The Economic Impact of Repealing or Limiting Section 1031 Like-Kind Exchanges in Real Estate

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Presentation Outline

1. Overview of Study Results
2. Evidence on Use of Real Estate (RE) Like-Kind Exchanges
3. Estimated Magnitude of Exchange Tax Benefits
4. Effects of Elimination of Like-Kind Exchanges in RE on Property Values and Required Rents
5. Economic Benefits of 1031 Exchanges – Empirical Evidence
6. Like-Kind Exchanges and Taxes
7. Consequences of Removal of LKEs Based on the Established Micro-economic Effects

The Impact of Repealing Like-Kind Exchanges in Real Estate

1. Overview of Study Results

Overview of Study Results

1. Widespread use of RE like-kind exchanges:
   - 6% (5%) of all commercial RE sales based on $ volume (# of transactions)
   - Use of exchanges in high-tax states varies between 10% & 18% of all sales in their respective market
   - These %s are likely **understated**

2. We estimate the static present value of lost tax revenue to be, on average, $2-$4 billion per year, assuming taxpayers would not delay transactions
   - But…taxpayers would delay transactions, driving revenue gains toward zero
   - Note: JCT's estimated revenue loss, that does factor in investor behavior, **is only 9**% of its corresponding tax expenditure estimate

Overview of Study Results (2)

3. But…elimination would produce many negative consequences
   - Liquidity would be reduced (holding periods would increase)
     - Less efficient allocation of scarse resources
     - Less ability, especially for small investors, to reposition portfolios
   - Prices in most markets would decrease in the short-run; especially in markets where marginal investor expects to use exchanges to dispose of property:
     - Short-run CRE price declines of 8%-17% in markets with moderate taxes; 22%-27% declines in high tax states/markets
     - These declines would
       - reduce the wealth of a large cross-section of households
       - slow or stop construction in many local markets
   - Longer-run rent increases of 8%-20% in moderately taxed markets; 28%-38% required increases in high tax states/markets
     - Such increases would reduce affordability of CRE space for both large & small tenants

Overview of Study Results (3)

4. RE exchanges are associated with increased investment, reduced leverage & shorter holding periods (more liquidity)
   - Replacement like-kind exchanges are associated with an investment that is approximately $305,000 greater (33 percent of value) than "regular" acquisitions by the same investor following a sale of a property.
   - Capital expenditures (specifically building improvements) in replacement exchange properties tend to be higher by about $0.27/sf-$0.40/sf ($0.18/sf-$0.24/sf for building improvements).
   - Investors in like-kind exchanges use less leverage compared to ordinary acquisitions.
   - Holding periods for properties disposed through 1031 exchanges are, on average, shorter.

Overview of Study Results (4)

5. Most exchange replacement properties are subsequently sold in fully taxable sales
   - In 88% of our sample, investors disposed of properties acquired in a 1031 exchange through a fully taxable sale.
   - The estimated taxes paid in an exchange followed by a taxable sale vs. ordinary sale followed by an ordinary sale are on average 19% higher.

But…Elimination Would Produce Many Negative Consequences, cont.

- Less reinvestment in commercial and residential real estate
- Greater use of leverage (with it attendant costs)
- Downward pressure on employment, especially in related sectors
- Decreased tax benefits for local governments

The Impact of Repealing Like-Kind Exchanges in Real Estate

2. Evidence on the Use of Real Estate Like-Kind Exchanges

Evidence from Transaction Data

- CoStar COMPS database includes historical information on CRE transactions in over 878 CBSAs dating back to 1989
- CoStar agents physically inspect the property & record/verify a variety of property characteristics & transaction details
- COMPS database includes 1,609,711 confirmed CRE transactions from 1997 through 2014
  - Total transaction volume = $4.8 trillion (unadjusted for inflation)
- Sales in which CoStar determined that buyer and/or seller were engaged in a like-kind exchange = 81,104
  - 5% of all transactions
  - 6% by sales volume

Table 3: % of CoStar Sales Involving an Exchange by Property Type

	Full sample: 1997-2014		1997-2007		2008-2014	
Property type	Based on number of sales	Based on $ transaction volume	Based on number of sales	Based on $ transaction volume	Based on number of sales	Based on $ transaction volume
Multifamily (≥ 10 units)	12%	8%	16%	11%	5%	5%
Multifamily (< 10 units)	10%	11%	14%	15%	4%	7%
Flex	6%	7%	9%	8%	3%	4%
Total	5%	6%	8%	7%	2%	4%
Office	5%	5%	8%	6%	2%	3%
Industrial	5%	5%	7%	8%	2%	3%
General retail	4%	7%	7%	10%	2%	5%
Hospitality	3%	3%	5%	3%	2%	2%
Speciality	2%	3%	4%	4%	1%	2%
Land	2%	3%	3%	3%	1%	2%
Health care	2%	1%	3%	1%	1%	1%
Sports & Entertainment	2%	1%	3%	3%	0%	0%
Mixed-Use	1%	1%	2%	2%	1%	1%

Table 5: % of 81,104 Exchanges by State: 1997-2014

	Based on:			
	Number of sales		$ Transaction volume	
State	Percentage	Cumulative	Percentage	Cumulative
California	46.5%	46.5%	39.7%	39.7%
Washington	9.1%	55.6%	7.3%	46.9%
Colorado	6.4%	62.0%	4.6%	51.5%
Oregon	5.1%	67.1%	3.4%	54.9%
Arizona	4.8%	71.9%	4.0%	58.9%
Texas	3.7%	75.6%	5.5%	64.4%
Nevada	3.5%	79.0%	3.4%	67.8%
Illinois	3.3%	82.3%	3.5%	71.2%
Florida	3.0%	85.4%	4.1%	75.3%
New York	1.7%	87.1%	7.8%	83.1%
Ohio	1.2%	88.3%	0.9%	84.1%
Georgia	1.1%	89.5%	1.2%	85.3%
North Carolina	0.9%	90.4%	0.9%	86.2%
Minnesota	0.9%	91.2%	0.8%	87.0%
New Jersey	0.8%	92.0%	1.8%	88.8%
Massachusetts	0.7%	92.8%	1.4%	90.2%
Virginia	0.7%	93.5%	1.8%	92.0%
Maryland	0.7%	94.2%	1.0%	93.1%
Pennsylvania	0.6%	94.9%	0.9%	93.9%

Table 7: Exchanges as % of All CoStar Sales by State: 1997-2014

State	Based on: Number of sales	$ transaction volume
Oregon	16.3%	15.9%
Washington	15.0%	12.0%
California	11.6%	9.9%
Nevada	8.6%	7.7%
Utah	8.5%	7.4%
Colorado	8.4%	8.9%
Hawaii	7.9%	6.2%
Alaska	7.2%	5.8%
Texas	5.1%	5.5%
Arizona	5.0%	5.2%
Montana	4.9%	6.5%
Idaho	3.8%	7.5%
Wyoming	3.5%	4.6%
Minnesota	3.5%	4.6%
Illinois	2.9%	3.6%
New Mexico	2.5%	3.4%
District of Columbia	2.2%	3.9%
Kansas	2.2%	3.3%
Missouri	2.1%	2.6%
North Carolna	2.0%	2.9%
South Carolina	2.0%	2.7%
Mississippi	2.0%	1.3%
North Dakota	2.0%	4.1%
Iowa	2.0%	2.9%

