

I.R.C. Section 1031 Exchanges: Legislative Update



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President

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Section 1031: 100 Years and Counting

Section 1031 allows for the deferral of gain on the sale of real property “held for investment or used in a trade or business.”

First enacted in 1921.

Qualifying Like-Kind Properties Include:

- Rental properties (houses, duplexes, apartment complexes, etc.)
- Office buildings
- Retail spaces (strip malls, stand alone stores, gas stations, etc.)
- Industrial and warehouse facilities
- Mini-storage units
- Raw land (land held for speculation)
- Golf courses and sporting complexes
- Vacation homes – under very limited circumstances
- Partial Interests – TIC %, remainder interests, contract rights
- Leases (30 years or more)

1031 Exchange for Real Property Only

Tax Reform Changes: Section 1031 applies to real property only.

Examples:

- 80 acres of bare ground exchanged for 80 acres of bare ground closer to home.
- 80 acres of bare ground exchanged for an apartment building, retail center, vacation home (limited circumstances), or other real property held for investment or used in a trade or business.
- Office building exchanged for a farm.

1031 Exchange for Personal Property Eliminated

Personal property exchanges were eliminated (\$30B revenue raiser).

- Depreciation recapture is taxed.
- However, 1031 for personal property was replaced by allowing gain to be offset by expensing until 2023, at which point it phases out by 20% per year.

Also eliminated: Artwork, collectibles, franchises, broadcast rights, crypto currencies, sports contracts

2021: Capital Gains Tax Rates Remain Largely Unchanged (For Now)

Gain due to appreciation

- 15% up to \$200,000 (single) \$250,000 (married)
- 3.8% Net Investment Income Tax for earners over \$200,000 (single); \$250,000 (married)
- 20% for earners over \$400,000 (single); \$450,000 (married)

Gain due to depreciation (25%)

State capital gains (0 – 13.3% CA)

Gain on properties held less than one year (Ordinary Income)

33% potential long term capital gain tax for income over \$450,000

Farm Sale with \$1,000,000 Gain

TAX CALCULATION:

Federal Capital Gains Tax:	\$200,000	(\$1,000,000 x 20%)
Net Investment Income Tax:	\$ 38,000	(\$1,000,000 x 3.8%)
State Capital Gains Tax:	\$ 85,000	(\$1,000,000 x 8.5%)
Total Tax Paid:	\$323,000	
Funds After Tax:	\$677,000	v. \$1,000,000

Sale of Property with \$100,000 Gain

TAX CALCULATION (No Basis):

Federal Capital Gains Tax:	\$15,000		(\$100,000 x 15%)
State Capital Gains Tax:	\$ 5,000		(\$100,000 x 5%)
Total Tax Paid:	\$20,000		
Funds After Tax:	\$80,000	v.	\$100,000

Section 1031 is a Tax Deferral Tool – Not Tax Avoidance

Basis in the relinquished property is carried over to the replacement property, regardless of the cost of either of the properties

Relinquished Property:

