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Capping 1031 Exchanges Would Cripple Wisconsin's Commercial Real Estate Economy and Farmers

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An essential tool in the rebuilding of our American economy is at serious risk as part of the $1.8 trillion American Families Plan being considered in Washington – and the damage will be felt in every state, city and town still reeling from the ravages of COVID-19.

For the last 100 years, like-kind exchanges, which allow investors to defer taxes on the sale of a property if the proceeds are reinvested in a new property have been a cornerstone of the U.S. commercial real estate market, generating economic benefits on every level which far exceed the amount of taxes deferred. The $1.8 trillion plan presented last month by President Joe Biden proposes to cap the amount of gains that can be deferred at $500,000.

This cap is a recipe for economic stagnation, not recovery.

Every community in the nation, including those here in Wisconsin, have witnessed the closing of countless shopping malls, strip centers, and restaurants due to the pandemic. The fallout continues in hotels and office buildings. Virtual meetings will permanently replace significant business travel, and many people will work from home exclusively. A substantial reinvestment to repurpose these properties and redevelop commercial spaces will be required for the economy to regain its strength.

The Federation of Accommodators, the national organization of 1031 Exchange companies, analyzed and aggregated the data from 8 companies in Wisconsin. This is just a portion of the market. There are many more companies that facilitate exchanges. The data covered 2015 to 2019. They found that there were 3,225 properties involved in exchanges from those companies during that period. They had a total value of $4 billion. Those transactions also generated $12 million in state and county transfer taxes and recording fees in Wisconsin. It is estimated that 15% to 20% of all commercial transactions involve a 1031 exchange. In agriculture it is closer to 30%. It provides fundamental liquidity to real estate. It is clear that Section 1031 is important to the real estate economy in Wisconsin and that it generates significant tax revenue for state and local governments.

Section 1031 brings important capital to revitalize communities in Milwaukee and the surrounding suburbs. It has been used to provide affordable multifamily housing in working class communities and to bring a neighborhood food store into a "food desert." In the suburbs, Section 1031 was recently used to revitalize a strip shopping center that was 70% vacant after losing its anchor store.

Proponents of the cap may argue that the provision is a 'loophole' used to avoid payment of taxes on gains. In reality, a 1031 exchange is a deferral, not an elimination of tax, and according to a study done by the professors David Ling, of the University of Florida, and Milena Petrova, of the Syracuse University, 80% of the taxpayers do only one 1031 exchange and then dispose of the property in a taxable sale.

Taxes are paid over a 15-year window. A restrictive cap – whether $500,000 or any other amount – on the ability to reinvest into commercial real estate and the redevelopment of properties at this critical juncture in our nation's economy would send an already struggling commercial real estate market into a tailspin. Additionally, 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.

It further examined the potential benefits from the use of 1031 exchanges for 2021 and concluded that transactions from Section 1031 exchanges will support 568,000 jobs (260,000 in businesses using 1031, and another 308,000 from suppliers to those businesses), generating $27.5 billion in labor income which in turn will generate $55 billion value added to the GDP. Additionally, it will generate $5 billion in Federal taxes from the jobs plus $6 billion per year of additional federal income taxes due to foregone depreciation (reduced deductions) on the replacement property and $2.8 billion state & local taxes.

Just the $5 billion generated from the jobs in one year far exceeds the estimate in the 2021 Biden budget that says capping 1031 at $500,000 raises on average of $1.95 billion per year over 10 years. Why would anyone change Section 1031? According to Ernst & Young's study, it doesn't raise any money.

Like-kind exchanges play a critical role in many facets of the nation's economy, including:

- fueling the redevelopment of distressed commercial properties;
- financing the construction or renovation of multi-family and affordable housing;
- allowing business to move to bigger facilities while keeping their capital in the business;
- allowing the middle class to build a real estate portfolio which will one day fund retirement;
- farmers, ranchers, and forest owners heavily rely on like-kind exchanges;
- like-kind exchanges promote land conservation and environmental protection.

The resurgence of our economy will need to be generated from many sources. Clearly, added Federal programs on infrastructure and financial assistance are necessary. But the private sector must also play a significant role in the recovery, as it has before. A key component of infrastructure – buildings that make up our housing stock, offices, shops, warehouses and many other types of properties – is being missed in this effort. These structures need as much ongoing capital commitment as roads, bridges and other parts of infrastructure. The best way to encourage improvements and strengthen this infrastructure stock is to keep Section 1031 unchanged to encourage investment and most importantly, reinvestment in the real estate economy.

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