NEXT UP:
Preserving the 1031 Like-Kind Exchange – the Data Speaks

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Outline of Discussion

- Policy background of 1031 like-kind exchanges
- Why Section 1031 is in trouble
- The keys to saving LKEs – education and data
- What the data says:
  - Ling-Petrova study
  - NAR survey
  - EY study

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Like-Kind Exchanges Policy Background

- Section 1031 added to Internal Revenue Code in 1921
- Rationale: If investor or business continues with investment in asset that merely changes form & not substance, gain or loss should not be recognized, but deferred until asset is ultimately sold
- Provides tax deferral – not tax forgiveness
- Other examples include incorporation & partnership formation
- Court cases & IRS rulings allow great deal of flexibility
- Partial repeal of 1031 in Tax Cuts & Jobs Act of 2017

Why 1031 is in Trouble

- Tax concepts at work are not well understood by public
  - Capital gains
  - Like kind
  - Basis
  - Reinvestment of capital
  - Deferral
  - Depreciation
- Political left is often suspicious of tax incentives for capital
- Negative media about real estate moguls and big companies
- Need for political candidates to offset cost of new spending

Keys to Saving LKEs – Education & Data

- Many policy makers not up to speed about benefits of LKEs & how they work
- Members of Congress need “real life” examples of how 1031 has created jobs & growth in their states/districts
- Source must be credible
- Need independent data to back up examples

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What Data Do We Have?

1

Ling-Petrova Study

- 2015 microeconomic study by 2 university professors of impact of 1031 on RE sector
- Updated Summer 2020

2

NAR Survey

- 2020 survey of NAR members on activity in LKEs

3

EY Study

- 2015 macroeconomic study of impact of 1031 on U.S. economy
- Updated Fall 2020

Ling-Petrova Study

The Tax and Economic Impacts of Section 1031 Like-Kind Exchanges in Real Estate

David C. Ling and Milena Petrova

September 2020

Metholodogy of Ling-Petrova Study

- ✓ Document widespread use of RE LKEs
- ✓ Develop analytical model to quantify incremental PV of an exchange to the owner relative to taxable sale
- ✓ Conduct empirical analysis of exchanges to examine economic benefits

Use of 1031 Exchanges: Evidence from Transaction Data

- Employed several data sources to examine use of exchanges in CRE:
  - Transaction property data from Costar & Marcus & Millichap Research Service
  - Exchange data from IPX1031 & survey data from National Association of REALTORS® (NAR)
- Most comprehensive database of CRE sale/purchase transactions is from CoStar
  - Focused on 2010 to June 2020
  - Analysis based on 816,002 property transactions with median price of $1.1 million & total transaction volume of $3.4 trillion (unadjusted for inflation)
  - LKEs represent ~ 6% of total transactions with median price of $2.1 million & transaction volume of $241 billion.
  - Observed exchange share in CoStar understated, since CoStar flags a transaction as including a "1031 exchange sale condition" only if this information has been disclosed by one of the parties involved (buyer, seller, or a broker)
- Based on all sources, study concludes that share of LKEs likely ranges from 10-20% of all CRE transactions over sample period and are predominantly smaller deals.

Distribution of LKEs by Property Type based on Costar

	% of all exchanges	% of total $ volume of exchanges
Retail	31.4	21.4
Multifamily	31.3	37.9
Office	12.2	18.3
Industrial	11.0	7.8
Land	4.1	1.9
Other	10.0	12.7

Top 20 Exchange Markets (based on Costar)

CBSA		% of all exchanges	% of total $ volume of exchanges
Los Angeles		12.8%	15.4%
New York City		5.5%	0.8%
Denver		3.7%	3.4%
Seattle/Puget Sound		3.5%	3.4%
San Diego		3.5%	4.0%
San Francisco		3.5%	2.1%
Phoenix		3.4%	3.8%
Washington, DC		3.3%	1.0%
Orange County (California)		3.2%	3.4%
Portland		2.6%	4.0%
Inland Empire (California)		2.6%	3.6%
East Bay/Oakland		2.2%	2.1%
South Bay/San Jose		2.2%	1.6%
Minneapolis/St Paul		2.1%	2.3%
Northern New Jersey		2.1%	1.2%
Long Island (New York)		2.0%	1.4%
Chicago		1.8%	1.6%
South Florida		1.8%	1.5%
Dallas/Ft Worth		1.7%	1.0%
Las Vegas		1.7%	1.4%

