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100 Years of 1031 Exchanges: How they stimulate the economy and aid in pandemic recovery - by Michele Fitzpatrick

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The U.S. looked very different 100 years ago. Federal spending was a mere \$5.06 billion, and the average new home price was \$6,296. And though those numbers have changed drastically, our needs have stayed the same.

The U.S. Internal Revenue Code was established in 1918. The enactment of the 1031 Exchange

followed three years later in 1921, to help drive the economy by supporting the real estate market. Its primary purpose was to allow landowners to defer taxes from a real estate sale by reinvesting income from the sale into another property. Once the tax deferral was in place, it encouraged taxpayers to exchange their real estate.

Although there have been some revisions along the way, the 1031 Exchange code remains the same.

“No gain or loss shall be recognized on the exchange of real property held for productive use in a trade or business if such property is exchanged solely for real property of like-kind which is to be held either for productive use in a trade or business or for investment.”

In a nutshell, it permits people to exchange properties and defer their taxes if they reinvest in a like kind property without profiting from the transaction.

Economic Recovery and the Benefits of Property Exchanges

As a qualified intermediary, I can list dozens of benefits of exchanging property. Not only does the investor benefit, but there are trickle-down benefits for many others. Consider the cast of characters involved in a single real estate transaction; there's a seller's attorney, the bank's attorney, a mortgage officer, title company, bank, appraiser, inspector, seller's realtor, buyer's realtor and an insurance agent. Now, add in everyone who's employed by the companies involved in this transaction. And lastly, factor in all the expenses paid to the city and state for transfer taxes, filing fees, and other ancillary fees.

I could go on, but as you can see, the benefits of exchanging property add up quickly, stimulating the economy with thousands of dollars and providing many jobs. And for every 1031 Exchange, there is a minimum of two transactions, which doubles the numbers of fees and jobs.

Simply put, the 1031 Exchange stimulates the economy by removing the substantial tax bills that are a major barrier for real estate investors. Exchanging encourages sales and allows investors to get into bigger and better properties, in turn making smaller properties available for first time investors willing to create “sweat equity.”

Pandemic Impacts

The year-long COVID-19 pandemic created challenges for both our citizens and the economy. But there's new hope on the horizon as Spring approaches. Vaccines are rolling out, kids are returning to school, and employees are heading back to the office.

The full economic impact of the past 12 months is still unclear. However, we know that many retail and office spaces have gone vacant. Investors are now looking to buy and repurpose these spaces. Their owners' ability to use a 1031 Exchange to sell and buy their properties will be a critical part of the process.

Pending Tax Code Revisions

The new administration is looking to revise the tax code once the COVID-19 stimulus package is finalized. And once again, 1031 Exchange is coming under scrutiny. The 1031 Exchange is greatly misunderstood and often seen as a tax break, rather than an economic stimulus. But, the reality is that taxes are deferred – not eliminated – by utilizing a 1031 Exchange.

The Ling & Petrova Study commissioned by The Federation of Exchange Accommodators (FEA examined more than 1.6 million commercial real estate transactions between 1997 and 2014). It found that nearly eighty-eight percent of properties acquired in a 1031 Exchange were ultimately sold in a taxable sale, rather than a subsequent exchange.

The FEA cites that a repeal of the 1031 Exchange could have the following effects:

1. The real estate market would slow down, halting the economic recovery.
2. Real estate investors may lack the cash flow they need to expand their businesses, farms or real estate holding, due to tax payments and depreciation recapture.
3. Capital costs may increase, leading to a contraction of our economy. Without 1031 Like-Kind Exchanges, businesses and entrepreneurs would have less incentive and ability to make real estate and capital equipment investments.

As you can see, this 100-year-old tax policy is as relevant today as it was in 1921. This is why it has stood the test of time.

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