California: 39.7% of all exchanges but 9.9% of all sales in California

Most widely used in Western states

%s in remaining states less than 2%

%s are larger when recent price appreciation has been high

Table 6: Exchanges as a % of All CoStar Sales by CBSA: 1997-2014

CBSA	Based on: Number of sales	Based on: $ transaction volume
Portland-Vancouver-Hillsboro, OR-WA	18%	17%
San Diego-Carlsbad, CA	17%	13%
Seattle-Tacoma-Bellevue, WA	17%	12%
Santa Rosa, CA	15%	14%
San Francisco-Oakland-Hayward, CA	13%	9%
Los Angeles-Long Beach-Anaheim, CA	12%	10%
San Jose-Sunnyvale-Santa Clara, CA	12%	7%
Boulder, CO	11%	14%
Sacramento--Roseville--Arden-Arcade, CA	11%	12%
Oxnard-Thousand Oaks-Ventura, CA	10%	10%
Las Vegas-Henderson-Paradise, NV	9%	8%
Colorado Springs, CO	9%	11%
Denver-Aurora-Lakewood, CO	9%	8%
Tucson, AZ	8%	12%
Riverside-San Bernardino-Ontario, CA	8%	10%
Dallas-Fort Worth-Arlington, TX	7%	7%
Houston-Sugar Land-Baytown, TX	5%	5%
Phoenix-Mesa-Scottsdale, AZ	4%	4%
Austin-Round Rock, TX	4%	3%
Minneapolis-St. Paul-Bloomington, MN-WI	4%	5%
Total US	5%	6%

Again, use of exchanges much higher in Western CBSAs

%s in remaining CBSAs less than 4%

We Believe CoStar is Underreporting Exchanges

- In a prior study using CoStar data (Ling & Petrova, 2008), we found much greater use of exchanges
  - Exchanges represented 27% of sales
- Primary explanation:
  - CoStar has grown significantly since 2007 by acquisitions
    - Acquired firms did not track exchanges as carefully

Evidence from IRS Data: Table 8
(in $billions)

Individuals + Corporations + Partnerships	2011	2010	2009	2008	2007	2003-2011 Sum	2003-2011 Mean
FMV of all like-kind property received (Form 8824, line 17)	$70.8	$78.6	$63.3	$118.4	$199.4	$1,267.8	$140.9
Deferred gain from all industries (From 8824, line 24)	33.7	39.9	33.8	56.1	90.0	577.2	64.1
Deferred gain from RE is 66% of total (based on 2007 data):							
Deferred gain from RE industry	22.2	26.3	22.3	37.0	59.4	381.0	42.3
Estimated deferred tax liability from RE industry *	4.7	5.5	4.7	7.8	12.5	80.0	8.9
Estimated economic loss to Treasury:							
Minimum-9.2% of deferred tax liability	0.4	0.5	0.4	0.7	1.1	7.4	0.8
Average-45.0% of deferred tax liability	2.1	2.5	2.1	3.5	5.6	36.0	4.0
Maximum-64.0% of deferred tax liability	3.0	3.5	3.0	5.0	8.0	51.2	5.7
Deferred gain from RE is 30% of total deferred gain:							
Deferred gain from RE industry	10.1	12.0	10.1	16.8	27.0	173.2	19.2
Estimated deferred tax liability from RE industry *	2.1	2.5	2.1	3.5	5.7	36.4	4.0
Estimated economic loss to Treasury:							
Minimum-9.2% of deferred tax liability	0.2	0.2	0.2	0.3	0.5	3.3	0.4
Average-45.0% of deferred tax liability	1.0	1.1	1.0	1.6	2.6	16.4	1.8
Maximum-64.0% of deferred tax liability	$1.4	$1.6	$1.4	$2.3	$3.6	$23.3	$2.6

- * Estimated deferred tax liability assumes deferred gain would have been taxed at 21%
- But…these estimates of deferred tax liabilities overstate exchange benefits/lost tax revenue

The Impact of Repealing Like-Kind Exchanges in Real Estate

3. Estimated Magnitude of Exchange Tax Benefits

Incremental Value of Exchange
Relative to Fully Taxable Sale

- $INCNPV_t$ = PV of net cash flows if taxpayer **exchanges** into replacement property
  - PV of net CFs if taxpayer **sell**s relinquish property & **purchases** replacement property

Incremental Value of Exchange
Relative to Fully Taxable Sale

- $INCNPV_t$ = PV of net cash flows if taxpayer **exchanges** into replacement property
  - PV of net CFs if taxpayer **sell**s relinquish property & **purchases** replacement property

$$INCNPV_t = [SC_t^1 - EC_t + TDS_t^1 - B_t] - \sum_{i=1}^{n} \frac{\tau_o (DEP_i^{2,s} - DEP_i^{2,e})}{(1+k)^i} - \frac{\tau_{dr} (RECAP_{t+n}^{2,e} - RECAP_{t+n}^{2,s})}{(1+k)^n} - \frac{\tau_{cg} (CG_{t+n}^{2,e} - CG_{t+n}^{2,s})}{(1+k)^n}.$$

deferred tax liability in year t

increased depreciation recapture tax on taxable sale of replacement property

reduced PV of annual depreciation deductions t

increased capital gain tax on taxable sale of replacement property

- Note: CFs from operations and sale do not affect $INCNPV_t$
- $INCNPV_t$ is fully developed in an appendix

Base-Case Model Parametrization

- Price of relinquished = price of replacement property
- Mortgage debt: same for relinquished & replacement property
- Selling cost in fully taxable sale: 3% of relinquished property's sale price
- Exchange costs: equal to selling costs of a fully taxable sale
- Ordinary income tax rate: 39.6%
- Depreciation recapture tax rate: 25%
- Capital gain tax rate: 23.8%
- After-tax discount rate: 6%
- Non-depreciable land portion of relinquished & replacement property's original tax basis: 20%(no personal property)
- Relinquished & replacement property are both non-residential real property
- **Other key assumptions**: # of years since acquisition of relinquished property ($HOLD^1$), annualized rate of nominal price appreciation since acquisition of relinquished property (π^1), expected holding period of replacement property ($HOLD^2$).

