The Tax and Economic Impacts of Section 1031 Like-Kind Exchanges in Real Estate

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We employ several data sources and document the widespread use of real estate like-kind exchanges

- Based on CoStar COMPS: the CRE industry most comprehensive database of property sale/purchase transactions
  - Like-kind exchanges represent approximately 6% of total transactions with a **median price of $2.1 million** and **transaction volume of $241 billion over 2010-06/2020**.
  - **Observed exchange share in CoStar understated**, since CoStar flags a transaction as including a "1031 exchange sale condition" only if this information has been disclosed by one of the parties involved (buyer, seller, or a broker).
- Based on Marcus & Millichap Research Services:
  - 23% of their apartment, shopping center, office, and industrial property transactions involved a 1031 buyer
  - **39% of net leased** properties involved an exchange
  - Exchanges are **relatively equally distributed among the four major property types**: apartment (22%), office (20%), industrial (21%) and retail (27%)
- Based on July 2020 Survey by the National Association of Realtors (NAR):
  - 12% of participants' transactions over the past four years (2016-2019) were part of a 1031 like-kind exchange
- Based on exchange data from the Investment Property Exchange Services, Inc. (IPX1031®), a national leader in 1031 exchange services:
  - During 2010-June 2020 IPX1031® served as a qualified intermediary in **123,359 (131,748) relinquished (replacement) property exchanges**, involving a variety of property types
  - 75 percent of properties involved in a 1031 exchange have a price of less than $1.5 million
  - Like-kind exchanges include a large number of single family and modest multifamily residential rental properties

→ Based on these sources we conclude that the share of exchanges likely ranges from 10 to 20% of all CRE transactions over the period of 2010-2020

Exchanges are associated with higher investment

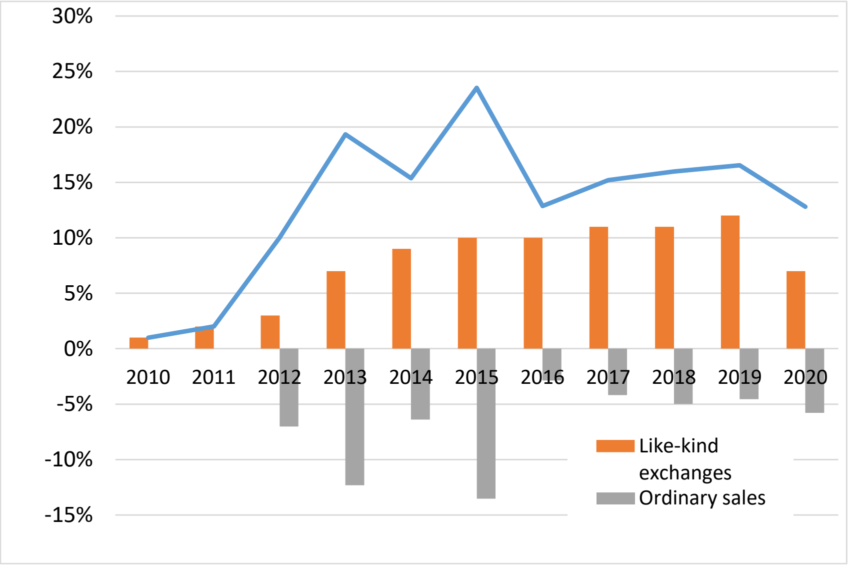
- A seller using a 1031 exchange has the incentive to invest the full amount of proceeds from the sale of the relinquished property to acquire the replacement property(s).

- On average replacement exchanges are associated with an increased investment of **$127,500** or **15.4% of the value** of the relinquished property

- The price difference ($P_{replacement}$-$P_{relinquished}$) is positive in **62% of the like-kind exchanges** and only **45% of the non-tax motivated** transactions.
  - Taxes are not fully deferred in 38 percent of the like-kind exchanges.

