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## **1031 Exchange and the Tax Reform Bill - What it could mean to investors - by Michele Fitzpatrick**

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Like most financial institutions, we've been closely following and analyzing the Tax Reform Bill at Northern Bank, so we can better understand its implications for our investor clients and get all the information we need to address their questions and concerns.

Currently, 1031 Exchange allows real estate investors to defer capital gains taxes through "Like Kind Exchanges" (LKEs). What's currently on the table as part of the proposed Tax Reform Bill is a \$500,000 cap on LKEs, which will most likely impact real estate investors who utilize exchanges to grow, diversify, consolidate or plan for the future of their business.

Since 2016, Northern Bank has facilitated hundreds of 1031 Exchanges each year. Those exchanges save our clients thousands in capital gains taxes, enabling them to invest in better properties and improved locations, while increasing their cash flow and often relieving their management burdens.

Here are some important benefits 1031 Exchange provides investors:

**Estate Planning:** Investment properties make up a large percentage of our clients' assets, which will need to be considered when creating their estate plans. Many clients are faced with situations where their heirs may not want to or are not able to manage a particular investment property, and the inheritance becomes a burden. Investors may utilize 1031 Exchange to acquire multiple properties for each heir, smaller more manageable properties in more desirable locations or opt for a vacation rental in a retirement community for future use.

**Management Relief:** If anyone has been a landlord before, you understand the feeling you get when the phone rings in the middle of the night; tenant with no heat or a burst water pipe. Many seasoned landlords don't want these management headaches forever. 1031 Exchange can help landlords find a more suitable property to alleviate this stress. Often times, this can be achieved by exchanging the troublesome property for a property that is newer or newly renovated, a condo with a management

company, a vacation property with a rental and management company, a Delaware Statutory Trust or a NNN (Triple Net Lease) commercial property.

**Diversification:** Often, in conjunction with estate planning, investors plan to diversify their assets. They may have one large multi-family or commercial property and choose to purchase multiple smaller properties. This is beneficial when dividing assets for estate planning, or as a strategy to slowly ease out of investment real estate.

**Consolidation:** On the flip side, clients who have many years left to invest may be in the position to consolidate their multiple properties into one larger multi-family or commercial property. This often alleviates management burdens, consolidates bills and improves cash flow.

**Increased Depreciation:** The IRS allows an investor to depreciate a residential investment property over 27.5 years, and a non-residential property for 39 years. If the value of the investor's property has significantly increased as it approaches the end of its depreciation lifecycle, it can be a powerful tax strategy to utilize 1031 Exchange and purchase a new appreciated asset. The depreciation clock can start over again on the excess basis (or the profit).

**Cash Flow:** So often investors are looking to increase their cash flow, but location, property condition, property size, city taxes and utility fees are hindering their income. Some examples of how clients have used 1031 Exchange to increase their cash flow include: vacation rentals in a desirable spot that command top nightly and weekly rents, avoiding condos with high HOA fees that offer little amenities or return and NNN commercial properties where tenant is responsible for all expenses.

Beyond the individual investor benefits, 1031 can play a role in stimulating job growth and the economy. Recent research by Ernst & Young (1) estimates that LKEs are expected to generate 568,000 jobs this year, including 27.5 billion of labor income with a total of \$55.5 billion of value added to the U.S. economy.

Another study commissioned by the FEA (Federation of Exchange Accommodators) and authored by Ling & Petrova(2) concludes that "approximately 10 – 20% of all commercial real estate transactions involve a 1031 and that a broad range of taxpayers – both small and large – utilize LKEs. Eliminating LKEs would create a lock-in effect resulting in fewer transactions and price declines."

The Tax Reform Bill is still being debated in Congress, so the results remain to be seen. At Northern Bank we're making sure our clients are aware of the potential changes, so we can continue to work with them to find solutions that enable them to expand their business.

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Northern Bank, including its subsidiary Northern 1031 Exchange, LLC does not provide tax, legal or

accounting advice, nor can we make any representations or warranties regarding the tax consequences of your exchange transaction. We strongly encourage you to seek appropriate professional advice regarding your specific facts and circumstances.

1. <https://www.1031exchange.com/new-ernst-young-macroeconomic-impact-study-2021/>

2. The Tax and Economic Impacts of Section 1031 Like-Kind Exchanges in Real Estate, David C. Ling & Milena Petrova, September 2020.

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