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Section 1031's Beneficial Effect on the Real Estate Life Cycle

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Section 1031's Beneficial Effect on the Real Estate Life Cycle

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Supported by principles of equity and efficiency,[1] a version of §1031[2] has been part of the U.S. tax law for 100 years. Nonetheless, the Biden administration has proposed limiting its application to exchanges with gains of no more than $500,000.[3] Instead of recounting the general arguments supporting §1031, this article presents real-world situations to demonstrate the integral role §1031 plays in the life cycle of real estate and the broader economy.

LOCK-IN EFFECT AND TAX EFFICIENCY

To begin, assume a person who owns real estate worth $10 million with a $2 million basis. That person would recognize $8 million of gain on the taxable disposition of the property. The tax rate on that gain including the federal capital gains rates and possible recapture and state and local taxes could be greater than 30%. Assuming a 30% tax rate, tax on the gain would be around $2.4 million. After paying that tax, the person would have $7.6 million to reinvest. Most property owners would not voluntarily relinquish an asset worth $10 million for a similar asset worth $7.6 million. Property owners would typically stay invested in the $10 million property to avoid losing value, especially if transferring their investment to similar property.

This simple example illustrates the lock-in effect. To avoid taxable gain and loss of net worth, the property owner would retain the $10 million property it already owns. The incentive to retain property is greater the more gain that might be recognized and tax owed and the more similar the replacement property is to the current investment — one would not pay tax to go from one property into something very similar. Thus, ownership of property remains locked in with the current owner if the gain on the sale of property is taxable. By removing the tax on proceeds reinvested in like-kind property, §1031 helps eliminate the lock-in effect and promotes efficiency. By minimizing the lock-in effect, §1031 helps real estate move through its life cycle efficiently, resulting in better real estate product for end users, flow capital throughout real estate markets, and investment opportunities for a broad swath of the tax-paying public. A simplified example of the real estate life cycle illustrates how repealing §1031 would unleash the lock-in effect, disrupt the real estate economy, and send shockwaves through the broader economy.

REAL ESTATE LIFE CYCLE

The life-cycle for real estate begins with raw land, which the owner may use for farming or resource extraction (raw-land phase). That property could be acquired by an investor to hold for appreciation in value, perhaps in anticipation of future improvement (investment phase). That property could then be developed into commercial (retail, office), residential (apartments, houses), industrial (warehouse, factory), health care (hospital, assisted living), or other use (improvement phase). After the property is improved, it will typically be used for its intended improved pur-

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[1] *See, e.g.*, David C. Ling and Milena Petrova, *The Economic Impact of Repealing or Limiting Section 1031 Like-Kind Exchanges in Real Estate* (Mar. 2015), *available at* https://v6k8u5d3.stackpathcdn.com/wp-content/uploads/2015/07/Ling-Petrova-Economic-Impact-of-Repealing-or-Limiting-Section-1031.pdf?x68069; Bradley T. Borden, *The Like-Kind Exchange Equity Conundrum*, 60 Fla. Law Rev. 643 (2008); Daniel N. Shaviro, *An Efficiency Analysis of Realization and Recognition Rules Under the Federal Income Tax*, 48 Tax L. Rev. 1 (1992).

[2] All section references herein are to the Internal Revenue Code of 1986, as amended (the ''Code''), or the Treasury regulations promulgated thereunder, unless otherwise indicated.

[3] *See* Emily Cadman, *Biden Targets $41 Billion Tax Break for Real Estate Investors*, Daily Tax Rep. (Apr 28, 2021).

pose for some time (business-use phase). After being used for some time for its original purpose, improved real estate may cease to meet its original purpose. For instance, the property's size may have suited the owner's needs at the time it is constructed, but business growth or improved business and logistics practices may require additional space. To be more specific, a warehouse may become undersized or its location might become difficult to facilitate the latest logistical practices. Over time, the improvements may become dated as new advancements and designs emerge. Thus, a state-of-the art factory can become obsolete or an apartment complex and its amenities can become worn and dated. Furthermore, externalities such as changing environmental or demographic variables may affect the usefulness and appropriateness of real estate.

After the usefulness of property declines, the property may be ripe for demolition and the land ready for a new structure, or improvements could be ideal for repurposing or renovation (renovation phase). In communities of all sizes, abandoned factories and warehouses are repurposed as beautiful loft apartments, apartment buildings receive much needed face lifts, or old structures are removed to make way for new improvements that put the property to its highest and best use. After being renovated, repurposed or redeveloped, property will typically be used for its intended redevelopment purpose for some time (new business-use phase).

