1031 exchanges and The American Families Act - by Mike Packman

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Last month, the Biden Administration rolled out the $1.8 trillion American Families Plan which included a proposal to limit the value of 1031 Exchange-like-kind capital gains tax deferrals to $500,000, while increasing the top tax rate on capital gains to 39.6% from 20%.

We believe there is an assumption implicit in this proposal and others made over the years that tax-advantaged investments like 1031 Exchanges serve no broader economic purpose. This is simply not the case. There are real economic benefits and while some accrue to wealthier individuals and investment partnerships, many mom-and-pop investors benefit, too. In fact, the median sales price of a property in a 1031 Exchange in 2018 and 2019 was approximately $500,000 according to CoStar. This reinvested capital creates jobs, underwrites community development, and supports real estate prices, the primary source of wealth for many families and individuals.

According to a study by Ernst and Young, in partnership with a coalition of industry groups, such as the Alternative & Direct Investment Securities Association (ADISA), 1031 Exchanges and their associated activity support approximately 568,000 jobs, and will generate about $27.5 billion in labor income this year while adding $55.3 billion to the U.S. gross domestic product. Overall, the federal, state, and local taxes paid by, and related to, the businesses that make use of the like-kind exchange rules would total approximately $7.8 billion in 2021.

Economic activity supported by the like-kind investment at businesses that make use of the like-kind exchange rule

There are, in other words, real and tangible benefits to individuals and the economy. As John Harrison, executive director of ADISA, wrote in a recent Wall Street Journal op-ed, “Section 1031 helps tenants, property owners, and the economy as a whole by accelerating the velocity of money and preventing excessive holding periods. This, in turn, helps to contribute to lower rents and an increase in real estate prices.”

Harrison takes issue with the description of Section 1031 as a “loophole,” noting correctly that it “… is a one-hundred-year-old, legitimate statute of the Internal Revenue Code.” It has withstood the test of time not just because of its tax advantages, but because it succeeds in directing capital to productive use. That function has been recognized by elected officials over many decades, in part because they can see the impact on their own communities. It is further worth noting that about 88% of exchanges ultimately lead to a taxable sale.

The potential increase in tax revenues from the proposed changes is modest, especially when viewed in the light of multi-trillion-dollar federal spending. By one estimate, as currently constituted 1031 exchanges will result in savings to investors of around $41 billion between 2020 and 2024, or about $10 billion a year. Recapturing a part of this won’t move the needle much on the deficit, but it has the potential to significantly impact those local markets where the capital would otherwise be deployed.

Investors should keep in mind that this proposal is just that – a proposal –and as such it is subject to change. Given the big benefits to the economy – weighed against the relatively modest cost to the treasury – hopefully, Congress will see a reason to modify the legislation before it passes into law.

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Editor's note: Please visit KNPRE's website to view the State of the 1031 Exchange Market White Paper