taxnotes federal

Volume 172, Number 10 ■ September 6, 2021

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Reprinted from *Tax Notes Federal*, September 6, 2021, p. 1601

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In this article, Baker and Breitstone argue that like-kind exchanges are a powerful economic stimulus, as anticipated by the drafters of section 1031 a century ago, and that restricting like-kind exchange treatment would actually result in a loss of tax revenue.

In this politically charged environment, it is popular to mischaracterize section 1031 like-kind exchanges as a loophole that is emblematic of an unfair tax system. It is also popular to regard its repeal as a way to pay for other legislative initiatives without understanding the aggregate economic damage and loss of tax revenue that would result. These attitudes ignore the fact that section 1031, like other nonrecognition provisions in the code, reflects sound tax policy. That tax policy recognizes that the ultimate tax revenue raised will be greater if the taxation of transactions that promote economic activity is deferred. As discussed below, section 1031 makes as much economic sense today as it did when like-kind exchanges were added to the code in 1921.

A recent article by Donald B. Susswein, Ryan P. McCormick, and Kyle Brown addressed the tax policy case for well-established nonrecognition transactions, including transfers to partnerships and corporations under sections 351, 368, 721, and 731, as well as like-kind exchanges under section 1031.[1] The authors ably point out that the tax policy rationale for deferring tax in all those transactions is that (1) the gain and resulting tax do not go away, but are simply deferred; and (2) the transferred assets generally are more efficiently managed in a way that will likely generate more income and tax revenue.

A 2020 microeconomic impact study by professors David C. Ling and Milena Petrova[2] and a 2021 macroeconomic impact study by EY[3] validated the original economic expectations behind the tax policy underpinning section 1031 by quantifying the powerful economic benefits of like-kind exchanges in current terms and dollars. Both studies concluded that section 1031 is a strong stimulator of U.S. economic activity that supports significant job creation, generates substantial tax revenue, and promotes a healthy and stable real estate market.

A hundred years ago Congress introduced like-kind exchange tax deferral treatment into the code. The legislative history describes an intent to

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[1]Susswein, McCormick, and Brown, "The Tax Policy Case for Section 1031," *Tax Notes Federal*, Aug. 9, 2021, p. 923.

[2]Ling and Petrova, "The Tax and Economic Impacts of Section 1031 Like-Kind Exchanges in Real Estate" (Oct. 2020).

[3]EY, "Economic Contribution of the Like-Kind Exchange Rules to the US Economy in 2021" (May 2021).

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(1) avoid unfair taxation of theoretical gains in ongoing investments in property when there has been no cashing out, and (2) encourage active reinvestment — goals that remain just as relevant today as they were in 1921:

> In other words, profit or loss is recognized in the case of exchanges of notes or securities, which are essentially like money; or in the case of stock in trade; or in case the taxpayer exchanges the property comprising his original investment for a different kind of property; but if a taxpayer's money is still tied up in the same kind of property as that in which it was originally invested, he is not allowed to compute and deduct his theoretical loss on the exchange, nor is he charged with a tax upon his theoretical profit. The calculation of the profit or loss is deferred until it is realized in cash, marketable securities, or other property not of the same kind having a fair market value.[4]

> The 1921 Act relieves such transactions from delay, simplifies the tax return, and promotes such exchange of property.[5]

> [The statute] would permit business to go forward with the readjustments required by existing conditions.[6]

Since its inception, section 1031 has permitted a taxpayer to delay recognition of gain, and accordingly defer taxes on that gain, if the taxpayer remains invested in qualifying like-kind property, albeit different property. The gain will be recognized, and the tax will be paid, when the taxpayer cashes out of the investment. The statute has been modified over the past century and now applies only to real property that is used in a trade or business or is held for investment.

Section 1031 gives businesses the flexibility and incentive to make prudent adjustments to their business strategy and assets. Many pre-pandemic commercial real estate (CRE) properties will need to be significantly renovated or repurposed to meet post-pandemic business models and tenant needs. For example, a hotel property that was regularly filled with business travelers may be more productive and serve its community better if renovated into affordable multifamily housing. It is likely that the taxpayer that owns the hotel lacks the skill, resources, or desire to undertake that major transformation. Section 1031 gives the taxpayer an incentive to transfer the struggling hotel property into the hands of a buyer that can reimagine and transition it to its best use, while allowing the taxpayer to transfer its prior investment into a different property better suited to the hospitality industry.

If the good business decision to divest the underperforming hotel property was countered with an immediate tax consequence, thereby reducing the cash available for reinvestment in a more efficient property, the taxpayer likely would simply forgo the transaction. Quite simply, the tax consequences would drive the business decision. This tax lock-in effect stymies not only the growth of individual businesses but also the U.S. economy as a whole.

Conversely, recent economic research confirms that the tax deferral permitted by section 1031 like-kind exchanges eliminates this lock-in effect and provides an incentive for increased transactional activity. This activity results in a plethora of benefits, including better performing buildings, more efficient farms and ranches, increased jobs and tax revenue, improved communities, and green spaces that benefit our environment and provide recreational opportunities for all Americans.