Figure 2: Incremental NPV as a % of Property Value

Figure 2A: 5 years since acquisition of relinquished property

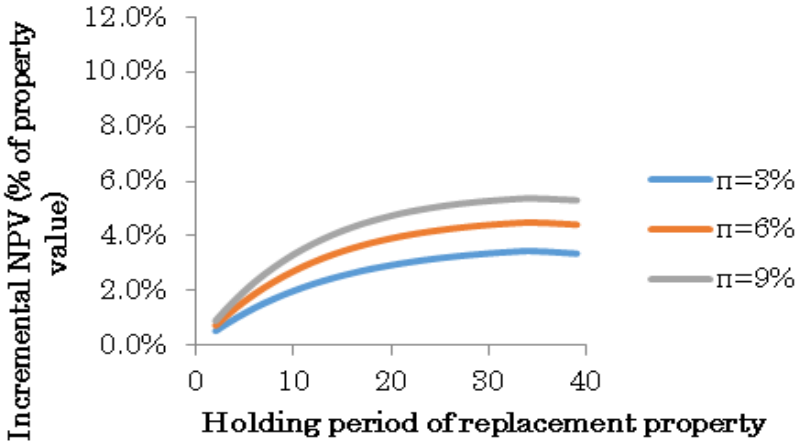

Figure 2B: 10 years since acquisition of relinquished property

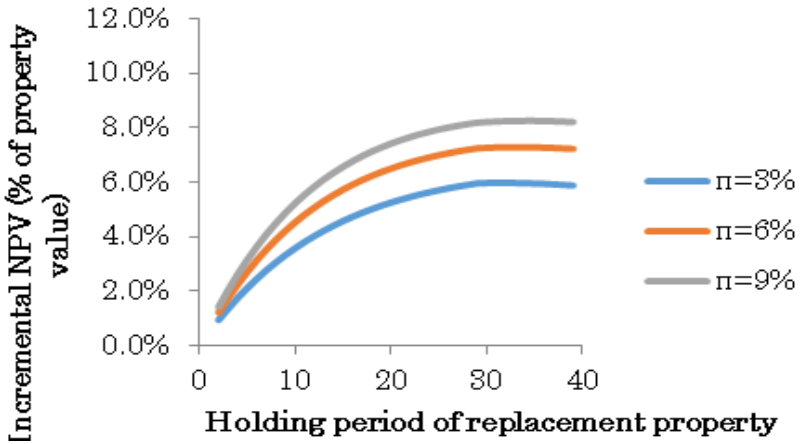

Figure 2C: 15 years since acquisition of relinquished property

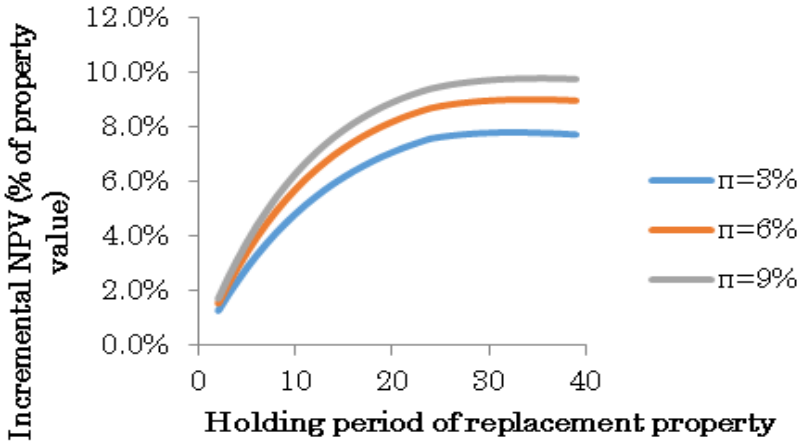

Figure 2D: 20 years since acquisition of relinquished property

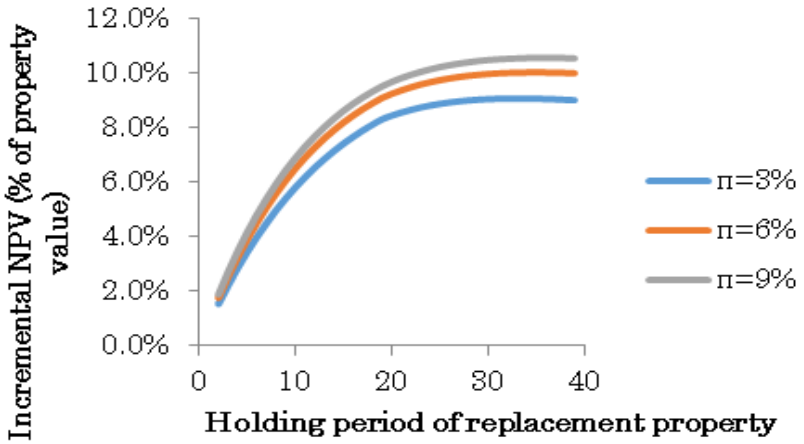

Figure 3: Incremental NPV as a % of Deferred Gain

Figure 3A: 5 years since acquisition of relinquished property

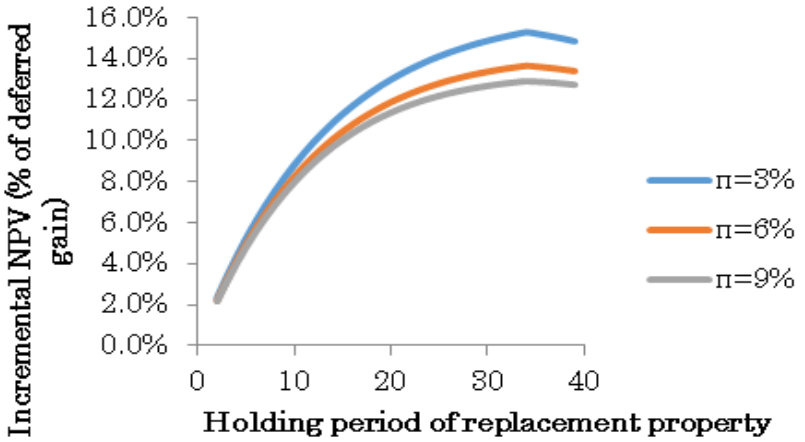

Figure 3B: 10 years since acquisition of relinquished property

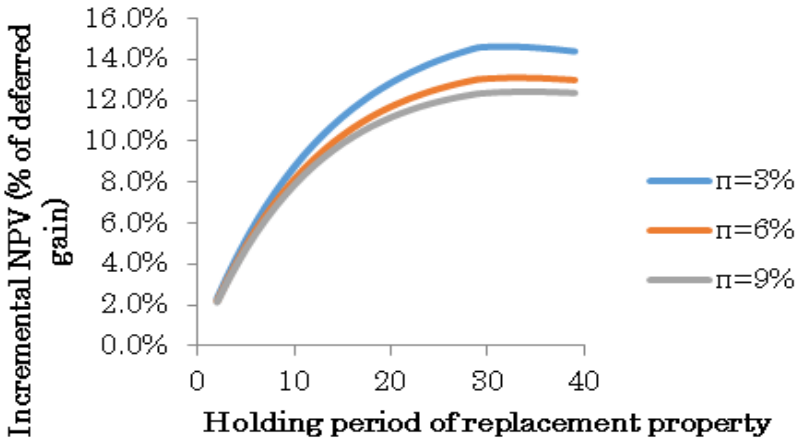

Figure 3C: 15 years since acquisition of relinquished property

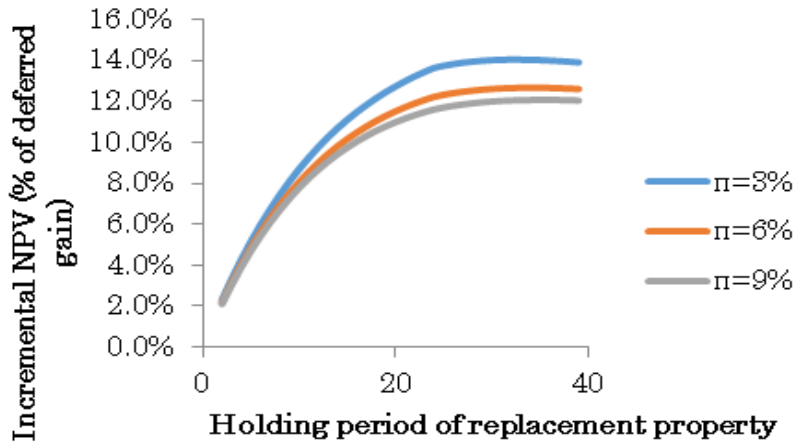

Figure 3D: 20 years since acquisition of relinquished property

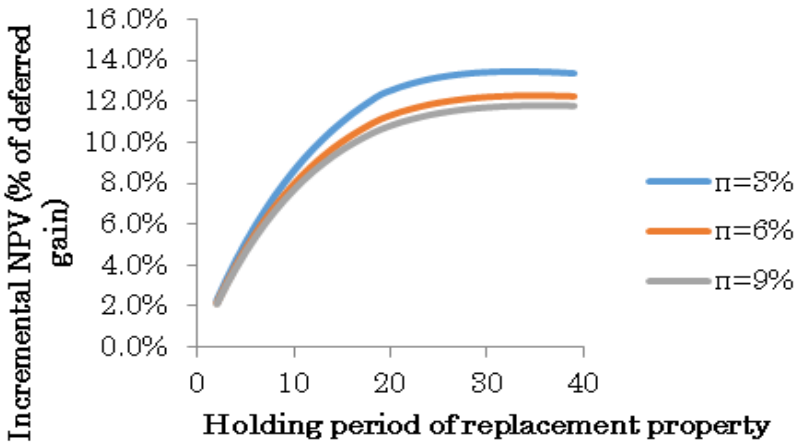

Figure 4: Incremental NPV as a % of Deferred Taxes

Figure 4A: 5 years since acquisition of relinquished property

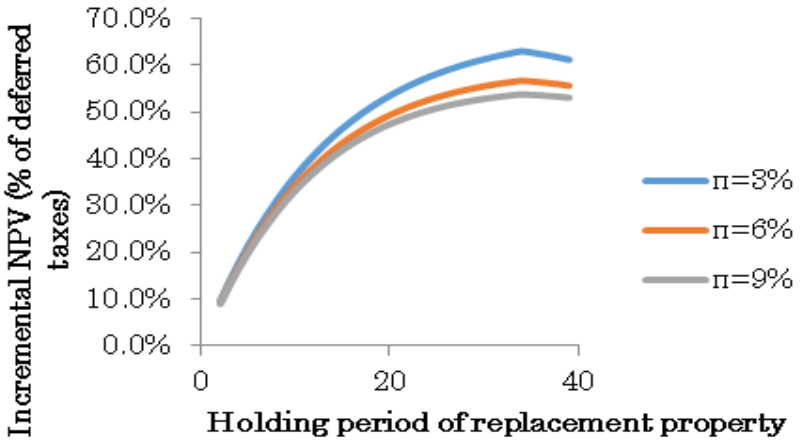

Figure 4B: 10 years since acquisition of relinquished property

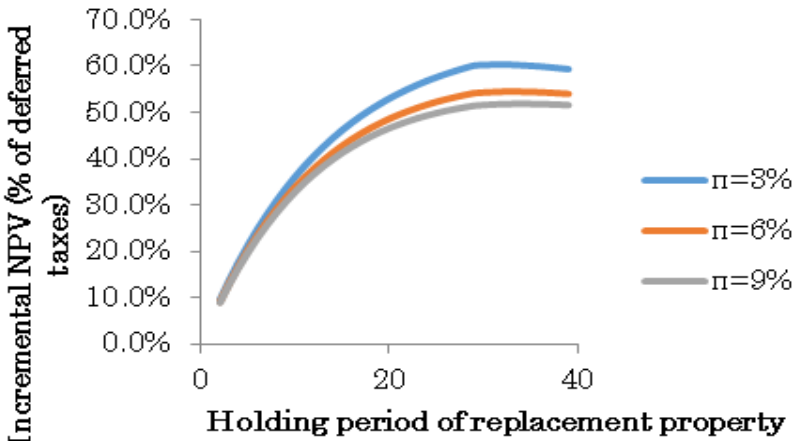

Figure 4C: 15 years since acquisition of relinquished property

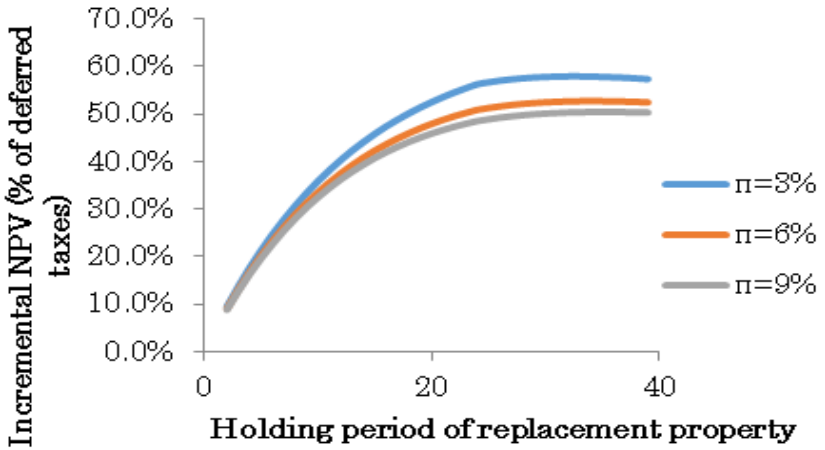

Figure 4D: 20 years since acquisition of relinquished property

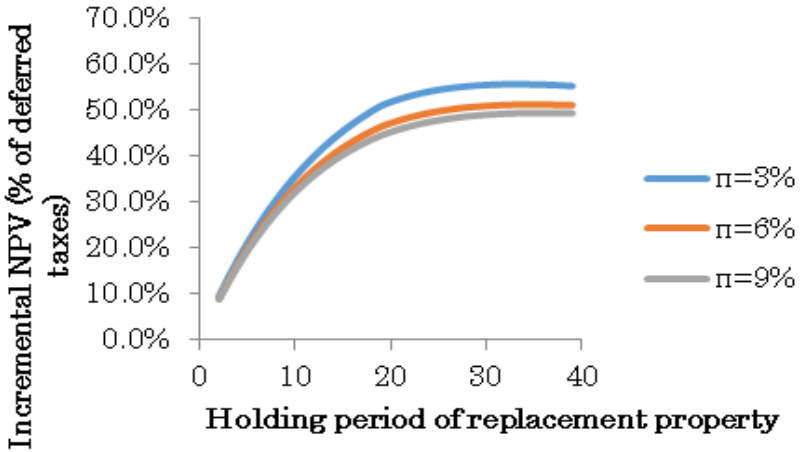

Figure 5: Sensitivity to Assumed Discount Rate

- Tax deferral benefit produced by exchange is immediate
- But…foregone depreciation deductions & increased future capital gain & depreciation tax liabilities occur **in subsequent years**
- Thus, incremental NPV of an exchange to the taxpayer is:
  - increased by a higher discount rate
  - decreased by a lower discount rate