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Percent of LKEs by State (2010-2020)

	Based on:			
	Number of sales		$ Transaction volume	
State	Percentage	Cumulative	Percentage	Cumulative
California	39.6%	39.6%	35.0%	35.0%
Washington	5.1%	44.7%	4.6%	39.7%
Arizona	4.8%	49.6%	4.1%	43.8%
Florida	4.4%	54.0%	5.4%	49.2%
Oregon	4.0%	58.0%	2.5%	51.7%
Colorado	4.0%	62.0%	4.1%	55.9%
New York	3.1%	65.1%	8.4%	64.2%
Texas	3.0%	68.1%	4.5%	68.7%
Minnesota	2.7%	70.8%	2.4%	71.1%
North Carolina	2.2%	73.0%	2.1%	73.2%
Nevada	2.1%	75.1%	2.2%	75.3%
Georgia	1.8%	76.9%	1.6%	76.9%
Illinois	1.8%	78.7%	1.9%	78.8%
South Carolina	1.4%	80.1%	0.9%	79.8%
New Jersey	1.3%	81.4%	2.1%	81.8%
Virginia	1.1%	82.5%	2.4%	84.3%
Ohio	1.0%	83.6%	0.7%	84.9%
Tennessee	1.0%	84.5%	0.7%	85.6%

Effects of LKEs on Treasury Revenues

- Elimination of LKEs would generate little in the way of additional tax revenue
- Liquidity would be reduced (holding periods would increase)
  - Less efficient allocation of scarce resources (lock-in effect)
  - Less ability for (especially small) investors to reposition portfolios
- Prices in some markets would decrease in the short-run
- Secondary effects could include decreased employment in RE & related sectors

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Conclusions of Empirical Evidence

- There is widespread use of RE like-kind exchanges
- 1031 exchanges are associated with increased investment, reduced leverage (lower risk) & shorter holding periods
- Tax revenue losses of LKEs may be overestimated while their benefits overlooked
- Elimination of RE LKEs will likely lead to:
  - Decrease in CRE prices
  - Less reinvestment in commercial & residential real estate
  - Greater use of leverage, and
  - Increase in investment holding periods and decrease in liquidity

Ling-Petrova Rationale for Like-Kind Exchanges

- Investment RE is extremely illiquid and difficult to value
  - Unlike liquid markets for stocks and bonds
- Exchanging one illiquid asset for another does not change the economic position of the investor (assuming no cash is received)
- RE estate exchanges:
  - Increase the liquidity of investment real estate
  - Allow capital to flow more freely to its most productive use
    - Especially important to the many small investors who make extensive use of exchanges to reposition portfolios
    - Has positive "macroeconomic" benefits as well
  - Allow more reinvestment in investment RE by reducing tax burdens on dispositions
  - Reduce the amount of leverage used to require replacement properties
  - Generate increased employment in related sectors
  - Produce increased transfer and recording fees/taxes for local governments
  - Do not generally create permanent tax deferral
    - In sample, 87% of exchanges are followed by a fully taxable sale

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NAR Survey

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Like-Kind Exchange Transactions of REALTORS® Survey, 2016 - 2019

- Sent to all 76,000 NAR Commercial members and a random sampling of 50,000 NAR residential members
- Total respondents: 3,933
- Asked about 1031 transactions between 2016 – 2019

WHO IS DOING 1031s?

