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

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A Study Funded by *The Real Estate Like-Kind Exchange Coalition*

Highlights

- Widespread use of real estate like-kind exchanges:
  - 6 percent (5 percent) of all commercial real estate sales based on volume (number of transactions)
  - Use of exchanges in high-tax states varies between 10 – 18 percent of all sales in the respective market

- Deferred gains are associated with a relatively small static value of lost Treasury revenues from real estate exchanges.
  - In 2011 $33.7 billion of deferred gains from real estate like exchanges is associated with a $200 million - $3 billion static present value of lost Treasury revenues
  - Meanwhile replacement exchanges in the same year are associated with increased investment of $517 million - $1.85 billion

- Estimated short-run declines in prices and long-run increases in rents required to offset the increased tax burden of eliminating like-kind exchanges based on a "typical project model":
  - Price declines of 8-12 percent in local markets with moderate taxes
  - Rent increases of 8-13 percent in the long run
  - More pronounced price and rent effects in high tax states

- The main economic benefits from real estate like-kind exchanges are increased investment, reduced leverage and reduced holding periods.
  - Higher investment
    - Replacement like-kind exchanges are associated with a higher investment of approximately $305,000 (33 percent of value) compared to acquisitions by the same investor following a sale of a property.
    - Capital expenditures (specifically building improvements) in replacement exchange properties tend to be higher by about $0.27/sf-$0.40/sf.
  - Decreased leverage – investors in like-kind exchanges benefit by a lower leverage of 6 percent compared to leverage, used to acquire properties in ordinary acquisitions.
  - Shorter holding periods – holding periods for properties acquired through 1031 exchanges tend to be on average half a year shorter.

- Costs of real-estate like-kind exchanges
  - Large deferred gains ($33.7 billion in 2011), but:
    - in contrast to the common view that exchanges are frequently rolled over to potentially avoid capital gain and depreciation tax liability indefinitely, in 88 percent of the cases investors dispose of properties acquired in a 1031 exchange through a taxable sale.
    - The estimated taxes paid in exchange followed by a taxable sale vs. ordinary sale followed by an ordinary sale are on average 19% higher.
    - The increased investment in real estate through 1031 exchanges is close in value to the static present value of lost Treasury revenues.

Conclusion: The results of our user cost models and empirical analyses suggest that the cost of like-kind exchanges is likely largely overestimated, while its benefits overlooked. The elimination of real estate exchanges will likely lead to decrease in prices, increase in rents, decrease in real estate investment, increase in investment holding periods, and increase in the use of leverage.