Figure 6: Residential (Apartments) v. Nonresidential

- More rapid depreciation of residential increases immediate benefit of tax deferral
  - More depreciation recapture income to defer
- But…increased deferral benefit is offset by reduced depreciation deductions due to carry-forward of basis & deductions
- Net result?
  - Generally lower incremental NPV from exchange for apartments

Revised Look at Net Benefit/Lost Tax Revenue: Table 8 (in $billions)

Individuals + Corporations + Partnerships	2011	2010	2009	2008	2007	2003-2011 Sum	2003-2011 Mean
FMV of all like-kind property received (Form 8824, line 17)	$70.8	$78.6	$63.3	$118.4	$199.4	$1,267.8	$140.9
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Deferred gain from RE is 66% of total (based on 2007 data):							
Deferred gain from RE industry	22.2	26.3	22.3	37.0	59.4	381.0	42.3
Estimated deferred tax liability from RE industry	4.7	5.5	4.7	7.8	12.5	80.0	8.9
Estimated economic loss to Treasury:							
Minimum-9.2% of deferred tax liability	0.4	0.5	0.4	0.7	1.1	7.4	0.8
Average-45.0% of deferred tax liability	2.1	2.5	2.1	3.5	5.6	36.0	4.0
Maximum-64.0% of deferred tax liability	3.0	3.5	3.0	5.0	8.0	51.2	5.7
Deferred gain from RE is 30% of total deferred gain:							
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Average-45.0% of deferred tax liability	1.0	1.1	1.0	1.6	2.6	16.4	1.8
Maximum-64.0% of deferred tax liability	$1.4	$1.6	$1.4	$2.3	$3.6	$23.3	$2.6

- Calculations assume taxpayers would have disposed of their properties in fully taxable sales in the absence of ability to exchange
- Thus, these estimates still overstate exchange benefits/lost tax revenue
  - JCT's "dynamic" revenue estimate (for all exchanges-2015-2019) is < 10% of its tax expenditure estimate
- Treasury's discount rate?

