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The Importance of Like-Kind Exchanges During Periods of Reduced Commercial Real Estate Market Liquidity

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Like-kind exchanges under Internal Revenue Code Section 1031 are a critical component of the commercial real estate investment landscape and indirectly, the banking system. Exchanges facilitate market liquidity and transaction flow in a sector that contributes an estimated $3-$4 trillion dollars* to the US economy annually. As reported in a 2021 study by Ernst & Young, the 1031 exchange subsector alone directly and indirectly supports nearly 1 million jobs, nearly $50 billion in labor income, and nearly $100 billion of value add.

Section 1031 allows investors who own real property with significant gains to sell and purchase replacement properties that may need improvements or re-purposing to be viable and productive. Exchange investors often have more equity, greater purchasing power, and lower loan-to-value ratios than other purchasers, thereby reducing systemic risk in the banking industry. Additionally, exchange investors contribute liquidity in an otherwise illiquid market and help provide price discovery.

Exchanges are particularly important to the commercial real estate market during periods of reduced transaction activity. As capital markets restrict and inhibit more normalized real estate investment activity, the tax deferral offered by Section 1031 continues to create incentives to sell, adding much needed liquidity to the market, and creating a defined trade window with transaction deadlines. This, in turn, facilitates timely transactions and price stability even when the broader market is experiencing buyer/seller pricing gaps and tighter buyer underwriting due to increased interest rates, reduced availability of capital, and expected reduced demand for commercial real estate space. Without Section 1031 transaction flow, commercial real estate markets would slow even more and require more time to recalibrate.

In 2019, the US commercial real estate market had 37,106 transactions and $606.8 billion dollars of volume based on Real Capital Analytics data which tracks commercial real estate transactions greater than $2.5 million. In the first half of that year, there were 16,570 transactions and $262.4 billion of dollar volume. In the first half of 2023, due to the rapid increase in interest rates, tighter lender underwriting, weakened economic outlook and a wide range of geopolitical issues, the transaction count fell 22.1% below the first half of 2019 to 12,902.** Commercial real estate sales and the dollar volume declined 28.7% below the first half of 2019 to $187 billion. But, according to the Federation of Exchange Accommodators, the number of 1031 exchanges initiated*** increased nearly 15% from 17,467 in the first half of 2019 to 20,070 in the first half of 2023.

The 15% rise in the number of exchanges initiated, when commercial real estate transaction count fell by 22.1%, underscores the importance of like-kind exchanges in periods of reduced commercial real estate market activity. Sustaining transaction velocity in times of weakened market momentum is important to achieving market and pricing stability. This, in turn, reduces the likelihood of market and economic shock that results from rapidly falling prices and the risks attendant to the banking and financial market sectors. The liquidity created by 1031 exchanges can reduce the risk of commercial property default, which in turn reduces risk in the banking and financial systems that would otherwise imperil the broader financial market.

* Based on *"Economic Impacts of Commercial Real Estate"* published by NAIOP Research Foundation plus *"Economic contribution of the like-kind exchange rules to the US economy in 2021: An update"* published by EY.
** Omits STORE Capital entity acquisition in 1Q 2023
*** Exchanges initiated includes **all** 1031 exchanges, not only those involving commercial real estate