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Business

COMMERCIAL REAL ESTATE | AUTOMOBILES

Investors Fear Losing a Prized Loophole

A Biden plan would rein in a century-old tax deferral on property sale gains.

Square Feet
By JOE GOSE

As a real estate investor, Michael Clarke has learned how to roll earnings from the sale of one property into the purchase of another to save on his tax bill.

Last year, Mr. Clarke sold a residential rental property that he had owned for decades in suburban Washington for \$700,000 and used the proceeds to buy a \$1.2 million Dollar General building in rural Virginia. Recently, he sold another long-owned rental home for \$580,000 and rolled those proceeds into the purchase of a rental worth roughly \$800,000.

Thanks to a 100-year-old provision in the tax code, Mr. Clarke did not have to pay taxes on the gains from the properties he sold.

Known as Section 1031, which covers a transaction that is commonly referred to as a like-kind exchange, the law provides real estate investors a tax deferral on the financial gain of a sale if they roll the proceeds directly into a similar investment property within 180 days. The rationale for the benefit is that it promotes economic activity and that, by replacing one property with another, investors are forgoing pocketing their underlying sales gains.

But the Biden administration wants to rein in Section 1031, arguing that it and other tax policies on its radar benefit the wealthy and not workers. The effort would generate \$19.5 billion in tax revenue over 10 years, according to the administration's estimates, and help pay for its \$1.8 trillion proposal to help American families attain a middle-class lifestyle.

Under the Biden proposal, the deferral in any one year would be limited to gains of up to \$500,000 for single taxpayers and \$1 million for married taxpayers. That would effectively gut like-kind exchanges and re-



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Michael Clarke, a real estate investor, was able to defer taxes on his gains under a provision allowing like-kind exchanges.

duce the amount of transaction activity, real estate observers contend.

"This proposal definitely concerns me," said Mr. Clarke, who has deferred his tax bill by conducting numerous like-kind exchanges over 30 years. "It would trap capital because people won't want to sell, and that would harm the economy."

A large contingent of real estate interests share Mr. Clarke's apprehension. From 2010 through 2020, like-kind exchanges accounted for 10 percent to 20 percent of all commercial real estate transactions, according to a study by David C. Ling, a real estate professor at the University of Florida, and Milena Petrova, an associate professor of real estate and finance at Syracuse University.

Not only has a flourishing niche in the real estate industry been built around like-kind exchanges, but the transactions also generate business for companies that provide insurance, title, inspection and other real estate services, supporters say. What is more, capital that is used to buy and fix up

replacement assets as part of an exchange winds up in the pockets of tax collectors and laborers, they add.

Like-kind exchanges and related consumer spending could generate \$7.8 billion in federal, state and local taxes in 2021, according to a study by Ernst & Young. All told, the accounting and consulting firm concluded that Section 1031 could support as many as 710,000 jobs that generate labor income of up to \$34.4 billion this year.

"I find it ironic that we would constrain capital when we're looking for ways to invest in affordable housing, to reconfigure office space and to repurpose shopping centers," said Hessam Nadji, president and chief executive of Marcus & Millichap, a commercial real estate brokerage that has a robust like-kind exchange business. "That's the opposite of what we should be doing coming out of a pandemic."

But opponents of Section 1031 maintain that it is obsolete. The government enacted the deferral mechanism in 1921 to fuel real



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President Biden has proposed overhauling Section 1031 to help pay for his plan to fund infrastructure projects and build up America's middle class.

estate transactions after tax rates had risen to 77 percent from 7 percent for top earners following World War I, said Steven M. Rosenthal, a senior fellow with the Urban-Brookings Tax Policy Center, a nonprofit research organization in Washington.

At the time, capital gains were taxed as ordinary income, and the high rates had created a "lock in" effect that discouraged investors from selling assets, said Mr. Rosenthal, who would prefer to see a full repeal of Section 1031 versus mere adjustments.

President Biden wants to roughly double today's capital gains tax rate of 20 percent for earners of more than \$1 million, but Mr. Rosenthal argues that a severe lock-in effect comparable to the one decades ago is unlikely. In fact, another Biden proposal that would affect the value and taxation of inherited property would most likely encourage more transactions, he added.

"If I want to sell my IBM stock and buy AT&T stock, I have to pay taxes on that sale, even though I'm swapping one stock for another," Mr. Rosenthal said. "Why do we favor real estate over other like-kind investments? At the end of the day, like-kind exchanges are disproportionately benefiting the wealthy versus the wage earner."

Proponents counter that like-kind exchanges encourage reinvestment in communities and that investors across a broad range of incomes use them. Examining 2010 to 2020 transaction data, for example, Pro-

fessor Ling and Professor Petrova found that the median price of a like-kind exchange property was \$575,000.

The use of the tax deferral mechanism also provides an opportunity to close the national wealth gap that the killing of George Floyd and the subsequent unrest have focused attention on, said William Brown, a founder of Springhill Real Estate Partners. The firm is a syndicator that pools like-kind exchange proceeds and money from smaller investors to invest in apartments in the West and Northwest. In general, like-kind

\$19.5B

Estimated tax revenue the Biden plan would generate over 10 years.

exchanges allow these investors to trade up from duplexes to fourplexes, and then from fourplexes into larger apartment communities, and so on, he said.

"More and more minorities want to become real estate investors because they can see the benefit of building wealth and income," said Mr. Brown, an African American and a past president of the National Association of Realtors. "Getting rid of the 1031 exchange would hamper their ability to do that, because most investors cannot af-

ford to sell a property and then buy something else after paying taxes."

Section 1031 also encourages the reuse of buildings because investors often focus on adding value to older properties that need work, said Karlin Conklin, a principal and co-president of Investors Management Group, another syndicator that invests in apartments. In 2017, Investors Management paid \$19 million for a 136-apartment property in suburban Portland, Ore., and plowed an additional \$1.5 million into it to build a clubhouse and make other upgrades.

"We made it a far better apartment community in which to live and a far better building within the neighborhood," said Ms. Conklin, who with her husband has personally been investing in properties for more than 20 years. "Without exchanges, there's going to be less money dedicated to improving older real estate stock that is in need of a capital infusion."

The proposal to overhaul Section 1031 is nothing new — similar ideas have surfaced after presidential elections only to sink. In 2017, however, the Trump-era tax cuts eliminated exchanges of machinery, vehicles and other personal property from the provision.

In this congressional session, Democrats appear to be placing enormous emphasis on creating a fairer tax code along with investing in infrastructure and social programs, said Steve Wamhoff, director of federal tax policy at the Institute on Taxation and Economic Policy, a nonprofit group in Washington that advocates equitable revenue-raising measures.

"We're in an environment where it's more likely that we're going to raise taxes on the rich and take away some of the privileges they've enjoyed for many years under the tax code," he said.

Lobbyists representing groups that support Section 1031, including real estate brokers, investors, farmers and land trusts, are optimistic that they can illustrate why the benefits of like-kind exchanges outweigh Mr. Biden's plan to alter them. Information they are sharing with lawmakers includes study findings from Professor Ling and Professor Petrova that 88 percent of properties bought in like-kind exchanges are eventually sold in a taxable transaction.

"Section 1031 isn't Democrat or Republican — there are real estate owners in both parties that take advantage of it," said Jonathan Hipp, head of the U.S. Net Lease Group for Avison Young, a global commercial real estate brokerage. "There is a lot of hay to cut before this proposal gets through."