Institute for Portfolio Alternatives

NOVEMBER 2019

1031 ISSUE BRIEF

- The Institute for Portfolio Alternatives (IPA) provides national leadership for the Portfolio Diversifying Investments (PDI) industry. We bring together the investment managers, broker-dealers, investment advisers and industry service professionals – new and established – who are dedicated to driving transparency and innovation in the marketplace. Through advocacy and industry-leading education, the IPA is committed to ensuring all investors have access to real assets and the opportunity to effectively balance their investment portfolios.

- Our members, working directly with professional financial advisors, provide Main Street investors access to institutional quality investment strategies, including Section 1031 like-kind exchanges, once only available to Wall Street. As the burden of retirement planning and savings shift, it's paramount that Main Street has access to PDIs and the long term benefits these investments offer.

- Section 1031 has been part of the U.S. tax code since 1921 and is one of the most powerful economic tools in the code. Section 1031 transactions create a broad spectrum of activities that generate taxable income and jobs. It is important to note that Section 1031 provides only a tax deferral; ultimately, taxes must be paid on the gains.

- Real estate owners use like-kind exchanges to efficiently allocate capital to its most productive use. Like-kind exchanges enable owners to reposition portfolios, exchange non-essential assets for core assets, and realign property by geography or industry to improve operating efficiencies and manage risk. Like-kind exchanges also support reinvestment in real estate and enable new construction and development activity.

- Like-kind exchanges are used by a broad spectrum of taxpayers, including Main Street investors. Those include both small investors in single-family rental units or small apartment buildings as well as growing businesses that own real estate but need to move their facilities as they grow and expand.

- Like-kind exchanges encourage investment and reinvestment in U.S. assets, and make it easier for taxpayers to relocate or upgrade into assets that better meet their personal or business needs. For example, farmers and ranchers commonly exchange acreage to relocate, consolidate, or improve their operations without diminishing their cash flow. As cited by the Federal Exchange Accommodators, approximately 50% of exchanges have gain of less than $500k and 75% have gains of less than $1 million.

- Like-kind exchange rules have facilitated the preservation of significant acreage of environmentally sensitive land, and have resulted in improvements and upgrades to buildings in need of repair.

- Section 1031 is grounded in sound tax policy that generates broad economic and environmental benefits that serve the public interest. Section 1031 should continue to be protected. Any proposal to restrict or eliminate like-kind exchanges should be rejected by Congress.

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- There have been several well documented economic studies on Section 1031 like-kind exchanges. These studies found that the forced immediate recognition of gain upon the disposition of investment real estate and other capital assets will result in a higher cost of capital, greater reliance on debt financing, and will serve as a deterrent to investment in new assets. This impacts Main Street disproportionately since Wall Street has greater access to capital and debt financing.
  - In 2015 Ernst & Young[1] completed a macroeconomic study, finding that either repeal or limitation of like-kind exchanges could lead to a decline in US GDP for real estate and new construction of $17 billion annually, with a net contraction of up to $13 billion annually, long term.
  - In 2015 Professors David C. Ling and Milena Petrova[2] also did a microeconomic study on commercial real estate. Their study supports that without like-kind exchanges, businesses and entrepreneurs would have less incentive and ability to make real estate and other capital investments. This study further found that taxpayers engaged in a like-kind exchange make significantly greater investments in replacement property than non-exchanging buyers.
    - The Ling and Petrova study reviewed over 1.6 million commercial real estate transactions over an 18-year period.
    - Its major findings include:
      - 1/3 of all exchanges pay some tax during the year of the exchange.
      - Exchanging taxpayers invest about 33% more capital into replacement property acquired than non-exchanging buyers.
      - 88% of all replacement properties are disposed of through a taxable sale, not through a subsequent exchange or taking the gain to the grave.
    - The Ling & Petrova study supported the conclusions of Ernst & Young, noting that repeal of Section 1031 would result in property values falling 8 to 12%, and rent rising up to 13%.

[1] Ernst & Young, Economic Impact of Repealing Like-Kind Exchange Rules, Prepared on behalf of the Section 1031 Like-Kind Exchange Coalition, March 2015 (revised November 2015), available at https://www.1031taxreform.com/wp-content/uploads/EY-Report-for-LKE-Coalition-on-macroeconomic-impact-of-repealing-LKE-rules-revised-2015-11-18.pdf.

[2] Professors David C. Ling and Milena Petrova, The Economic Impact of Repealing or Limiting Section 1031 Like-Kind Exchanges in Real Estate, March 2015 (revised June 22, 2015), available at https://www.1031taxreform.com/wp-content/uploads/Ling-Petrova-Economic-Impact-of-Repealing-or-Limiting-Section-1031-in-Real-Estate.pdf.

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