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Highlights of

The Tax and Economic Impacts of

Section 1031 Like-Kind Exchanges in Real Estate

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The 2020 study focuses on the period from 2010 to June 2020 and provides a comprehensive view of the use and geographic distribution of IRC Section 1031 like-kind exchanges. The authors examined data from CoStar, the National Association of Realtors, Marcus & Millichap Research Services and Investment Property Exchange Services ("IPX 1031").

The study concludes that approximately 10 – 20% of all commercial real estate transactions involve a 1031 and that a broad range of taxpayers – both small and large – utilize like-kind exchanges.

In evaluating the benefit of a like-kind exchange ("LKE"), the authors considered the incremental net present value of the exchange compared to a taxable sale as well as the corresponding tax disadvantages of an exchange, namely reduced depreciation deductions and increased capital gains tax and depreciation recapture tax on a taxable sale in the future. These findings show:

- The incremental net present value of an exchange ranged between 0.5% and 12% of the purchase price of the relinquished property, with a mean of 5%.
- The fair market value of a replacement property would need to decline by about 6% and the after-tax rental income would need to increase by 6% in order to offset the loss in tax benefits if 1031 was repealed.
- The incremental value of an exchange as a % of the tax liability ranged between 8 -58%, with a mean of 37%. Said differently, 63% of the value of the immediate tax deferral is eliminated due to reduced depreciation deductions on the replacement property and increased capital gains taxes on the future sale.

Taxpayers engaged in like-kind exchanges invest more capital into their replacement properties than non-tax motivated purchasers, and take on less debt. These lower loan to value ratios decrease risk in our financial system. Generally, 1031 investors have shorter holding periods than investors who do not engage in LKEs.

LKEs benefit investors of all sizes. In the data set provided by Investment Property Exchange Services, Inc. (IPX1031®), the median sale price of the relinquished properties was $575,000, and 75% of the properties in the data set were valued at less than $1.5 million, suggesting that like-kind exchanges are not exclusively utilized by institutional and corporate entities.

The fair market values (FMV) of replacement properties purchased in like-kind exchanges are, on average, 15% greater than properties purchased by non-tax motivated buyers. Further, the data indicates that in 62% of transactions, taxpayers invest in replacement property of greater value (compared to 45% of transactions in a non-tax motivated transaction).

Exchange buyers are likely to have the ability to make a larger down payment on replacement property leaving them with more capital to invest in improvements and upgrades to their properties. Increased investment in building improvements leads to greater investment returns, higher rents and property values, and higher prices at disposition.

The IPX1031® data set also shows that in 38% of the transactions, the FMV of replacement property is **less than** the FMV of relinquished property meaning that in more than 1/3 of the exchanges some tax is paid in the year of disposition.

Eliminating LKEs would create a lock-in effect resulting in fewer transactions and price declines. Without the ability to exchange, Taxpayers would continue to hold on to sub-optimal assets which in turn would exact a cost on the economy - properties would be more highly leveraged and owners would spend less on capital improvements.

Removing the lock-in effect allows taxpayers to preserve their investment capital and acquire larger properties, upgrade facilities, repurpose assets, and redeploy their capital into other geographic areas. These activities create jobs and contribute to the local and state tax bases, which in turn results in higher property tax revenue.

Like-kind exchanges also have a spillover effect into adjacent industries including construction, title insurance, and mortgage lending. Eliminating LKEs would result in disruptions of local real estate markets, hurting investors large and small on a local and national basis.

The overwhelming majority of exchangors who participate in LKEs eventually sell the replacement property in a taxable sale. The CoStar data set shows that just 12% of the replacement properties disposed of were sold through a subsequent exchange. Replacement properties sold in a taxable sale will face incrementally higher capitals gains tax and depreciation recapture tax.

The Joint Committee on Taxation estimates that $51.0 billion in tax revenue will be lost between 2019 and 2023 due to LKEs. The study concludes that this number is substantially overestimated 1) in that it is a static number that assumes an elimination of Section 1031 would not affect taxpayer's behavior – behavior that would likely further reduce revenue to Treasury; and 2) it does not take into account the difference in cost of capital to the U.S. Treasury compared to that of an individual.

The authors estimate that the present value of lost revenue, if LKEs were eliminated, is closer to $20 billion over five years, before accounting for any change in taxpayers' behavior. This is due in part to the fact that the U.S. Treasury's cost of capital is much lower than an individual taxpayer's. This cost of capital "wedge" means the net present value of lost revenue to Treasury is substantially lower than the net present value of the tax benefits of an exchange.