The Impact of Repealing Like-Kind Exchanges in Real Estate

4. Effects of Elimination of Like-Kind Exchanges on Property Values & Rents

Analysis Tool: User Cost of Capital Model

- Discrete-time, partial equilibrium model that measures & values cash flows to equity investor(s) after all operating, finance, and tax expenses (savings) have been paid
- In our application, the model solves for price that equates marginal investor's expected NPV to zero under old tax law parameters
- **Short-run effect** of tax law change on prices is estimated as % reduction in the marginal investor's maximum bid price (value)
- Effects can be calculated holding all other assumptions constant; alternatively, expected GE effects, such as changes in the level of economy-wide interest rates, can also be included
- Full model: see equations (2) and (3)

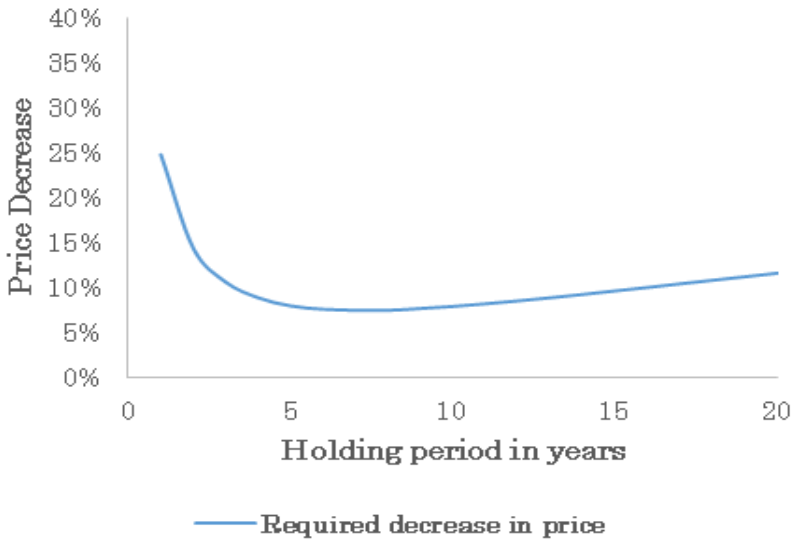
Short-Run v. Long-Run Effects

- The model [equation (2)] can also be used to solve for the long-run increase in 1st year rents necessary to offset negative tax law change
  - Analogous to calculating change in the user cost of capital (rent/price ratio) induced by the tax change
- Estimated impact of tax law change: compare equilibrium level of rent under current law to rent required after elimination of exchanges
  - Assuming all-in construction costs don't change

- Parameter assumptions based on 2014 4th quarter data

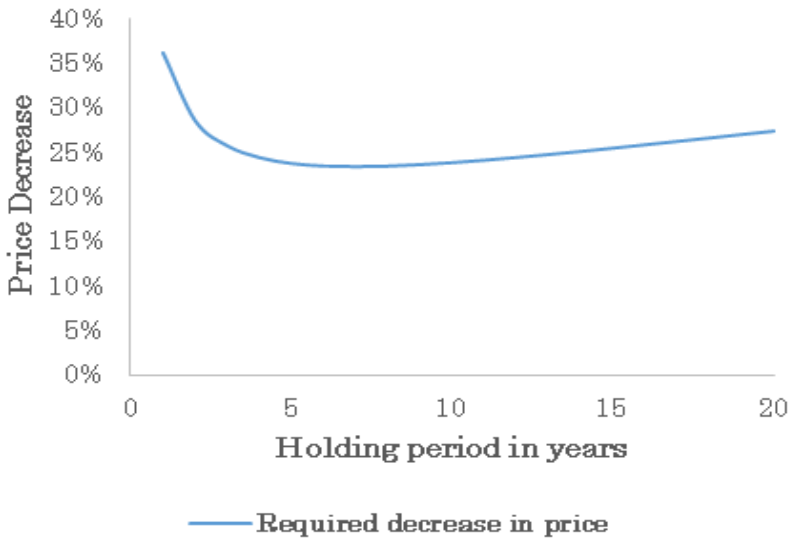
Figure 10: Required Price Decrease After Elimination—Nonresidential

Figure10A: $\tau_{OI} = 39.6\%, \tau_{CG} = 23.8\%, \tau_{DR} = 25\%$



- Price declines of 8%-12% over holding periods of 3-20 years; 10%-17% for apartments

Figure10B: $\tau_{OI} = 52.9\%, \tau_{CG} = 33\%, \tau_{DR} = 38\%$

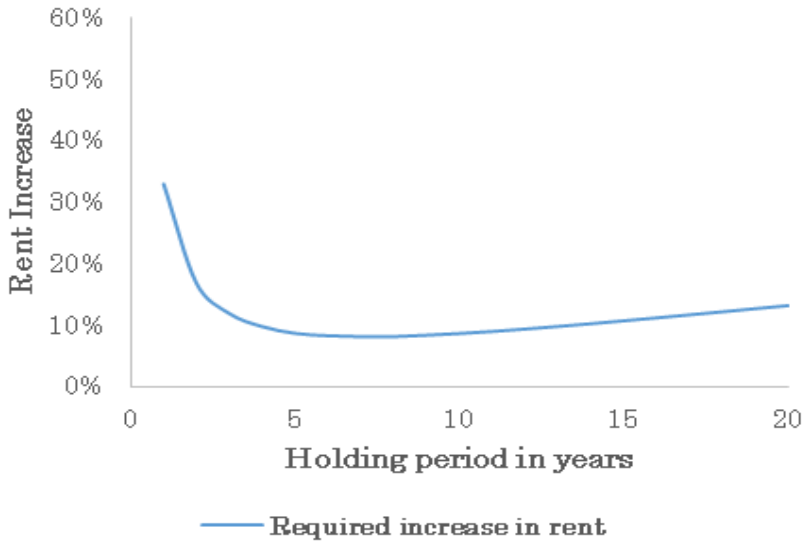


- Price declines of 23%-27% over holding periods of 3-20 years; 22%-27% for apartments

Such declines would reduce wealth of a large cross-section of households & slow or stop construction in many local markets, thereby putting **downward pressure** on employment & state & local tax receipts

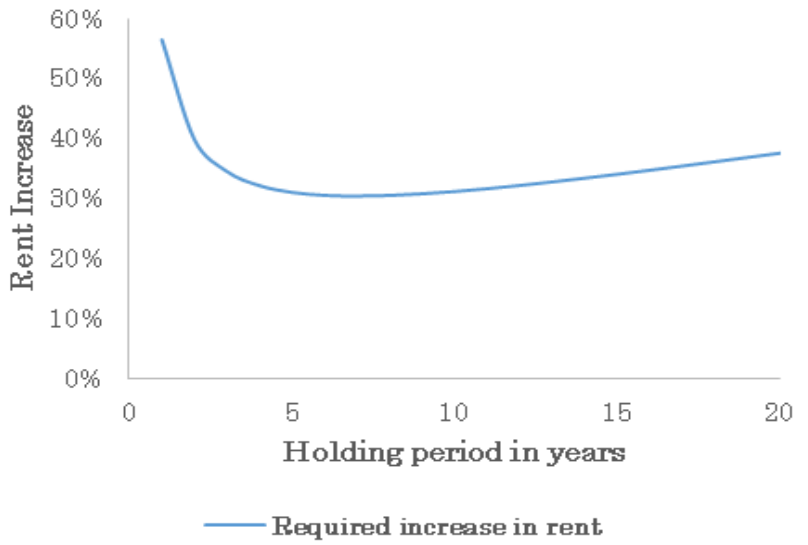
Figure 11: Required Increase in Rents After Elimination—Nonresidential

