



1031 Tax Reform Updates

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Ling & Petrova Section 1031 Microeconomic Study Overview

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

*A microeconomic study by Professor David C. Ling, University of Florida and Professor Milena Petrova, Syracuse University
Sponsored by The Real Estate Like-Kind Exchange Coalition
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Highlights

The study finds significant benefits from like-kind exchanges:

- Like-kind exchanges encourage investment.
- Like-kind exchanges contribute significant federal tax revenue.
- Like-kind exchanges lead to job creation.
- Like-kind exchanges result in less debt.

Excerpts

“The elimination of exchanges would disrupt many local property markets and harm both tenants and owners.”

“The cost of Section 1031 is significantly overstated...”

“The many ‘micro’ and ‘macro’ benefits of providing investors with the flexibility to dispose of highly illiquid, capital intensive assets via an exchange exceed the costs.”

– “*The Economic Impact of Repealing or Limiting Section 1031 Like-Kind Exchanges in Real Estate*,” 2015

Overview

The Real Estate Like-Kind Exchange Coalition, of which FEA is a member, released a new microeconomic study that details the implications a repeal of Section 1031 would have on the commercial real estate industry in the United States.

Reviewing more than 1.6 million commercial real estate transactions between 1997 and 2014, the study’s authors found the widespread use of Section 1031 improves liquidity and increases investment in the real estate market. The findings also show that common misperceptions about the provision are false.



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The temporary tax deferral provided by like-kind exchanges contributes not only to an increase in real estate investment but also an increase in overall taxes paid to the Treasury. The study finds that government figures for the cost of Section 1031 like-kind exchanges are likely largely overstated and the benefits of the provision are overlooked.

[Download the study, “The Economic Impact of Repealing or Limiting Section 1031 in Real Estate” here.](#)

Findings

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. The rules lead to lower levels of debt in commercial and multifamily real estate markets. Like-kind exchanges are integral to a strong and prosperous real estate market, stimulating job creation, investment and economic growth.

Local real estate markets benefit from like-kind exchanges

- Use of like-kind exchanges is widespread. Across the country, nearly 6% of all commercial real estate transactions are like-kind exchanges. In high-tax states like California, Oregon, Colorado and Arizona, like-kind exchanges make up between 10-18% of real estate transactions.
- Misperceptions about indefinite deferral or tax avoidance are false: Nearly 88% of exchanged real estate replacement properties are eventually disposed of in a taxable sale resulting in substantially more tax being paid than would have been due had the exchange not occurred.
- Like-kind exchanges contribute significant federal tax revenue. Exchanged properties later sold in a conventional, taxable sale produce an increase of approximately 19% in taxable gain over non-exchanged properties subsequently sold in a conventional sale.
- Section 1031 leads to property improvements. Section 1031 investors are more likely to make greater capital improvements to real estate properties acquired through an exchange than properties purchased by the same owner through an ordinary sale. Capital expenditures in improvements to exchanged properties tend to be higher by about \$0.27/sf-\$0.40/sf.
- Like-kind exchanges lead to higher investment in property. Investment in exchanged property is an average of \$305,000—or 33% of the property value—higher than acquisitions by the same investor in a property acquired following a conventional sale.
- Like-kind exchanges result in less debt. Investors in like-kind exchanges use 6% less leverage compared to ordinary acquisitions. This makes the real estate market more stable and reduces financial system-wide risk.
- Like-kind exchanges promote real estate sales activity. Holding periods for properties acquired through Section 1031 like-kind exchanges are shorter.

Common Misperceptions about Section 1031 are False

- The cost of like-kind exchanges to the Treasury are likely largely overstated. Taking into account macroeconomic factors, such as the economic activity stimulated by the exchange transactions, the increased investment and capital improvements to replacement properties, the study concluded that the true cost of Section 1031 is estimated to be a fraction of government estimates.



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- Misperceptions that like-kind exchanges facilitate indefinite deferral or tax avoidance are false. Nearly 88% of exchanged real estate replacement properties are eventually disposed of in a taxable sale.
- Like-kind exchanges promote taxable gain, benefiting the Treasury in increased tax liabilities. Exchanged properties later sold in conventional, taxable sales produce an increase of approximately 19% in taxable gain over non-exchanged properties subsequently sold in a conventional sale.

Repeal of Section 1031 Will Have a Negative Impact on the Real Estate Market

The study finds that real estate owners and tenants would likely see negative consequences from the elimination of real estate exchanges including:

- Decreases in real estate prices;
- Long term increases in rents;
- Decreases in real estate investment;
- Increases in investment holding periods; and
- Greater reliance on the use of debt rather than equity.

In combination, these effects would harm tenants and real estate owners impacting local property markets and the economy overall.

Implications on the US Economy

The Ling & Petrova microeconomic study, focusing on the effects of a repeal of Section 1031 on the real estate industry, complements the findings from the Ernst & Young macroeconomic study focused on the effects of a repeal of Section 1031 on the overall economy.

[The March 2015 Ernst & Young study, "Economic Impact of Repealing Like-Kind Exchange Rules,"](#) concluded that a repeal of Section 1031 would slow economic growth, reduce GDP and hurt many small businesses.

The Ling & Petrova study confirms findings from the Ernst & Young study. Together the studies show the long-term impacts that a repeal of Section 1031 would have on the economy:

- **Real estate values would drop;**
- **The cost of capital would increase;**
- **Average holding periods would increase;**
- **The velocity of investment in the economy will decrease;**
- **Rents will rise; and**
- **The economy will contract.**

The Ernst & Young study determined that a repeal of Section 1031 would unequivocally result in lower economic growth in the U.S. economy and was a cross-purposes with the stated goals of tax reform.

The findings of both studies reinforce the argument that like-kind exchanges matter: they provide an essential incentive to improve properties, increase in investment, reduce leverage and reduce holding periods, all of which



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stimulates transactional activity. Like-kind exchanges help keep the economy moving. A repeal of the provision would unfairly burden several important industries, harm the economy as a whole and cost the government in the long run.

Both studies recommend retention of Section 1031 like-kind exchanges. Find a summary and report of the Ernst & Young study, "[Economic Impact of Repealing Like-Kind Exchange Rules](#)" [here](#).

About the Study

This in-depth microeconomic study of the U.S. commercial real estate markets highlights the critical role that Section 1031 like-kind exchanges play in stabilizing rents, safeguarding property values and strengthening our economy.

Download the Study / Other Resources

- [Ling & Petrova Microeconomic Study Overview](#)
- [Ling & Petrova Microeconomic Study Synopsis](#)
- [Ling & Petrova Section 1031 Microeconomic Study \(PDF\)](#)
- [Coalition Press Release](#)
- [About the Authors](#)
- [Section 1031 FAQs](#)
- [Ernst & Young Macroeconomic Study Overview](#)