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Myths and misconceptions cloud the real danger of capping 1031 exchanges - by Stephen Breitstone

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Congress is considering various means of financing President Biden’s $1.8 trillion American Families Plan, and an essential tool in the rebuilding of our American economy–1031 like-kind exchanges–is at risk as part of that proposal.

The Biden plan to eliminate the ability to defer taxes on property gains over $500,000 from like-kind exchanges of real estate would cripple commercial redevelopment at a time when our communities need that investment more than ever. As Congress debates this measure, it is important to correct some of the myths and misconceptions surrounding 1031 exchanges.

Myth: Investors continually rollover 1031 exchanges.

Fact: A majority of 1031 exchanges are a one-time occurrence. A microeconomic study of 1.6 million properties conducted by professors Ling (Univ. of Fla.) and Petrova (Syracuse Univ.) concluded that 80% of the investors did one 1031 exchange, and then disposed of the property through a taxable sale, rather than a subsequent exchange, with all of the deferred taxes ultimately paid.

Myth: 1031 exchanges are a loophole to avoid paying taxes.

Fact: 1031 exchanges are a deferral paid over time. Like-kind exchanges allow an investor to defer the taxes on gains from the sale of property by investing that sum into another property. Taxes are paid, usually over a 15-year window because most investors do only one 1031 exchange and they are done. During that window, the local, regional and state economies reap many benefits. 1031 exchanges result in significant reinvestment into commercial or multifamily properties, which supports the creation or retention of jobs and generates state and local taxes and fees.

Myth: A cap is needed to help fund the American Families Plan.

Fact: The numbers just do not add up – and would do more harm than good! A cap on, or elimination of, 1031 exchanges would not come close to raising any significant portion of the $1.8 trillion needed for the American Families Plan, and in the end would be harming, not helping, our families, communities and the national economy. A macroeconomic study initiated by Ernst & Young in 2017, and recently updated, concluded that if section 1031 were limited or repealed, it would shrink GDP by a whopping $9.3 billion per year. The study also looked at the potential benefits from the use of 1031 exchanges for 2021 and concluded that 1031 exchanges will support 568,000 jobs. Those jobs will generate $5 billion in federal taxes, which alone far exceeds the estimate in the 2021 Biden budget which projects an average of $1.95 billion raised annually over 10 years from a $500,000 cap. When you also consider that $6 billion per year of additional federal income taxes would be generated from foregone depreciation (reduced deductions) on replacement exchange properties–not to mention $2.8 billion in state and local taxes—why would anyone want to cap section 1031?

Myth: A cap at $500,000 won’t hurt smaller investors or underserved communities.

Fact: A cap–at any amount–would significantly discourage commercial and multifamily reinvestment in underserved communities at a time when our economy needs it the most. 1031 exchanges have been used for more than 100 years by real estate owners from all walks of life, as a means to foster economic development and to build wealth to fund retirement. Exchanges have been particularly valuable in encouraging reinvestment and redevelopment of underserved, low-income or inner-city communities. Smaller investors have benefitted from 1031 exchanges as they present the ability to acquire property and build wealth without taking on debt. Why should they be capped at $500,000 as they grow their portfolio? It takes much more than $500,000 to retire plus they are eventually going to pay taxes on it as much as 30% to 40% when you add up the capital gains taxes, Medicare tax, depreciation recapture and state taxes. By capping section 1031 exchanges, many smaller investors are likely to be hurt, as well as the communities that need every willing investor.

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