Figure11A: $\tau_{OI} = 39.6\%, \tau_{CG} = 23.8\%, \tau_{DR} = 25\%$



- Rent increases of 8%-13% over holding periods of 3-20 years; 11%-20% for apartments

Figure11B: $\tau_{OI} = 52.9\%, \tau_{CG} = 33\%, \tau_{DR} = 38\%$



- Rent increases of 29%-37% over holding periods of 3-20 years; 28%-38% for apartments

Such increases would reduce the affordability of CRE space for both large & small tenants

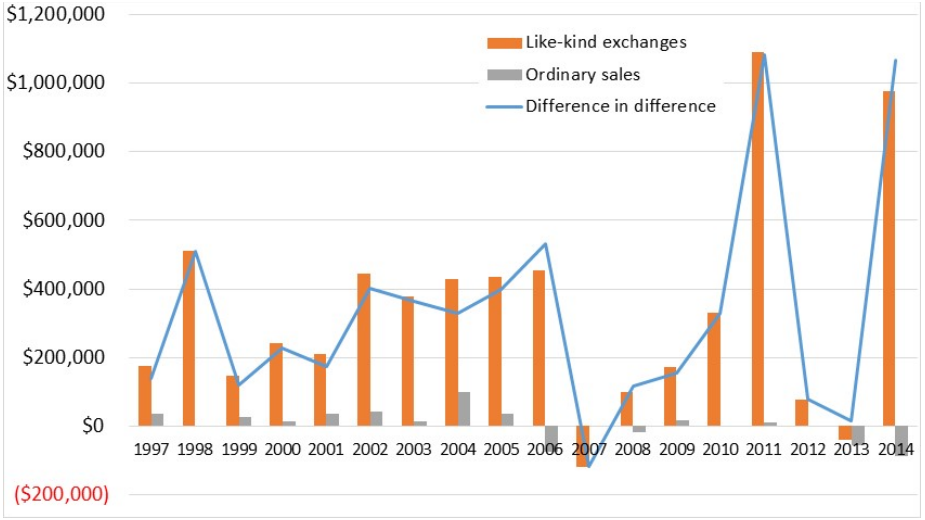
The Impact of Repealing Like-Kind Exchanges in Real Estate

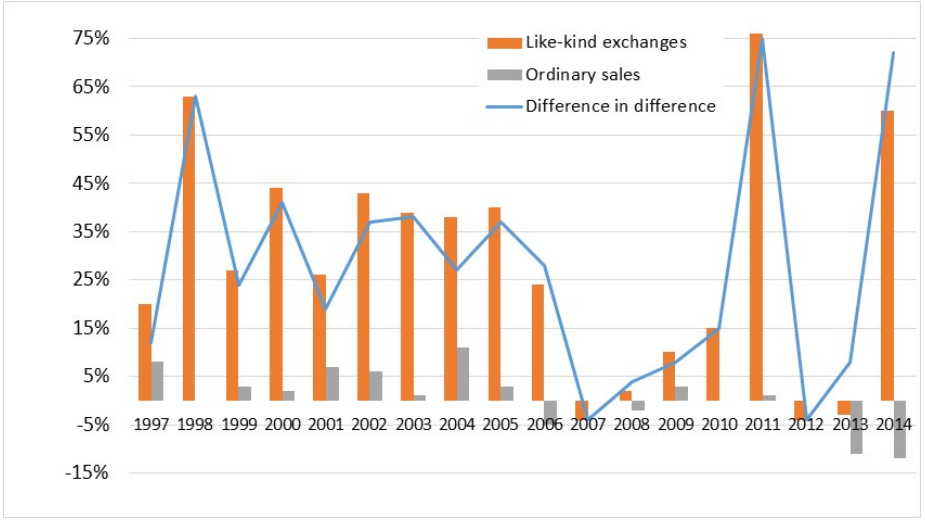
5. Economic Benefits of 1031 Exchanges – Empirical Evidence

Exchanges Are Associated with Higher Investment

- Price difference (replacement – relinquished) is positive in 66% of the matched like-kind exchanges; 51% of the time in ordinary sales
- Difference in replacement and relinquished property price:
  - On average: $305,000, or 33% of value of the relinquished property
  - When $P_{replacement}$-$P_{relinquished}$>0 is $187,500 (-8% of value)
  - When $P_{replacement}$-$P_{relinquished}$<0 is $12,933 (10% of value)

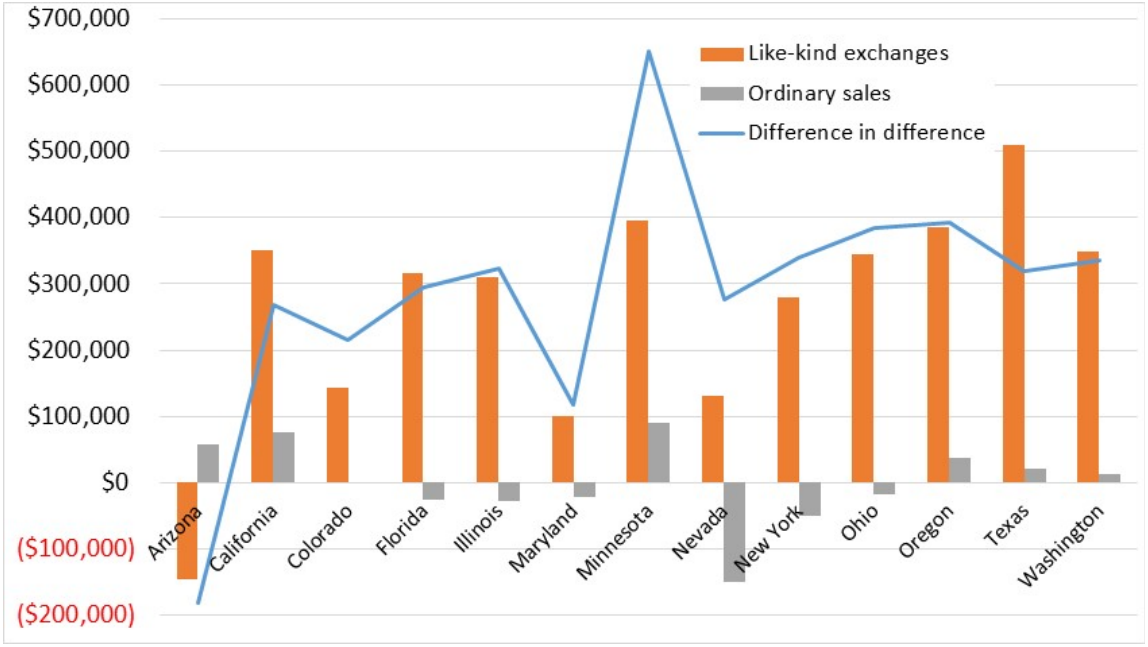
(Replacement – Relinquished) Prices for Exchanges & Ordinary Sales