- Results are robust over time and by state

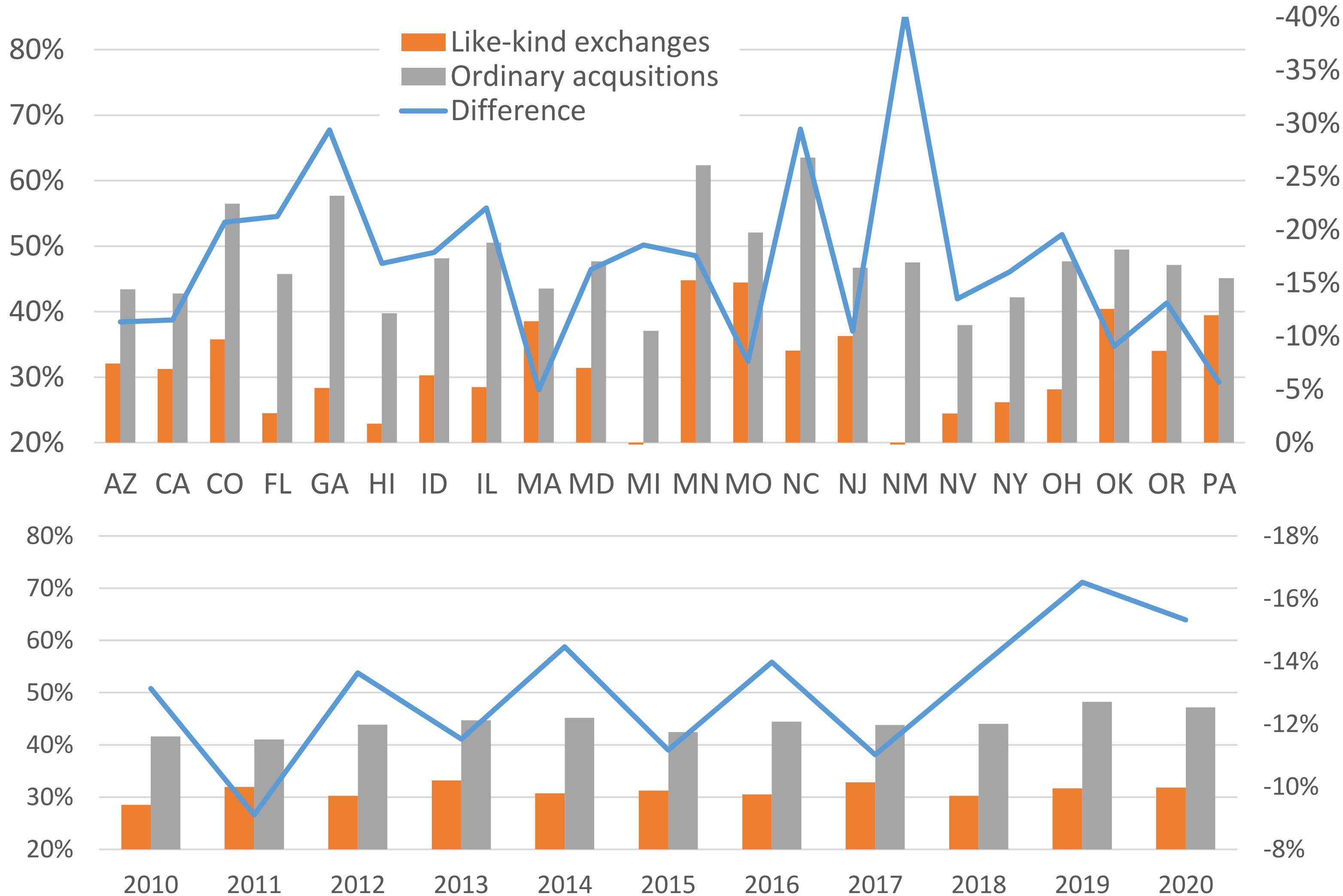
Replacement-Relinquished Percentage Price Differences for Exchanges & Ordinary Sales by Year