The Ling and Petrova Study

Ling and Petrova reviewed a large, national sample of CRE transactions that occurred between 2010 and 2020. Using data from CoStar, Marcus & Millichap Research Services, the National Association of Realtors, the National Council of Real Estate Investment Fiduciaries, and Investment Property Exchange Services Inc., they reviewed more than 1 million transactions, which included more than 100,000 like-kind exchange transactions. The data verified that like-kind exchanges are commonly used in all 50 states

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[4] H.R. Rep. No. 73-704, at 13 (1934), *reprinted in* 1939-1 (part 2) CB 554, 564, 1934 WL 32214, at 14.

[5] 61 *Cong. Rec.* 5201 (1921).

[6] H.R. Rep. No. 67-350, at 10 (1921); *see also* S. Rep. No. 67-275, at 11 (1921). H.R. Rep. No. 67-350, at 10 (1921), *reprinted in* 1939-1 (part 2) CB 168, 175-76; *see also* S. Rep. No. 67-275, at 11 (1921), 1921 WL 21833 at 10.

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and across a broad spectrum of property values. Ling and Petrova estimated that like-kind exchanges are involved in 10 to 20 percent of all CRE transactions, including industrial, office, hotel, retail, multifamily residential, and other sectors. The study quantifies the importance of like-kind exchanges to economic opportunity, job creation, and healthy and stable real estate markets.

Moreover, section 1031 is an important capital formation tool that reduces reliance on debt. Ling and Petrova found that buyers involved in like-kind exchanges not only acquire replacement properties valued at amounts approximately 15.4 percent greater than those of non-exchanging buyers, but also invest more capital into improvements on their replacement properties, thus generating jobs and tax revenue. Further, because the full value of the relinquished property must be rolled into the replacement property to receive a full tax deferral, exchanging taxpayers enjoy greater equity and less debt on their properties. The data indicate that the average loan-to-value ratio for like-kind exchange replacement properties is only 30 percent, compared with a loan-to-value ratio of 43 percent for non-exchanged properties. Greater investment, coupled with significantly lower debt, reduces financial risk for lenders as well as borrowers, thereby providing more economic stability for taxpayers, the financial system, and the country as whole, particularly during times of economic downturn or uncertainty.

Ling and Petrova's deep dive into the CRE data confirmed that section 1031 eliminates the lock-in effect and stimulates transactional activity, which begets economic activity. On average, real estate sold through a like-kind exchange is held for roughly one year less than properties disposed of through a taxable transaction — 10.5 years versus 11.4 years, respectively. Quicker turnover provides liquidity to real estate markets, generating jobs and taxable income for service providers engaged in real estate transactions. Like-kind exchanges encourage taxpayers to more effectively manage their real estate holdings and related businesses by moving into more efficient facilities and locations that will better meet their future needs. Better use of capital results in growth for the taxpayer's business and in jobs for others.

Ling and Petrova concluded that if section 1031 were eliminated, the cost of capital and loan-to-value ratio in real estate acquisitions would increase, the amount of investment would decrease, and holding periods would lengthen, contributing to illiquidity in the real estate market. As a result, there would be an expected 6 percent decline in property values and a 6 percent increase in rents nationwide.

Finally, Ling and Petrova posited that the tax cost of like-kind exchanges has been significantly overestimated by the government. Their empirical data debunked the myth that taxpayers routinely "swap until they drop," using successive like-kind exchanges until death, at which time their properties get a stepped-up basis, thereby eliminating tax on any built-in gain. The data from such a long time frame demonstrate that the overwhelming majority of like-kind exchanges — at least 80 percent — are one-time events followed by a disposition of the replacement property in a taxable sale, at which time any deferred gain is taxed.

Further, they calculated that approximately 63 percent of the value of the tax deferral is actually returned to Treasury while the taxpayer is still holding the replacement property, through forgone depreciation. This is because in a like-kind exchange, the taxpayer's basis in the relinquished property is transferred to the replacement property, resulting in significantly reduced allowable depreciation for the replacement property than would be permitted if the property were acquired through a taxable transaction. Lower depreciation deductions equate to higher incremental income, which is taxed at ordinary income tax rates. And for individuals (including those holding real estate in passthrough entities), ordinary income rates are considerably higher than the capital gain tax rates. The study concluded that this additional tax revenue, coupled with the economic stimulus impact of like-kind exchanges, suggests that anticipated tax revenue from elimination of like-kind exchanges has been materially overstated, while the benefits to taxpayers, businesses, commercial real estate markets, and communities has been overlooked.

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The EY Study

Too frequently, section 1031 is viewed only through the lens of the taxpayer engaged in the like-kind exchange. This myopia ignores the reality that like-kind exchanges are a catalyst for myriad business activities, ancillary to the exchange, that generate jobs and taxable income. EY analyzed the direct and indirect economic impact of like-kind exchanges on the following three distinct levels to quantify the broader impact on the U.S. economy:

1. the taxpayers (including businesses) engaged in like-kind exchanges;
2. suppliers (and service providers) to those taxpayers; and
3. related consumer spending by taxpayers, suppliers, and service providers, and their respective employees, using income generated by like-kind exchanges and related transactions.