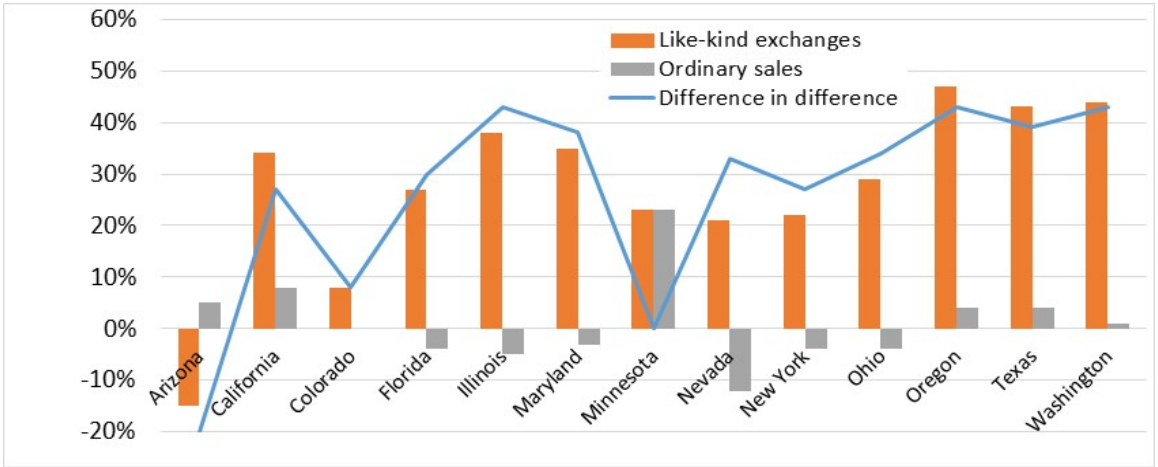




By year

(Replacement – Relinquished) Prices for Exchanges & Ordinary Sales



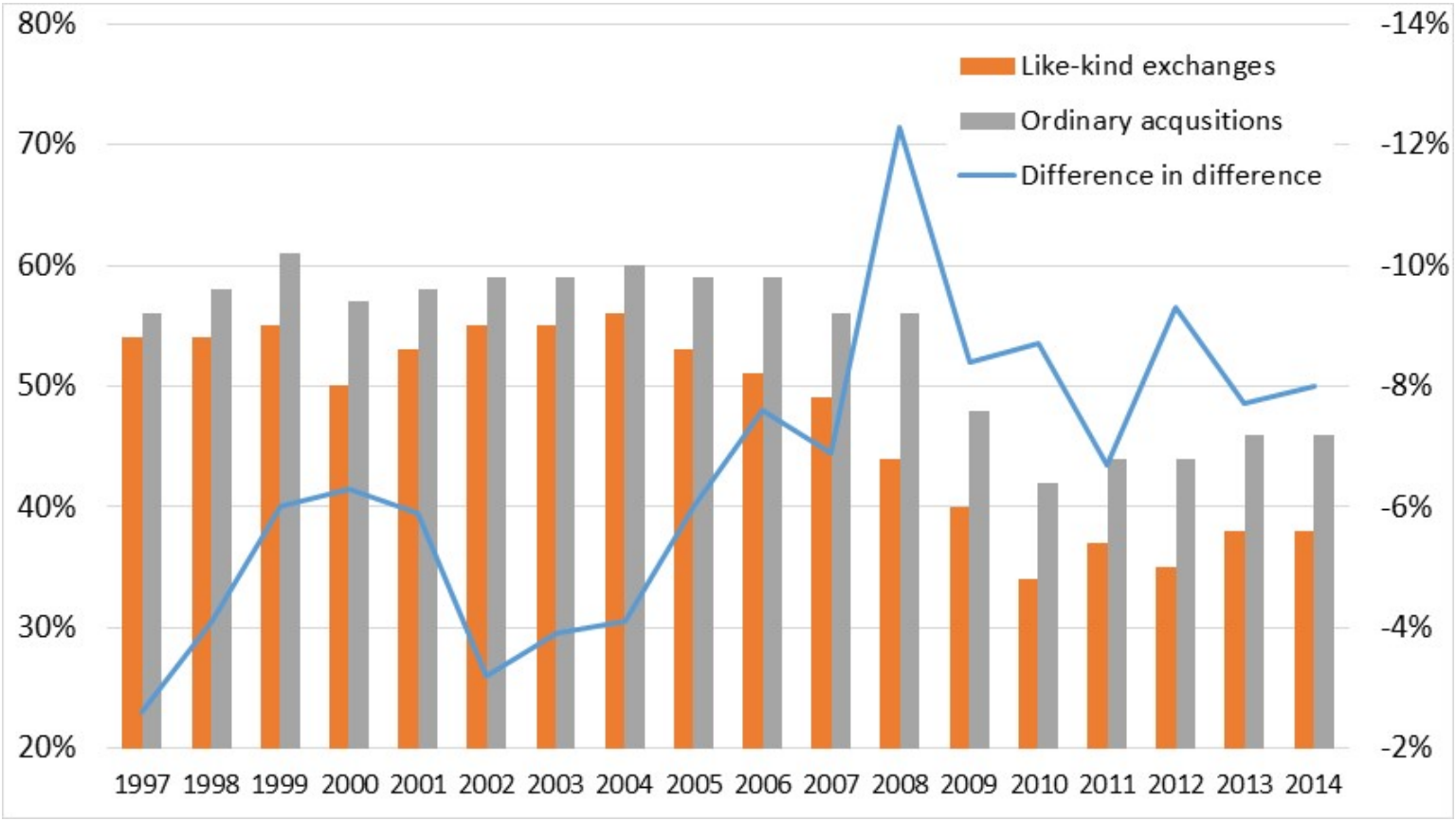


By state

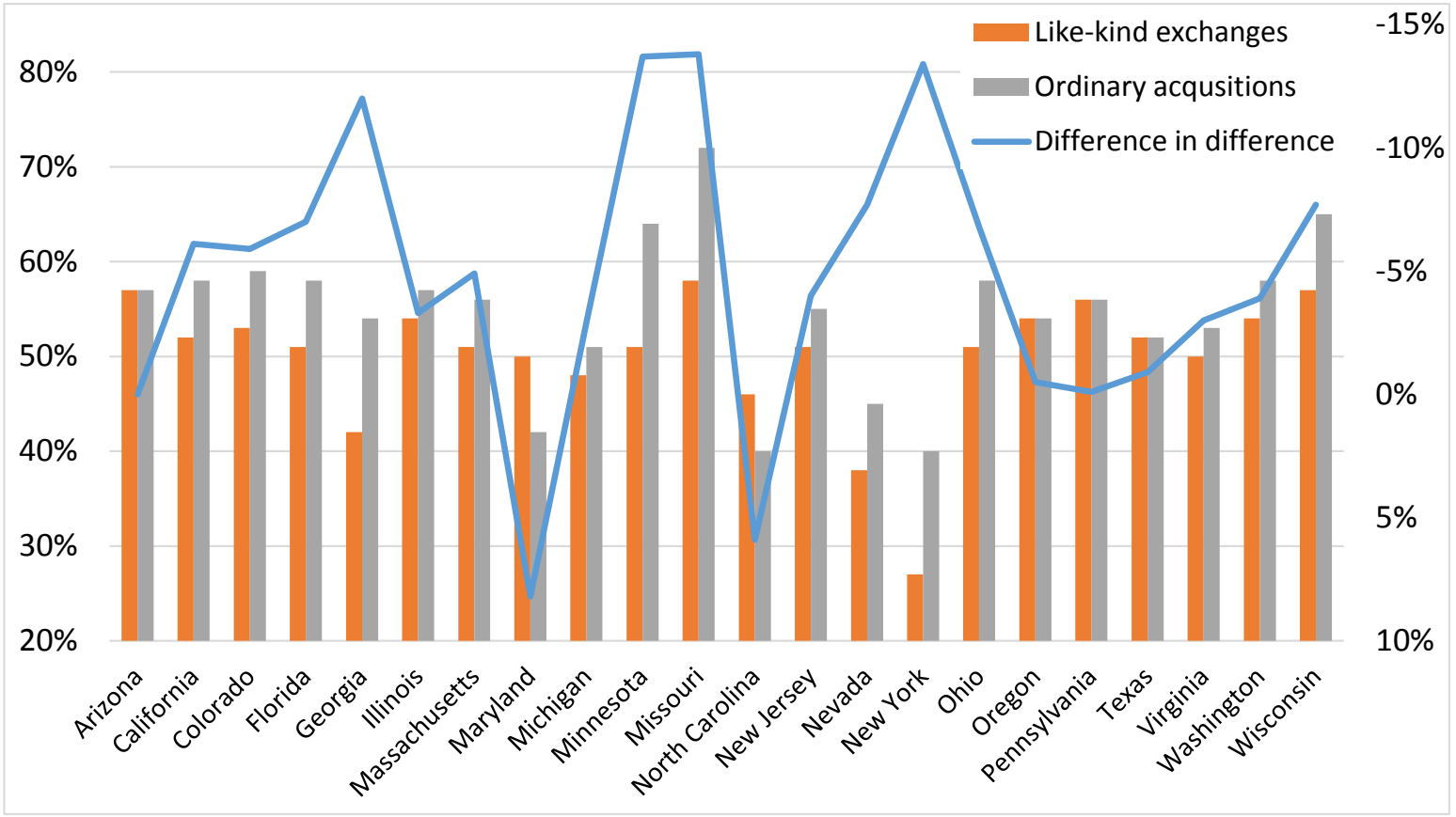
Exchanges Are Associated with Lower Leverage

