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What Biden’s proposed change to 1031 Exchanges may mean for commercial real estate - by Michael Packman

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The Biden administration has held a consistent position when it comes to 1031 Exchanges – they do not like them. Each annual budget proposal has included plans to substantially curb, if not eliminate, the value of 1031 Exchanges.

A Look Back

On March 8, 2022, the Biden administration introduced the Inflation Reduction Act which, among many other things, included a proposal to do away with 1031 Exchanges on real estate profits of more than $500,000 and increase the top tax rate on capital gains to 39.6% from 20%. Fortunately, the Inflation Reduction Act passed, on August 16, 2022, without any of the limitations on 1031 Exchanges that Biden had initially proposed.

Try, Try Again

Even though previous attempts to limit 1031 Exchanges were removed from legislation, the Biden administration's 2024 budget proposal once again includes the same limitations as before and seeks to, as described in the proposal, close "the so-called 'like-kind exchange loophole' that lets real estate investors defer tax indefinitely, reform tax preferred retirement incentives to ensure that the ultrawealthy cannot use these incentives to amass tax free fortunes, and close a loophole that benefits wealthy crypto investors."[1] If passed, these new rules would affect all 1031 Exchanges taking place after December 31, 2023.

The Potential Impact to Commercial Real Estate

If enacted, the Biden plan would significantly reduce the availability of deployable real estate investment capital. While some transactions, especially those involving one-or- two family residential sales, will be below the proposed threshold, most exchanges have traditionally been well in excess of the Biden-proposed limits. For example, an investor who bought a property for $10 million, sold it for $20 million, and was subject to the top capital gains rate would pay nearly $4 million in taxes, leaving only $16 million to reinvest. Under current law, the tax could be deferred and the entire $20 million could be rolled into a new like-kind real estate purchase.

The estimated increase in tax revenues from the proposed changes is modest when viewed in the light of multi-trillion-dollar federal spending. By one estimate, the current 1031 Exchange rules will result in investor's saving approximately $41 billion between 2020 and 2024, or about $10 billion a year. Recapturing a part of this will not move the deficit needle much, but it has the potential to have a significant negative impact those local markets where the capital would otherwise be reinvested. Hiring in construction and related businesses is likely to suffer as well. It is worth noting, too, that up to 88% of the properties involved in an exchange will eventually be taxed.[2]

Employment Supported by the Like-Kind Exchange Rules[3]

The Biden administration's focus on 1031 Exchanges is not the first time changes to the legislation has been proposed. Nearly 40 years ago, the so-called "Starker Case," involving the sale of timberland by the Starker family to Crown Zellerbach, set off a series of events that ultimately led to the adoption of the 45-calendar-day identification deadline and the 180-calendar day deadline in the

Deficit Reduction Act of 1984. That legislation also eliminated the exchange of partnership interests. Tax-deferred like-kind exchange transactions between domestic and non-domestic property were banned five years later by the Revenue Reconciliation Act of 1989. On the other hand, fractional, or co-ownership was established in 2002 and guidelines on structuring reverse exchanges – the ability to purchase and warehouse the new property before selling the current one – were issued in 2000.4

Implicit in much of the legislative history is the assumption that proposed changes would only impact the “rich,” but there are many “mom and pop” property owners in the market, too.5 In fact, according to the National Association of Realtors, the median sales price of a property in a 1031 Exchange in 2018 and 2019 was approximately $500,000 according to CoStar.6 This demonstrates that 1031 Exchanges are not just for large institutional investors and wealthy individuals but enjoy broad use across a range of taxpayer types, income levels, and property values.7

In Summary

It is important to 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, just as it did in 2022.

1. https://thediwire.com/bidens-budget-proposal-again-seeks-to-eliminate-1031-exchanges/
2. https://www.nar.realtor/magazine/real-estate-news/commercial/the-truth-about-1031s
3. https://1031buildsamerica.org/wp-content/uploads/EY-Economic-contribution-of-the-like-kind-exchange-rules-to-the-US-economy-in-2021-An-update-May-2022-Final.pdf
4. https://www.exeterco.com/History_Section_1031
5. https://magazine.realtor/commercial/feature/article/2021/03/the-truth-about-1031s
6. https://1031buildsamerica.org/study-ling-petrova-2020/
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