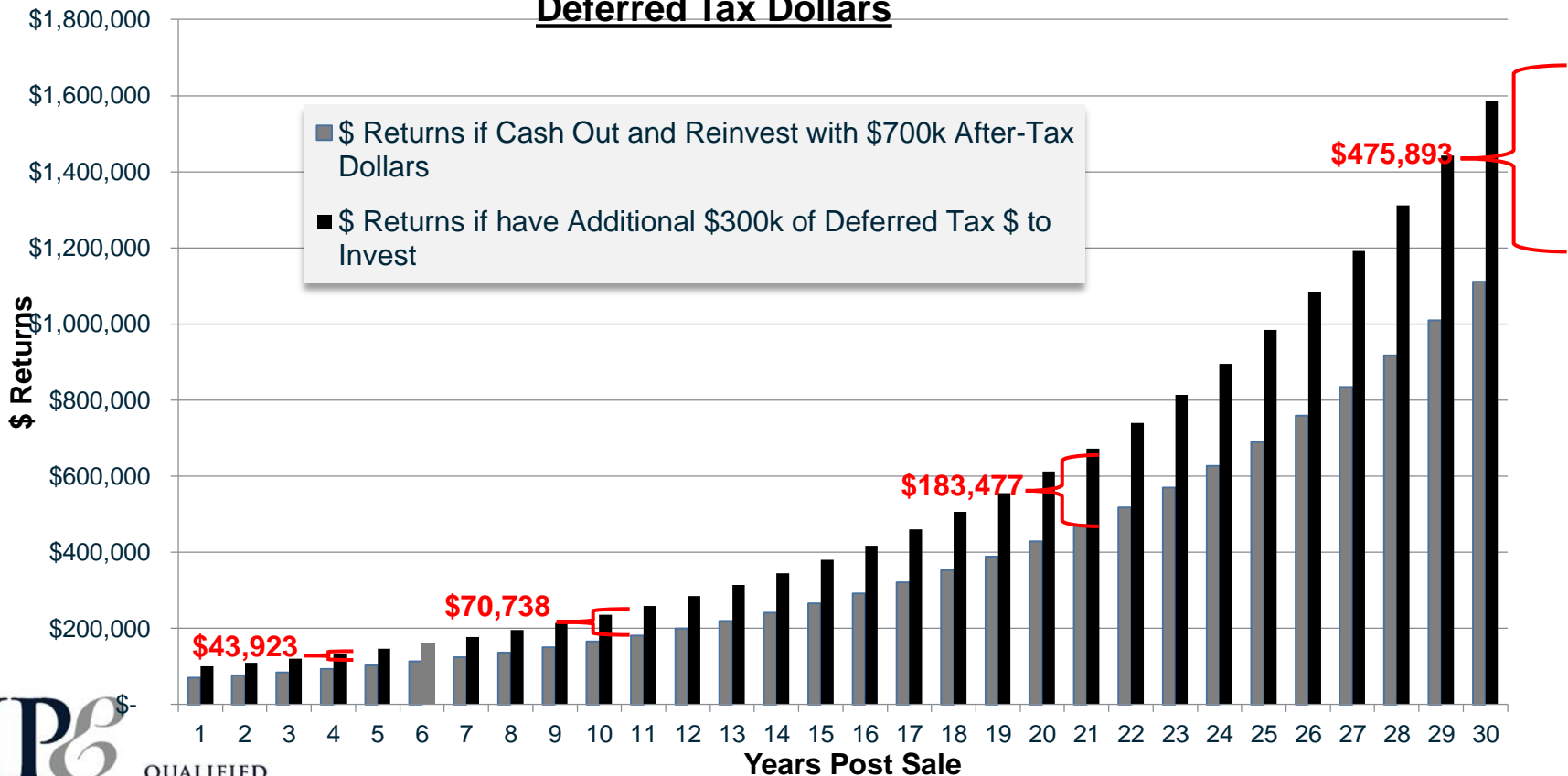
\$ 1,500,000	Sale Price of Property (2020)
<u>- 500,000</u>	<u>Basis of Property (1995 Purchase)</u>
1,000,000	Gain

- If an equivalent value replacement property is purchased, the basis in it is the same as the relinquished property.
- In past academic studies, it has been estimated that 88% of exchanged properties are “cashed out” during the life of the investment.

Illustration

Sale of 160 acre farm for \$1.5M with a \$500k basis. Assumed tax rate on \$1M gain is 30%. Assumed annual return from reinvestment is 10%.

\$ Returns - Reinvestment with After-Tax Dollars vs. with Add'l Deferred Tax Dollars