- Initial leverage used by investors in like-kind exchanges vs. ordinary sales
  - Unbalanced sample: 61% in LKEs vs. 64% in ordinary acquisitions
    - 62% in LKEs vs. 66% in ordinary acquisitions in acquisitions without sales conditions
  - One-on-one (like-kind exchange – sale) matched sample using propensity-score matching: 63% in LKEs vs. 70% in ordinary acquisitions
    - 64% in LKEs vs. 70% in ordinary acquisitions in acquisitions without sales conditions

Lower Leverage in Exchanges Is Robust by Year



Lower Leverage in Exchanges is Robust by State



Replacement Properties in Exchanges Are Associated with Higher CAPX

	Replacement exchange acquisitions		Ordinary acquisitions			
Panel A: Annualized capital expenditures per square foot (all properties)						
	Mean	Std. dev.	Mean	Std. dev.	Dif.	Significance
Capex/sf (excl. LC)	1.53	1.97	1.26	2.18	0.27	P(T>t)=0.22
Tenant improvement/sf	0.55	0.89	0.64	1.03	-0.09	
Building improvements/sf	0.57	0.80	0.39	0.78	0.18	P(T>t)=0.07
Building expansion/sf	0.002	0.016	0.004	0.046	-0.002	
Other capex/sf	0.15	0.49	0.13	0.61	0.02	
Panel B: Annualized capital expenditures per square foot (similar properties)						
Capex/sf (excl. LC)	1.78	2.15	1.38	1.34	0.40	P(T>t)=0.20
Tenant improvement/sf	0.65	0.96	0.77	0.98	-0.13	
Building improvements/sf	0.64	0.87	0.41	0.60	0.24	
Building expansion/sf	0.003	0.018	0.008	0.041	-0.004	
Other capex/sf	0.18	0.56	0.13	0.19	0.05	P(T>t)=0.11

Holding Periods Are Shorter for Investors in Exchanges

Panel A: All properties				
Holding period	Mean	Std. dev.	Min	Max
All sales	6.63	5.09	0.00	17.94
Panel B: Repeat sales				
Holding period	Mean	Std. dev.	Min	Max
All sales	3.97	3.57	0.00	17.94
Exchanges (1)	3.49	2.83	0.00	17.75
Non exchanges (2)	3.98	3.59	0.00	17.94
Difference (1)- (2)	-0.49***			
T-stat	-12.21			
Panel C: Matched sample of repeat sales				
Holding period	Mean	Std. dev.	Min	Max
All sales	3.60	2.85	0.00	17.54
Exchanges (1)	3.38	2.60	0.00	17.30
Non exchanges (2)	3.66	2.92	0.00	17.35
Difference (1)- (2)	-0.28***			
T-stat	-4.26			

88% of the Time Investors Dispose of Properties Acquired in Exchange through a Taxable Sale

	Relinquished 1031 exchange property	Relinquished 1031 exchange property sold through another exchange
Year	Mean	Mean
1997	2.2%	0.4%
1998	4.2%	0.5%
1999	4.5%	1.0%
2000	5.6%	1.5%
2001	6.1%	1.4%
2002	6.8%	1.6%
2003	7.2%	1.8%
2004	7.6%	1.4%
2005	7.8%	1.4%
2006	6.0%	0.9%
2007	4.8%	0.4%
2008	4.1%	0.4%
2009	3.1%	0.1%
2010	2.9%	0.0%
2011	2.9%	0.1%
2012	2.7%	0.0%
2013	2.5%	0.0%
2014	2.4%	0.1%

The Impact of Repealing Like-Kind Exchanges in Real Estate

6. Like-kind Exchanges and Taxes

The Estimated Taxes Paid in LKE Followed by a Taxable Sale vs. Ordinary Sale Followed by an Ordinary Sale Are on Average 19% Higher

	Exchange rolled into an exchange	Exchange followed by an ordinary sale	Ordinary sale followed by an ordinary sale (CG taxes liability >0)
Panel A: Capital gain and depreciation recapture tax liability over the holding period			
Capital gain tax paid	0.0%	19.3%	16.5%
Capital gain tax deferred	24.9%	0.0%	0.0%
Depreciation recapture tax paid	0.0%	3.2%	2.4%
Depreciation recapture tax deferred	8.2%	0.0%	0.0%
Panel B: Annualized capital gain and depreciation recapture tax liability over the holding period			
Annualized capital gain tax paid	0.0%	7.9%	5.5%
Annualized capital gain tax deferred	6.8%	0.0%	0.0%
Annualized depreciation recapture tax paid	0.0%	1.1%	0.5%
Annualized depreciation recapture tax deferred	2.2%	0.0%	0.0%

The Impact of Repealing Like-Kind Exchanges in Real Estate

7. Consequences of Removal of Exchanges Based on Established Micro-economic Effects

Consequences of Removal of Exchanges: Micro Effects

- Our empirical analysis suggest removal of exchanges will lead to:
  - Decrease in investment
  - Increase in holding periods
  - Increase in amount of leverage used to acquire properties
- Our theoretical analysis suggests that repeal of like-kind exchanges would lead to decrease in prices in short-run and an increase in rental rates in the longer run

Consequences of Removal of Exchanges: Macro Effects

- Reduction in growth in CRE markets, resulting from lower investment & decreases in prices, will lead to slower employment growth in sectors closely tied to exchanges, such as construction and financial services

- Removal of like-kind exchanges will increase marginal tax rates for many investors
  - General equilibrium models link the increase (decrease) of marginal tax rates to contraction (expansion) of the economy
  - Impact will be more pronounced in high tax states & in industries that make greater use of exchanges, such as CRE , transportation, and warehousing.
  - In addition to having direct economic effects through increases in the marginal tax rates and the cost of capital, secondary effects will include decreased employment in RE and related sectors.

Conclusions

- Document widespread use of RE like-kind exchanges
- Results of our user cost models and empirical analyses suggest the costs of like-kind exchanges may be overestimated, while their benefits overlooked.
- Elimination of RE exchanges will likely lead to
  - decrease in prices (SR)
  - increase in rents (LR)
  - decrease in RE investment
  - increase in investment holding periods, and
  - increase in use of leverage

The Economic Impact of Repealing or Limiting Section 1031 Like-Kind Exchanges in Real Estate

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July 2015

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