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

Evan Liddiard, CPA
Director of Federal Tax Policy

Erin Stackley
Senior Representative, Commercial Legislative Policy

NATIONAL ASSOCIATION OF REALTORS®
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
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
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
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

<table>
<thead>
<tr>
<th>Property Type</th>
<th>% of all exchanges</th>
<th>% of total $ volume of exchanges</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retail</td>
<td>31.4</td>
<td>21.4</td>
</tr>
<tr>
<td>Multifamily</td>
<td>31.3</td>
<td>37.9</td>
</tr>
<tr>
<td>Office</td>
<td>12.2</td>
<td>18.3</td>
</tr>
<tr>
<td>Industrial</td>
<td>11.0</td>
<td>7.8</td>
</tr>
<tr>
<td>Land</td>
<td>4.1</td>
<td>1.9</td>
</tr>
<tr>
<td>Other</td>
<td>10.0</td>
<td>12.7</td>
</tr>
</tbody>
</table>
## Top 20 Exchange Markets (based on Costar)

<table>
<thead>
<tr>
<th>CBSA</th>
<th>% of all exchanges</th>
<th>% of total $ volume of exchanges</th>
</tr>
</thead>
<tbody>
<tr>
<td>Los Angeles</td>
<td>12.8%</td>
<td>15.4%</td>
</tr>
<tr>
<td>New York City</td>
<td>5.5%</td>
<td>0.8%</td>
</tr>
<tr>
<td>Denver</td>
<td>3.7%</td>
<td>3.4%</td>
</tr>
<tr>
<td>Seattle/Puget Sound</td>
<td>3.5%</td>
<td>3.4%</td>
</tr>
<tr>
<td>San Diego</td>
<td>3.5%</td>
<td>4.0%</td>
</tr>
<tr>
<td>San Francisco</td>
<td>3.5%</td>
<td>2.1%</td>
</tr>
<tr>
<td>Phoenix</td>
<td>3.4%</td>
<td>3.8%</td>
</tr>
<tr>
<td>Washington, DC</td>
<td>3.3%</td>
<td>1.0%</td>
</tr>
<tr>
<td>Orange County (California)</td>
<td>3.2%</td>
<td>3.4%</td>
</tr>
<tr>
<td>Portland</td>
<td>2.6%</td>
<td>4.0%</td>
</tr>
<tr>
<td>Inland Empire (California)</td>
<td>2.6%</td>
<td>3.6%</td>
</tr>
<tr>
<td>East Bay/Oakland</td>
<td>2.2%</td>
<td>2.1%</td>
</tr>
<tr>
<td>South Bay/San Jose</td>
<td>2.2%</td>
<td>1.6%</td>
</tr>
<tr>
<td>Minneapolis/St Paul</td>
<td>2.1%</td>
<td>2.3%</td>
</tr>
<tr>
<td>Northern New Jersey</td>
<td>2.1%</td>
<td>1.2%</td>
</tr>
<tr>
<td>Long Island (New York)</td>
<td>2.0%</td>
<td>1.4%</td>
</tr>
<tr>
<td>Chicago</td>
<td>1.8%</td>
<td>1.6%</td>
</tr>
<tr>
<td>South Florida</td>
<td>1.8%</td>
<td>1.5%</td>
</tr>
<tr>
<td>Dallas/Ft Worth</td>
<td>1.7%</td>
<td>1.0%</td>
</tr>
<tr>
<td>Las Vegas</td>
<td>1.7%</td>
<td>1.4%</td>
</tr>
</tbody>
</table>
## Percent of LKEs by State (2010-2020)

<table>
<thead>
<tr>
<th>State</th>
<th>Number of sales</th>
<th>$ Transaction volume</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Percentage</td>
<td>Cumulative</td>
</tr>
<tr>
<td>California</td>
<td>39.6%</td>
<td>39.6%</td>
</tr>
<tr>
<td>Washington</td>
<td>5.1%</td>
<td>44.7%</td>
</tr>
<tr>
<td>Arizona</td>
<td>4.8%</td>
<td>49.6%</td>
</tr>
<tr>
<td>Florida</td>
<td>4.4%</td>
<td>54.0%</td>
</tr>
<tr>
<td>Oregon</td>
<td>4.0%</td>
<td>58.0%</td>
</tr>
<tr>
<td>Colorado</td>
<td>4.0%</td>
<td>62.0%</td>
</tr>
<tr>
<td>New York</td>
<td>3.1%</td>
<td>65.1%</td>
</tr>
<tr>
<td>Texas</td>
<td>3.0%</td>
<td>68.1%</td>
</tr>
<tr>
<td>Minnesota</td>
<td>2.7%</td>
<td>70.8%</td>
</tr>
<tr>
<td>North Carolina</td>
<td>2.2%</td>
<td>73.0%</td>
</tr>
<tr>
<td>Nevada</td>
<td>2.1%</td>
<td>75.1%</td>
</tr>
<tr>
<td>Georgia</td>
<td>1.8%</td>
<td>76.9%</td>
</tr>
<tr>
<td>Illinois</td>
<td>1.8%</td>
<td>78.7%</td>
</tr>
<tr>
<td>South Carolina</td>
<td>1.4%</td>
<td>80.1%</td>
</tr>
<tr>
<td>New Jersey</td>
<td>1.3%</td>
<td>81.4%</td>
</tr>
<tr>
<td>Virginia</td>
<td>1.1%</td>
<td>82.5%</td>
</tr>
<tr>
<td>Ohio</td>
<td>1.0%</td>
<td>83.6%</td>
</tr>
<tr>
<td>Tennessee</td>
<td>1.0%</td>
<td>84.5%</td>
</tr>
</tbody>
</table>
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
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
NAR Survey
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
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
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
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
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!