and Milena Petrova of Syracuse University researched multiple CRE data sets as well as more than one million transactions using CoStar data from 2010 to 2020 that included more than 100,000 like-kind exchange transactions. The researchers concluded that “although the present value of Treasury tax revenue losses associated with real estate like-kind exchanges is relatively small in magnitude, the elimination of exchanges would disrupt many local property markets and harm investors of all sizes at both local and national levels.” They also determined that 1031 exchanges are not dominated by large institutional investors, and that a broad range of taxpayers contribute to the positive economic impact. The median sale price of a property involved in an exchange during the study period was approximately $575,000, with 75% of properties involved in a 1031 exchange having a sale price of less than $1.5 million.

“We seem to have as many or more smaller, private capital investors looking to execute the exchange than we do the behemoths,” says Landon Williams, SIOR, senior vice president, Capital Markets with Cushman & Wakefield in Memphis, Tenn. “It’s not only the institutional capital and the REITs. On many occasions, we have newer investors who are trying to improve their personal financial position by using the 1031 exchange.”

The Petrova and Ling Study also discovered that buyers who used LKEs not only acquire replacement properties valued at amounts approximately 15.4% greater than those of non-exchanging buyers, they typically invest more capital into improvements on their replacement properties, which in turn generates jobs and tax revenue.

“There’s a truism in the industry, ‘Owners maintain, but buyers improve’,” says Baker, who believes that preserving Section 1031 is more important than ever in the wake of the pandemic, where many properties will need significant reinvestment or re-purposing in order to meet the needs of the evolving post-pandemic CRE market.

“You want to maintain the incentive for those owners to transfer those under-performing properties into the hands of buyers that have the wherewithal, the skill, and the imagination to do those transformations," says Baker. "And that will spur job growth for both skilled and unskilled tradespeople, plus title, escrow, financial and legal services, contractors, material suppliers…you have this whole stream of people and businesses that are generating taxable revenue because of the like-kind exchange. And if there's no exchange, no transaction, then there's no revenue."

Section 1031 appears to be safe for now, but as we have seen, it has been a frequent target of both Democrats and Republicans for over two decades. As the research bears out, the preservation of LKEs going forward is not only a vital investment tool for the CRE industry, but as an economic engine for the U.S. economy.

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