# THE TAX AND ECONOMIC IMPACTS OF SECTION 1031 LIKE-KIND EXCHANGES IN REAL ESTATE

New empirical research and economic modeling on the impact of real estate like-kind exchanges by Professors David Ling[1] and Milena Petrova[2] demonstrate the importance of exchanges for broad-based growth, economic opportunity, and job creation. The research sheds light on how exchanges support the expansion of small businesses, the availability of rental housing, and the creation of new jobs. Their work suggests that like-kind exchanges contribute to healthy, stable real estate markets, particularly during periods of economic stress, and reduce economic risk with little or no cost to taxpayers. Key takeaways from the study by the leading academic experts on like-kind exchanges include the following:

- **Like-kind exchanges are common throughout the country and a deeply ingrained feature of commercial real estate markets.** Exchanges represent a large share of overall real estate activity. An estimated 10 to 20 percent of commercial real estate transactions from 2010 through mid-2020 involved a like-kind exchange.

- **Like-kind exchanges are widely used by small businesses and small-scale property owners and investors.** The median 1031 transaction involves a property valued less than $600,000. Property owners use exchanges to acquire modest multifamily rental properties, small shopping centers, and other income-producing assets. Between 2010 and mid-2020, relinquished properties in 1031 transactions were sold at a median price of $575,000, with 75 percent of properties involved in a 1031 exchange sale having a price of less than $1.5 million.

- **Repeal of like-kind exchanges would lower property values and increase rental costs.** If section 1031 was repealed, all else equal, the market value of replacement properties would have to decline by an average of 6 percent to offset the additional tax burden for the buyer. Alternatively, the value of future after-tax rental income – and thus rental costs for potential tenants– would have to increase by 6 percent to offset the additional tax burden.

- **Like-kind exchanges stimulate capital investment and job-creating capital expenditures.** Taxpayers acquiring property through a like-kind exchange spend, on average, $127,500 more on the replacement property (15.4 percent of value) than taxpayers acquiring property following a fully taxable sale. Taxpayers acquiring property through a like-kind exchange also spend more on building improvements.

- **Like-kind exchanges support healthy, liquid real estate markets.** Property relinquished in a like-kind exchange has an average holding period that is almost one year shorter than the average holding period for property sold in a taxable sale (10.5 years vs. 11.4 years). The shorter average holding period contributes to an efficient marketplace. Exchanges eliminate the "lock in" effect on property ownership caused by the tax that would apply to built-in gain in a taxable sale. Properties that are otherwise languishing and suffering from underinvestment are transferred to owners with the time, resources, and desire to improve them. The end result is increased jobs for those involved in all aspects of property construction, maintenance, and operation.

- **Like-kind exchanges reduce reliance on debt and leverage.** Properties acquired in an exchange have mean loan-to-value ratios of 30 percent compared to 43 percent for properties acquired in fully taxable transactions. The reduced reliance on leverage removes a potential source of economic risk. Because like-kind exchanges are less reliant on outside sources of financing, they provide important support to real estate markets during periods of economic stress.

- **Repeal of like-kind exchanges would remove a critical source of financing for rental housing.** Transactions involving multifamily housing represented the largest share of like-kind exchanges between 2010 and 2020. Multifamily properties made up nearly 38 percent of the total dollar volume of exchanges during the 10-year period. As noted above, an inability to defer gain through an exchange would create pressure to raise rental costs on tenants.

- **The loss in federal tax revenue from like-kind exchanges is greatly overstated.** In a like-kind exchange, the value of the relinquished property and replacement property are seldom perfectly aligned. Any cash or non-like-kind property received in the transaction ("boot") is subject to immediate taxation. On average 63 percent of the value of the tax deferral from a like-kind exchange is recovered by the federal government through reduced depreciation deductions for the replacement property (because of a lower tax basis), as well as increased capital gain and depreciation recapture tax liability when the property is later sold. In addition, important collateral effects (e.g., the impact of exchanges on transaction activity, property values, and wages earned by market participants involved in exchanges) are not fully captured in the JCT tax expenditure estimates.

A Note on Methodology

The October 2020 study was commissioned by the Real Estate Research Consortium.[3] Professors Ling and Petrova utilized several data sources to examine the use of like-kind exchanges in commercial real estate property. These sources include CoStar, Marcus & Millichap Research Services, exchange data from IPX1031®, and survey data from the National Association of REALTORS®. The Professors analyzed 1,143,621 transactions captured by CoStar from January 1, 2010 until June 30, 2020. They identified 45,214 sales involving like-kind exchanges with a total like-kind exchange transaction volume of $241 billion. The full study provides a detailed examination of exchanges in different asset classes (retail, multifamily, office, industrial, and land) and different parts of the country. The study is a follow up to 2015 like-kind exchange research by Professors Ling and Petrova that was recently peer-reviewed and published in the *Journal of Real Estate Literature (2020)*. The 2015 research examined 1.6 million commercial real estate transactions between 1997 and 2014.

[1]McGurn Professor of Real Estate, Hough Graduate School of Business, University of Florida, Gainesville, FL 32611-7168, phone: (352) 273-0313, email: ling@ufl.edu.

[2]Associate Professor of Real Estate and Finance, Department of Finance, Whitman School of Management, Syracuse University, Syracuse, NY 13244; phone: (315) 443-9631; email: mpetrova@syr.edu.

[3]The following organizations are members of the Real Estate Research Consortium: Alternative & Direct Investment Securities Association; American Hotel & Lodging Association; American Land Title Association; American Seniors Housing Association; Asian American Hotel Owners Association; Commercial Real Estate Finance Council; Federation of Exchange Accommodators; International Council of Shopping Centers; Institute for Portfolio Alternatives; Mortgage Bankers Association; NAIOP, Commercial Real Estate Development Association; Nareit; National Association of REALTORS®; National Multifamily Housing Council; and The Real Estate Roundtable.