

Like-Kind Exchange: Protecting Consumers, Property Values and the Economy

A new, in-depth study of the US commercial real estate market highlights the critical role that “like-kind exchanges” or “1031 exchanges” play in stabilizing rents, safeguarding property values and strengthening our economy.

What is a like-kind exchange? Like-kind exchange rules allow taxpayers to defer tax when they exchange one property held for investment or business use for other property of a “like kind.” These rules promote savings and investment, allow capital to flow freely and efficiently—ensuring its best use, encourage commerce and ultimately stimulate US economic growth and job creation.

As the first-of-its-kind study entitled, “The Economic Impact of Repealing or Limiting Section 1031 Like-Kind Exchanges in Real Estate,” confirms, like-kind exchange rules have led to a more dynamic real estate sector – one that encourages reinvestment and building improvement activity and allows real estate owners to better allocate resources. Furthermore, the rules lead to lower levels of debt in commercial and multifamily real estate markets.

Key findings include:

- **Like-kind exchanges encourage investment.** On average, taxpayers using a like-kind exchange acquire replacement property that is \$305K-\$422K more valuable than the relinquished property, while replacement properties without using an exchange are cheaper or of equal value.
- **Like-kind exchanges contribute significant federal tax revenue.** In 34 percent of exchanges, some federal tax is paid in the year of the exchange. More importantly, over the long run, like-kind exchanges boost tax revenue because of the higher tax liability that arises in the years following the initial exchange.
- **Like-kind exchanges lead to job creation.** Real estate acquired through a like-kind exchange is associated with greater investment and capital expenditures (i.e., job-creating property upgrades and improvements) than real estate acquired without the use of like-kind exchange.
- **Like-kind exchanges result in less debt.** When the price of the replacement property is close to, or less, than the price of the relinquished property, like-kind exchanges result in a 10 percent reduction in borrowing, or leverage, at the time of the acquisition.

Despite the significant benefits of like-kind exchanges, some policymakers have proposed eliminating them. The result would undermine the real estate marketplace, raise taxes and discourage job-creating property improvements.

According to the study, if like-kind exchange rules are repealed:

- **Taxes would increase for thousands of commercial property owners.** For a typical property owner who defers his or her gain on a commercial property, repealing like-kind exchanges would raise the effective tax rate on the taxpayer's investment (including rental income and gain; nine-year holding period) from 23 percent to 30 percent.
- **Property values would drop.** In order for a commercial property to generate the same rate of return for the investor (if section 1031 were repealed), prices would have to decline. In local markets and states with moderate levels of taxation, commercial property price would have to decline 8 to 12 percent to maintain required equity returns for investors expecting to use like-kind exchanges when disposing of properties. These price declines would reduce the wealth of a large cross-section of households and slow or stop construction in many local markets.
- **Rents would increase.** Over time, real rents would need to increase from 8 to 13 percent before new construction would be economically viable. These higher rents would reduce the affordability of commercial space for both large and small tenants. The price declines and rent effects of eliminating real estate like-kind exchanges would be more pronounced in high-tax states.
- **Real estate sales activity would decline.** Like-kind exchanges increase the liquidity of the real estate market. An analysis of 336,572 properties that were acquired and sold between 1997 and 2014 showed that properties involved in like-kind exchanges had significantly shorter holding periods.

Like-kind exchange rules are integral to a strong and prosperous real estate market, stimulating job creation, investment and economic growth. As the study's authors conclude:

Like-kind exchanges are associated with increased investment, shorter holding periods, and lower leverage ... the removal of exchanges will lead to a decrease in investment, an increase in holding periods (decrease in liquidity) and increase in the use of leverage to finance acquisitions. These micro effects are likely to have macro-economic consequences as well. For example, decreased construction and investment activity in commercial real estate markets will depress employment in sectors and markets where like-kind exchanges are commonly used.

About the Study:

"The Economic Impact of Repealing or Limiting Section 1031 Like-Kind Exchanges in Real Estate," was developed using the most comprehensive database of US commercial real estate activity in existence.

Authors Dr. David Ling (finance professor at the University of Florida's Warrington College of Business and past president of the American Real Estate and Urban Economics Association) and Dr. Milena Petrova (finance professor at Syracuse University's Whitman School of Management) analyzed more than 1.6 million real estate transactions over an 18-year period (1997 – 2014). Combined, the total volume of the transaction (unadjusted for inflation) is \$4.8 trillion.