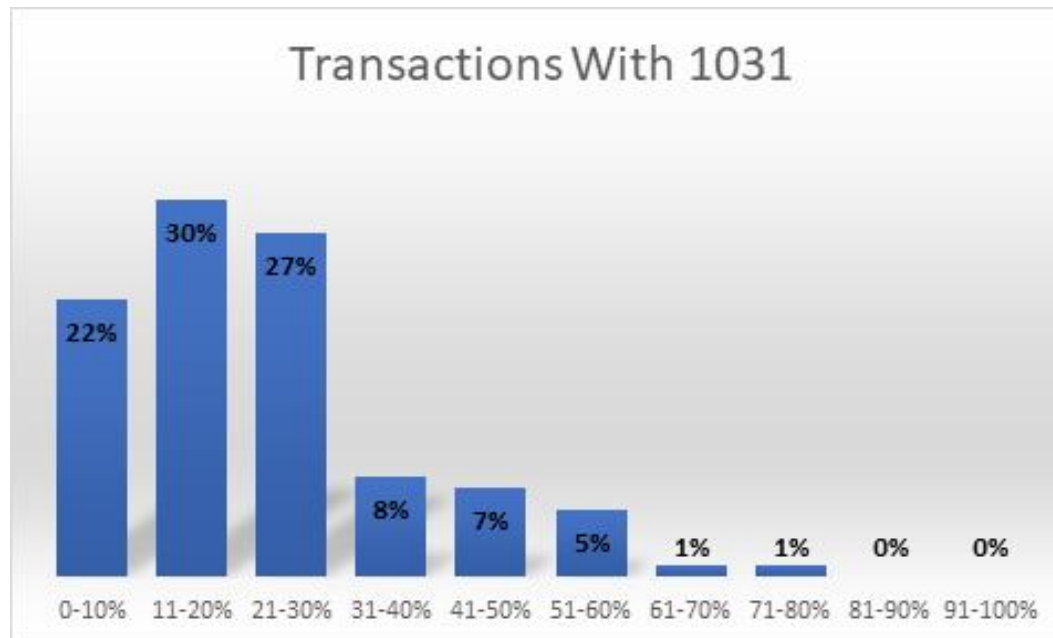
Tax Proposals Impacting Real Estate

American Families Plan

- Capital Gains/Dividends: Raise to 39.6% (plus the 3.8% Obamacare surtax) on “households making over \$1 million
- Stepped-Up Basis at Death: Eliminate and trigger capital gains taxes at death for gains in excess of \$1 million (\$2.5 million per couple when combined with “existing real estate exemptions”)
- Like-Kind Exchanges: Eliminate like-kind exchange deferral for exchanges with “gains greater than \$500,000”
- Increase IRS Funding: \$80 billion to IRS to “crack down” on tax avoidance by wealth and large corporations. \$700 billion revenue raiser.

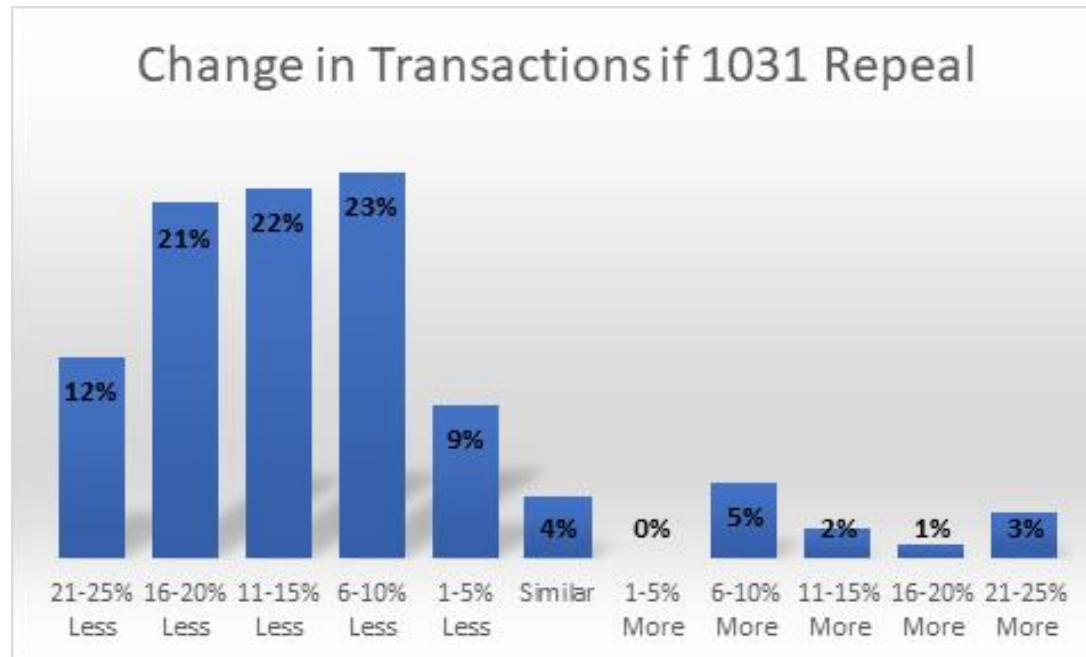
Iowa RLI 2021 Land Value Survey

55% of respondents stated that between 10% and 30% of land sale transactions involve Section 1031 in either the sale or purchase.



Iowa RLI 2021 Land Value Survey

85% of participants stated that if Section 1031 is eliminated, land sales transactions would be reduced.



Exchanges Accommodated by IPE 1031 in Iowa

The Facts:

- **\$3 billion** of properties exchanged in transactions handled by IPE 1031 (2015-2019)
- \$2.3 billion were farms.
- Out of 2,460 exchange transactions handled by IPE 1031 between 2015-2019, the median value was \$443,000.
- A large majority of commercial and ag exchanges are greater than \$500,000. Commercial exchanges would be effectively repealed under proposal to cap exchanges at \$500,000.
- Section 1031 benefits owners of all sizes: Large exchanges are powerful drivers of state and local economic activity and should not be limited.
- Section 1031 is a tax deferral tool, not tax avoidance. In past studies, it has been estimated that 88% of exchanged properties are “cashed out” during the life of the investment.

