Real Estate is Gearing Up to Defend 1031 Exchanges Yet Again

By Nick Pipitone

Real estate investors may remember the Biden administration's proposal to put a cap on 1031 exchanges last year, but the proposal never made it very far. Commercial real estate lobbyists descended on Washington, D.C., convincing congressmen and women against the move. It may come as a surprise then that the Biden administration has announced the same exact proposal again for its Fiscal Year 2023 budget. "Ten thirty ones," also known as like-kind exchanges, are easy targets for politicians, who see them and the real estate industry as tax revenue generators. The likelihood that Biden's 1031 exchange proposal gets passed is slim, but that doesn't mean commercial real estate professionals should rest on their laurels.

Dan Wagner, Senior Vice President of Government Relations at The Inland Real Estate Group, LLC, told me, "It's basically groundhog's day again" when it comes to Biden's proposal about 1031 exchanges. But Wagner emphasized that budget proposals are political documents and not necessarily what gets passed. On the campaign trail, Biden proposed to eliminate 1031 exchanges, and many view the often-used part of the tax code as a loophole designed for the ultra-wealthy. But if you talk to anyone in real estate, you realize the benefits of 1031 exchanges, not just for the wealthy but for small investors and real estate owners everywhere.

An easy target

A 1031 exchange is a process of swapping real estate in order to defer all or most capital gains taxes. Like-kind exchanges allow real estate owners to swap out current investments and properties for new ones without recognizing capital gains, enabling assets to grow tax-deferred. Like-kind exchanges have been in the IRS tax code in some shape or form for 100 years. But in recent years, they've been targeted at the federal level by politicians of all stripes. Both the Obama and Trump administrations targeted like-kind exchanges, just like the Biden administration that has succeeded them.

President Biden's proposes capping the capital gains deferral in 1031s at $500,000 for an individual and $1 million for a couple. Real estate experts say the move would essentially eliminate like-kind exchanges because deferring half a million is minimal for most real estate transactions. Last year, the Biden administration argued capping like-kind exchanges would generate $2 billion a year for the U.S. Treasury Department.

This tax revenue windfall would be beneficial, but Wagner of Inland told me, "The juice isn't worth the squeeze." Essentially eliminating 1031 exchanges would cost the federal government more money than it would save. A recent study by Ernst & Young estimates that like-kind exchanges generate almost $5 billion per year in direct and indirect federal taxes. 1031 exchanges are an economic engine that boosts investment, improves real estate market liquidity, and generates jobs. The same Ernst & Young study estimated that like-kind exchanges created 568,000 jobs and $27.5 billion in labor income in the U.S. in 2021.

As easy as it is to vilify a tax deferral for real estate owners, some real estate deals may never get done without like-kind exchanges. During a virtual briefing for The Real Estate Roundtable last year, Steve Chirico, Mayor of Naperville, Illinois, said that because of 1031s, his city was able to secure a Costco store, which produced jobs and generated as much sales tax revenue as their entire downtown business district. The strip mall space was formerly anchored by a Kmart, which had been vacant and blighted for close to 7 years. The property owner was hesitant to sell it because he would've had to pay substantial capital gains taxes. However, the owner was able to sell to Costco because he swapped the property. Naperville had been trying for years to breathe life into that part of town, and securing the Costco store was a huge economic win. "The halo effect of all the Mom and Pop businesses that have now occupied vacant spaces in that very worn-out and distressed area that we once had – it has now been transformed, and it happened during the pandemic," Chirico said.

Continuous education

So, why do politicians target 1031 exchanges? It's mainly because they're seen as a tax loophole. But the attacks on 1031 exchanges in recent years have been a wake-up call for the commercial real estate industry. Continuous education and lobbying of federal politicians are needed to keep them safe. "We feel confident everything will be fine this year," Wagner said. "But we recognize education is essential with Congress because Washington staffers can be very young. There's turnover, and the issue keeps coming up repeatedly."

A real estate investing platform, 1031 Crowdfunding, is one of many real estate organizations advocating to save like-kind exchanges from rule changes, along with Wagner. In the attempt to cap like-kind exchanges last year, the organization gathered more than 700 petitions to send to Congress. Edward Fernandez, President and CEO of 1031 Crowdfunding, told me his organization has a form on its website so investors and real estate owners can fill it out and send it to their senator and local congressman to lobby against the 1031 changes. "When you're talking about like-kind exchanges, you're not just talking about taking away a tax deferral treatment," Fernandez said. "You're also talking about drastically changing the economy."

Even if like-kind exchanges appear safe to many, their perceived threat will likely cause a flurry of activity. The same thing happened last year, as investors off-loaded high-tax assets in the Northeast and West Coast in exchange for lower-cost properties in more business-friendly areas like the Sun Belt. Early in 2021, many real estate investors saw the vast, trillion-dollar stimulus packages during the pandemic as a sign that taxes would eventually go up. It's another reason some investors have flocked to lower-tax environments like Atlanta, Phoenix, Dallas, and Houston. After selling in a more expensive market, buying in a market like Phoenix can enable investment capital to go way further in a 1031 exchange.

Nevertheless, the crackdown on like-kind exchanges appears unlikely. Politicians may talk tough on the campaign trail, but it may never happen. Mid-term elections are right around the corner, making the elimination of 1031s even more improbable this year. Numerous studies have shown that like-kind exchanges are an economic engine and an excellent long-term policy despite the short-term tax revenue loss. Still, their findings probably won't stop future proposals to eliminate or cap 1031 exchanges. Real estate professionals and lobbyists know now more than ever that this part of the tax code is a frequent target, making efforts to educate Congress, staffers, and the public a continuous job. Commercial real estate can't sit by idly with something as beneficial as like-kind exchanges.