Exchanges are associated with lower leverage

- Since drawing out some of the sale proceeds from an exchange transaction results in immediate tax liability, the exchange buyer in a replacement acquisition is **more likely to have a larger down payment** compared to a non-tax-motivated buyer
- We examine initial leverage used by investors in like-kind exchanges vs. ordinary sales
  - Unbalanced sample: **initial leverage is 30% in LKEs vs. 43% in ordinary acquisitions**
  - One-on-one (like-kind exchange – sale) matched sample using propensity-score matching:
    - **31% in LKEs vs. 45% in ordinary acquisitions based on means**
    - 24% in LKEs vs. 57% in ordinary acquisitions based on medians
  - LKEs are further associated with **a large number of all-cash transactions**

Lower leverage in exchanges is robust by year and state



Capital expenditures are increased in exchanges

- To the extent that less leverage is used to acquire replacement properties in like-kind exchanges, tax-motivated investors will have higher debt capacity to invest in building improvements
- Our capital expenditure analysis is based on matching Costar data with detailed capital expenditure data from NCREIF
- The results lend some support to the argument that acquisitions of replacement properties to complete a like-kind exchange are associated with higher capital expenditures

→ Capital expenditures associated with 1031 replacement properties are, on average, **higher by $0.66/sf**
→ **This increased capital investment is driven by significantly higher building improvements**

Holding periods are shorter for investors in exchanges

- To examine the potential "lock-in" effect on existing property owners of the repeal of tax-deferred exchanges, using data from Costar, we compare the holding periods of properties acquired and disposed in ordinary sales to the holding periods of properties disposed in like-kind exchanges

→ **We find that exchanges are associated with holding periods that are on average approximately 1/3 to a year shorter**

Implications of LKE elimination for market values

- We develop an analytical model to quantify the value of an exchange to the owner, relative to a fully taxable sale and further examine the cost of the program to the Treasury
- 5% is the average incremental present value of a like-kind exchange as a percent of the price of the relinquished property
  - This incremental tax benefit also captures the extent to which CRE **property prices would have to decline**, or the value of **future after-tax rental income would have to increase**, to fully offset the loss in tax benefits that would be associated with the elimination of exchanges, all else equal
- **37% is the average incremental value of an exchange strategy** as a percent of the deferred tax liability

→ 63 percent of the value of immediate tax deferral is eliminated by **reduced depreciation deductions** in the replacement property and **increased capital gain** and **depreciation recapture taxes**

Elimination of LKEs could therefore:

→ **put downward pressure on CRE prices in the short run**

→ **put upward pressure on rents in the longer run**

→ **reduce liquidity/transaction activity (short-run & long run)**

Estimated PV of revenue losses from RE like-kind exchanges

	In billions of $	
Total present value to all taxpayers of deferred tax liabilities	**2019**	**2019-2023**
Minimum	$0.8	$4.2
Average	$3.9	$20.1
Maximum	$6.0	$30.9

- Even these revenue loss estimates overstate cost of RE LKEs to Treasury as they assume taxpayers would dispose of their properties in fully-taxable sales in the absence of option to exchange
  - But…many would delay disposing of properties if exchanges not available
  - Others might engage in opportunity zones investments, UPREIT transactions or installment sales
- In short, **behavioral responses** by taxpayers would reduce the increase in Treasury revenues implied by a static analysis
- Reduced transaction activity would have **negative spillover effects in industries such as construction, title insurance, & mortgage lending**

Conclusions

- RE like-kind exchanges are widely spread across the US
- The results of the empirical analyses demonstrate that 1031 exchanges are associated with increased investment, reduced leverage (lower risk) and shorter holding periods
- Results of our analytical model and empirical analyses suggest the tax revenue losses of LKEs may be overestimated, while their benefits overlooked
- Elimination of RE LKEs will likely lead to:
  - **Decrease in CRE prices**
  - **Less reinvestment** in commercial and residential real estate
  - **Greater use of leverage**, and
  - Increase in investment holding periods and **decrease in liquidity**