Biden FY 2022 Budget

- *Proposes to raise **\$2.4 trillion** over a 10-year period*
- **Cost of Section 1031 over 10 years: *\$19.55 billion***
- **Section 1031 raises .008% of amount or revenue sought**

Key findings

Economic activity supported by like-kind exchange rules in 2021

Annual impact relative to size of US economy in 2021

568k Total jobs supported by like-kind exchange rules



46%

260k jobs

Businesses that make use of like-kind exchange rules



21%

122k jobs

Suppliers to businesses that make use of like-kind exchange rules



33%

186k jobs

Related consumer spending

\$27.5b Total labor income supported by like-kind exchange rules



40%

\$11b labor income

Businesses that make use of like-kind exchange rules



27%

\$7.4b labor income

Suppliers to businesses that make use of like-kind exchange rules



33%

\$9.1b labor income

Related consumer spending

\$55.3b Total value added supported by like-kind exchange rules



40%

\$22.4b value added

Businesses that make use of like-kind exchange rules



27%

\$14.8b value added

Suppliers to businesses that make use of like-kind exchange rules



33%

\$18.1b value added

Related consumer spending

Taxes paid by, and related to, businesses that make use of like-kind exchange rules, 2021

	Businesses that make use of like-kind exchange rules			Related suppliers	Related consumer spending	Total
	Business taxes	Employee taxes	Total direct			
	Dollars in millions					
Federal taxes	\$660	\$1,330	\$1,990	\$1,330	\$1,645	\$4,965
Individual income taxes	\$120	\$890	\$1,010	\$680	\$840	\$2,530
Payroll taxes	\$370	\$370	\$740	\$490	\$610	\$1,840
Corporate income taxes	\$140	\$0	\$140	\$90	\$110	\$340
Excise taxes	\$25	\$35	\$60	\$40	\$50	\$150
Customs duties and fees	\$5	\$35	\$40	\$30	\$35	\$105
State and local taxes	\$440	\$695	\$1,135	\$745	\$925	\$2,805
Property taxes	\$180	\$150	\$330	\$220	\$270	\$820
Sales taxes	\$110	\$150	\$260	\$170	\$210	\$640
Individual income taxes	\$0	\$300	\$300	\$200	\$250	\$750
Excise, license, and other taxes	\$110	\$95	\$205	\$130	\$160	\$495
Corporate income taxes	\$40	\$0	\$40	\$25	\$35	\$100
Total taxes	\$1,100	\$2,025	\$3,125	\$2,075	\$2,570	\$7,770

Note: All estimates are relative to the US economy in 2021. Figures are rounded.

Source: EY analysis.

Section 1031 Exchanges

- ***Stimulate Business Growth of All Sizes:*** Upsize, relocate, diversify, achieve greater efficiencies.
- ***Stimulate Needed Capital Investment:*** Upgrade and reinvest in highest and best uses.
- ***Repurpose Available Real Estate:*** Efficient and effective flow of capital to where it's most needed. 1031 exchangers invest 33% more in properties than non-exchanging buyers.
- ***Create Jobs:*** 1031 exchanges generate and support jobs and revenue for unrelated businesses upstream and downstream.
- ***Support Farmers and the Environment:*** Improve operations and efficiencies without diminishing cash flow. Conservation easements out of environmentally sensitive land.

Downstream Impact to Economy

- Property owners would be tax-locked and choose to not sell.
- Property owners would lose capital when selling and necessarily take on more debt.
- Realtors would face steep declines in transactional activity.
- Banks would be significantly impacted due to reduced loan volume.
- Abstract, title and closing operations would be negatively impacted.
- Attorneys would lose business.
- State and local tax revenue would drop due to reduced sales.
- Conservation efforts would suffer due to inability to exchange conservation easements.
- If “stepped-up” basis goes away, Section 1031 becomes indispensable.

How You Can Help

Action Is Needed Now: The following are some ways you can help with Section 1031 advocacy efforts:

- **Send a letter to Congress:** A letter is available for you to send to your members of Congress urging them to preserve Section 1031. You can access the letter on the Take Action page of the 1031taxreform.com website.
- **Reach out to Congressional members directly:** Stakeholders and opinion leaders with connections to Congressional members should initiate direct discussions with members and their staff to advocate in favor of retention of Section 1031. Information about the benefits of Section 1031 can be found at 1031taxreform.com.
- **Connect with your association:** A broad coalition of real estate, farm, conservation and business associations strongly support Section 1031. Support your association's efforts to show strength in numbers.

Use Us As Your Resource

Please do not hesitate to call us if you have questions about a transaction or Section 1031 generally.



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