- **61%** of REALTORS® report at least one 1031 transaction during 2016 – 2019
  - **68%** of NAR Commercial members had at least one
- **12%** of sales transactions by NAR Commercial Members were 1031s
- **5%** of sales transactions by NAR Residential Members were 1031s
- **84%** of the properties that were exchanged for like-kind properties were held by small investors in sole proprietorships (47%) or in S corporations (37%)
- **52%** of properties sold in a like-kind exchange were residential properties: (27% single-family homes for rent, 15% apartment buildings, and 10% condominium units)

WHAT ARE THE POSITIVE EFFECTS OF 1031s?

- **89%** of REALTORS® report that clients invested additional capital in the replacement property
- **75%** reported the additional investment was at least **10%** of the FMV of the replacement property
- **94%** of REALTORS® expect property values to decline if 1031 is repealed
- **87%** expect longer holding periods if 1031 is repealed
- **68%** expect higher rent in the acquired property if 1031 is repealed
- **50%** expect an increase in debt financing if 1031 is repealed

EY Study

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Economic Impact of Repealing Like-Kind Exchange Rules

Prepared on behalf of the
Section 1031 Like-Kind
Exchange Coalition
2015

2015 EY Study

- Purpose:
  - Examine the macroeconomic impact of proposals to repeal Section 1031 LKE rules

- Overall Findings:
  - Repealing LKEs would subject businesses that rely on them to a higher tax burden, resulting in longer holding periods, greater reliance on debt financing, and less-productive deployment of capital in the economy

- Impact of GDP, Investment & Labor:
  - If revenue from repealing 1031 is used to lower corporate tax rate, the combined impact would result in a smaller economy, with less investment and lower labor incomes for workers
    - GDP is estimated to fall by $8.1 billion each year in the long-run
    - Investment is estimated to fall by $7.0 billion in the long-run
    - Labor income is estimated to fall by $1.4 billion in the long-run

2015 EY Study (cont.)

- Impact of GDP, Investment & Labor (cont.):
  - If revenue from repealing 1031 is used to pay for higher government spending:
    - GDP is estimated to fall by $13.1 billion each year in the long-run

- Concentrated impact on certain industries
  - Economic activity supported by combined residential and non-residential real estate industries is estimated to contract in total by $9.3 billion in output annually in the long-run
  - Economic activity supported by the specialty construction trade contractors industry is estimated to contract in total by $7.7 billion in output annually in the long-run
  - Other industries would also suffer impacts:
    - Truck transportation - $4.7 billion
    - Heavy and civil engineering - $3.1 billion
    - Top ten sub-industries - $27.5 billion annually in long-run

2015 EY Study (cont.)

- Impact on Federal Tax Revenue:
  - Decline in long-run GDP can be expected to result in decline in annual federal revenue
    - Amount of decline depends on what revenue from repeal of 1031 is used for
    - If revenue is used to reduce corporate income tax rate – $8.1 billion annual revenue loss
    - If revenue is used to increase government spending – $13.1 annual revenue loss
    - If revenue is used to reduce business sector taxes – $6.1 billion annual revenue loss

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Focus of Updated 2020 EY Study

- 2015 study measured impact of GDP during a time of full employment
  - This is obviously no longer the case
- Also, 2015 study included impact of repeal on non-RE assets
  - 2017 TCJA repealed 1031 for non-RE, so impact now will be different

- 2020 update will focus more on impact of job growth spurred by LKEs during a period of less-than full employment
  - Will also focus on significant need to repurpose & renovate existing CRE to meet changing needs of pandemic & post-pandemic business models

- Expected completion is November 2020

Main Takeaways

- ✓ LKEs are well established & provide huge benefits but are not well understood
- ✓ As was case in 2017, keys to saving 1031 are education & solid data delivered by credible home state/district sources to policy makers
- ✓ Studies complement each other:
  - ✓ L-P shows impact on RE industry
  - ✓ NAR survey shows that 1031 used by Mom & Pop investors & businesses
  - ✓ EY updated study will focus on overall economy
- ✓ **Bottom Line Message: Repeal would harm economy & stagger CRE sector at worst possible time and not produce desired tax revenue to U.S. Treasury**

Thank You!

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