EY measured the activity of suppliers (including service providers) to taxpayers engaged in like-kind exchanges, recognizing that the purchase of goods and services from supplier businesses not only supports jobs, labor income, and value added at supplier businesses but also increases demand for goods and services from *their* suppliers within the supply chain. These include real estate brokers, qualified intermediaries, title and escrow companies, financial service providers, surveyors, appraisers, contractors, skilled tradespeople, laborers, building material manufacturers and suppliers, landscapers, architects, designers, attorneys, accountants, and property and systems inspectors, as well as movers, cleaners, and manufacturers and suppliers of furniture, fixtures, and equipment.

The third level — consumer spending — measures the economic activity generated by the taxpayer's employees, along with the employees of suppliers and service providers, using income generated from like-kind exchanges and related transactions on necessary items like rent, mortgage payments, and groceries, as well as discretionary spending at restaurants and on travel and entertainment. For example, an employee who patronizes a restaurant creates jobs for restaurant workers, farms, transportation companies, and others within a restaurant's supply chain.

Using pre-pandemic 2019 economic factors as a proxy for 2021, EY provided a one-year projection of economic contribution from like-kind exchanges. However, to the extent that these factors are consistent in years to come, their findings may be reflective of sustained annual economic contributions. EY focused on the contribution of like-kind exchanges to job growth, labor income, GDP, and tax revenue.

By looking at the full spectrum of direct and indirect activity, EY estimated that like-kind exchanges support 568,000 jobs throughout the broader economy, producing $27.5 billion of labor income in 2021. EY acknowledged that because of data limitations, it is likely that total like-kind exchange activity is underestimated — an opinion shared by Ling and Petrova. EY posited that job growth could be as much as 710,000, with labor income reaching $34.4 billion.

EY further estimated that the aggregate direct and indirect economic activity would produce $55.3 billion of value added to GDP in 2021. To the extent that like-kind exchange activity is underestimated, the contribution of value that section 1031 makes to GDP could be as high as $69.1 billion.

By taking the macroeconomic view, EY was able to quantify that like-kind exchanges contribute a sizeable amount of tax revenue that is overlooked in proposals to use section 1031 as a pay-for to defray the cost of legislative initiatives. Like-kind exchanges will generate almost $7.8 billion in federal, state, and local tax revenue this year in the form of individual and corporate income, payroll, employee, sales, licensing, and other taxes. Of this, $4.965 billion will go to the federal fisc, and $2.805 billion will go to state and local coffers. EY also measured the economic impact of forgone depreciation on the replacement properties, determining that it annually increases taxes by approximately $6 billion.

Just as Ling and Petrova found in their microeconomic study, EY's macroeconomic study concluded that section 1031 removes the lock-in effect, reduces the cost of capital, and increases the volume and velocity of investment in the U.S. economy. This results in more efficient overall

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allocation of capital for economic reasons rather than tax reasons. That, in turn, provides an incentive to transform real estate for its best use, which permits more efficient business growth.

Conclusion

The Biden administration's proposed budget for fiscal 2022 calls for limiting section 1031 like-kind exchange deferral to $500,000 of gain per taxpayer per year as a pay-for to defray the cost of the American Families Plan.[7] As a practical matter, this is tantamount to a full repeal of section 1031, particularly in economic terms. Virtually all CRE transactions, and many farm and ranchland transactions, are well over $500,000. These transactions often involve real properties with a very low tax basis, whereby most of the sales proceeds are treated as taxable gain.

Treasury estimates that this proposal would generate $19.55 billion in tax revenue over 10 years, 2022 through 2031.[8] At less than $2 billion of expected revenue per year, it is clear that limiting or eliminating section 1031 is a truly ineffective pay-for. Eliminating the roughly $5 billion of annual federal tax revenue generated by like-kind exchanges under current law, along with the additional $6 billion in federal taxes paid because of forgone depreciation, would reduce federal tax revenue by more than five times the expected boost. And that's before the hurt hits home at the state and local level — and before the loss of 568,000 jobs, $27.5 billion in labor income, and $55.3 billion from GDP.

The economic research by Ling and Petrova and by EY has proven that the economic expectations forecasted 100 years ago to justify the tax policy behind enacting the like-kind exchange statute are valid and worth preserving. The findings of these economists make a strong case that the most effective pay-for is to leave section 1031 intact under current law. Let like-kind exchanges be the powerful economic driver that those prescient tax drafters anticipated in 1921. ■

[7] Treasury, "General Explanations of the Administration's Fiscal Year 2022 Revenue Proposals," at 84 (May 2021).

[8] Office of Management and Budget, "Budget of the U.S. Government Fiscal Year 2022," at 52 (2021).

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