

Like-Kind Exchange: Protecting Consumers, Property Values and the Economy

Summary of “The Economic Impact of Repealing or Limiting Section 1031 Like-Kind Exchanges in Real Estate”

A new, in-depth study of the US commercial real estate market highlights the critical role that “like-kind exchanges” or “1031 exchanges” play in stabilizing rents, safeguarding property values and strengthening our economy.

What is a like-kind exchange? Like-kind exchange rules allow taxpayers to defer tax when they exchange one property held for investment or business use for other property of a “like kind.” These rules promote savings and investment, allow capital to flow freely and efficiently—ensuring its best use, encourage commerce and ultimately stimulate US economic growth and job creation.

As the first-of-its-kind study entitled, “The Economic Impact of Repealing or Limiting Section 1031 Like-Kind Exchanges in Real Estate,” confirms, like-kind exchange rules have led to a more dynamic real estate sector – one that encourages reinvestment and building improvement activity and allows real estate owners to better allocate resources. Furthermore, the rules lead to lower levels of debt in commercial and multifamily real estate markets.

Key findings include:

- **Like-kind exchanges encourage investment.** On average, taxpayers using a like-kind exchange acquire replacement property that is \$305K-\$422K more valuable than the relinquished property, while replacement properties without using an exchange are cheaper or of equal value.
- **Like-kind exchanges contribute significant federal tax revenue.** In 34 percent of exchanges, some federal tax is paid in the year of the exchange. More importantly, over the long run, like-kind exchanges boost tax revenue because of the higher tax liability that arises in the years following the initial exchange.
- **Like-kind exchanges provide only temporary tax deferral.** The overwhelming majority – 88 percent – of real estate replacement properties acquired through a like-kind exchange are disposed of through taxable sales, not subsequent like-kind exchanges.
- **Like-kind exchanges lead to job creation.** Real estate acquired through a like-kind exchange is associated with greater investment and capital expenditures (i.e., job-creating property upgrades and improvements) than real estate acquired without the use of like-kind exchange.
- **Like-kind exchanges result in less debt.** When the price of the replacement property is close to, or less, than the price of the relinquished property, like-kind exchanges result in a 10 percent reduction in borrowing, or leverage, at the time of the acquisition.

Despite the significant benefits of like-kind exchanges, some policymakers have proposed eliminating them. The result would undermine the real estate marketplace, raise taxes and discourage job-creating property improvements.

According to the study, if like-kind exchange rules are repealed:

- **Taxes would increase for thousands of commercial property owners.** For a typical property owner who defers his or her gain on a commercial property, repealing like-kind exchanges would raise the effective tax rate on the taxpayer's investment (including rental income and gain; nine-year holding period) from 23 percent to 30 percent.
- **Property values would drop.** In order for a commercial property to generate the same rate of return for the investor (if section 1031 were repealed), prices would have to decline. In local markets and states with moderate levels of taxation, commercial property prices would have to decline 8 to 12 percent to maintain required equity returns for investors expecting to use like-kind exchanges when disposing of properties. These price declines would reduce the wealth of a large cross-section of households and slow or stop construction in many local markets.
- **Rents would increase.** Over time, real rents would need to increase from 8 to 13 percent before new construction would be economically viable. These higher rents would reduce the affordability of commercial space for both large and small tenants. The price declines and rent effects of eliminating real estate like-kind exchanges would be more pronounced in high-tax states.
- **Real estate sales activity would decline.** Like-kind exchanges increase the liquidity of the real estate market. An analysis of 336,572 properties that were acquired and sold between 1997 and 2014 showed that properties involved in like-kind exchanges had significantly shorter holding periods.

Like-kind exchange rules are integral to a strong and prosperous real estate market, stimulating job creation, investment and economic growth. As the study's authors conclude:

Like-kind exchanges are associated with increased investment, shorter holding periods, and lower leverage ... the removal of exchanges will lead to a decrease in investment, an increase in holding periods (decrease in liquidity) and increase in the use of leverage to finance acquisitions. These micro effects are likely to have macro-economic consequences as well. For example, decreased construction and investment activity in commercial real estate markets will depress employment in sectors and markets where like-kind exchanges are commonly used.

About the Study:

"The Economic Impact of Repealing or Limiting Section 1031 Like-Kind Exchanges in Real Estate," was developed using the most comprehensive database of US commercial real estate activity in existence.

Authors Dr. David Ling (finance professor at the University of Florida's Warrington College of Business and past president of the American Real Estate and Urban Economics Association) and Dr. Milena Petrova (finance professor at Syracuse University's Whitman School of Management) analyzed more than 1.6 million real estate transactions over an 18-year period (1997 – 2014). Combined, the total volume of the transactions (unadjusted for inflation) is \$4.8 trillion.

Section 1031 LKE Revenue Loss: It is not what it appears to be

Professors David Ling (Univ. of Fla.) and Milena Petrova (Syracuse U.) updated their like-kind exchange research and submitted the first half for publication (National Tax Journal). The revised paper, dated August 20, 2017, now includes a third author, Professor David Barker from the University of Iowa. Their work remains powerful evidence of the importance of like-kind exchanges to real estate markets and property values.

- **Repeal would have a negative impact on real estate values:** “Overall, elimination of tax deferred exchanges for commercial real estate is likely to reduce market values, especially in high tax states, and cause disruptions in many local real estate markets, including reduced levels of construction and financial losses. The revenue gains to the Treasury, however, would be minor.”(at page 24)
- **The official revenue loss to the government is overstated:** “Using this model, we also estimate the effect of eliminating the option to exchange on Treasury tax collections. Unlike estimates that look only at the magnitude of deferred taxes to which a tax rate is applied, we take account of the disadvantages of exchanges to taxpayers, which are advantages to the Treasury. Our estimate of the gain to the Treasury if tax deferred exchanges had been eliminated in 2009, a year with relatively few exchange transactions, is \$4 million. For 2005, a year in which many exchange transactions took place, our estimate is \$280 million. An important reason that the benefit to taxpayers appears to be higher than the cost to the Treasury is the lower discount rate we apply to Treasury cash flows than to taxpayer cash flows.” (at page 24)
- **Revenue loss to the government is overstated due to a variety of factors:** “The (Joint Committee on Taxation) JCT’s tax expenditure estimate for like-kind exchanges in 2017 is \$90 billion over 2016-2020. However, this estimate does not include the present value of future foregone depreciation deductions or the present value of larger capital gains and depreciation recapture taxes the taxpayer incurs as a result of choosing an exchange strategy. Moreover, this estimate does not capture likely taxpayer responses to elimination of exchanges. The JCT’s revenue estimate from elimination, which does take into account behavioral responses such as delaying dispositions, is just \$9.3 billion over the five-year period, which is about one-tenth of the estimate that ignores a potential lock-in effect. If we apply the same fraction ($\$9.3 \text{ billion} \div \90 billion) to our estimated annual taxpayer benefits, the annual present value of lost tax revenue from real estate exchanges ranges from a low of \$10 million in 2009 and 2010 to a high of \$760 million in 2005. However, even these estimates are inflated because they assume the Treasury is discounting future tax revenues from an exchange at a 6 percent rate. Discounting at 2.26%, the current yield on nine-year treasury bonds, the static present value of annual lost tax revenue ranges from a low of \$4 million in 2009 and 2010 to a high of \$280 million in 2005.” (at page 23)ⁱ

ⁱ Barker, Ling, and Petrova, “The Benefits and Costs of Tax Deferral: An Analysis of Real Estate Tax-Deferred Exchanges.” (Pending Publication – National Tax Journal)