The cycle continues as the newly renovated or repurposed property loses its intended purpose and moves to a new renovation phase. The cycle is iterative, capable of continuing in perpetuity. The length of the real estate life-cycle will vary from property to property and the various phases may last longer for some properties than they do for other properties, and with some properties, the lengths of phases may vary. For instance, the business-use phase may last decades for some properties while the renovation phase lasts only a few years. Putting property to its highest and best use provides a better product to end users and supports community growth and development. In a free-market economy, the market can help dictate the real estate life cycle as market forces help inspire property owners to improve or renovate properties and provide a quality product at an efficient cost.

Tax law should play a minimal role in the real estate life cycle, and §1031 helps minimize the effect tax law has on the life-cycle of property by eliminating the lock-in effect. In fact, with §1031, the real estate industry sees investors and property owners not only specializing in certain types of property but also specializing in specific phases of the real estate life-cycle. As the following discussion demonstrates, this specialization allows for more efficient and effective property management and use through joint ventures of various types.

TYPICAL JOINT VENTURE

Real estate ownership varies from property to property. Many single-family homes and smaller properties are owned by individuals or families. Some larger business-use and investment properties are owned by individuals or families, but much of such property is owned in multiple-member entities with professional managers and various sources of capital.

A significant portion of real estate is held in real estate joint ventures. The term ''joint venture'' can refer to any number of arrangements, but as used in this article, real estate joint venture refers broadly to any arrangement that has investors and a professional manager. Joint ventures often are privately held entities taxed as partnerships, but publicly traded REITs come within this broad definition of joint venture. Section 1031 applies across the board to the different types of ownership structures and benefits the broad swath of managers and investors who participate in such arrangements. Thus, an individual who sells a single-family rental home can benefit from §1031, as well as the larger joint venture or REIT and their investors.

Real estate joint ventures provide multiple benefits but consider two: specialized ownership and capital aggregation. Section 1031 enhances both benefits by freeing capital and expertise to be deployed efficiently at each phase of a property's life cycle, putting real estate to its highest and best use and providing communities with quality real estate products and investment alternatives to a broad swath of the population.

SPECIALIZED OWNERSHIP

Many real estate joint ventures specialize in a particular type of property and a specific phase of a property's life cycle. Through specialization, managers develop sophisticated skills related to the ownership, improvement, and management of the property. They also develop relationships with suppliers and financial institutions allowing them to reduce the cost of owning, improving, and managing properties and pass those savings along to investors and the property's end users. By investing and reinvesting in the same types of properties during the same phases of the real estate life cycle, joint ventures spread the benefits of specialization to communities throughout the country. Section 1031 facilitates specialization and its resulting benefits, as the below example illustrates.

Assume the ''Farmers,'' a family of aging parents, adult children, and grandchildren, own 50 acres on the west side of town. The Farmers have owned and farmed the 50 acres for decades. Now the property is

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less suited for farming as farms have become larger and more mechanized, so the property is not as profitable for farming as it once was. Furthermore, the next generation of Farmers have no interest in farming the property. The Farmers have no experience improving or managing real estate, so they would like to sell the 50 acres. Recent sales indicate that buyers would pay in the $5 million range for the 50 acres.

If the Farmers sell the 50 acres in a taxable transaction, the sell will reduce their net worth. The Farmers have held and farmed the 50 acres so long that they have a very low basis in the property, so they expect to owe a total of $1 million of tax if they dispose of the 50 acres in a taxable transaction. They would like to reinvest in professionally managed real estate. Section 1031 allows the Farmers to sell the 50 acres and buy into professionally managed real estate. Reinvestment options include one or more of the following (with other types of reinvestments also being available): Delaware statutory trust (DST), triple-net property, or tenancy-in-common interests. Thus, the Farmers can roll the proceeds from the sale of the 50 acres into other real estate, delegate property management to professional property managers, and diversify their real estate investment portfolio. Section 1031 allows them to maintain their net worth while providing capital to the improvement of other property or financing for tenants of the triple-net properties. Thus, the 50 acres can be put to its highest and best use while the capital the Farmers receive is used to improve other property put the other property to its highest and best use.

The Farmers thus sell the 50 acres to ''Investor'' for $5 million. Investor believes that the property will rise in value and could be sold in a few lots, perhaps to an apartment developer, a hospital company, a developer of retail or office space, or some combination of thereof. After acquiring the property and holding it for a number of years, Investor obtains approval to subdivide the property into multiple lots. Before doing work that would cause Investor to become a dealer, Investor transfers a portion of the property to ''Apartment Company,'' a real estate venture that builds and manages apartments. Investor would like to use the proceeds to purchase other real estate that it can own for investment until it becomes ripe for development. Section 1031 allows Investor to defer tax and use its specialized skills to acquire the other property. Without §1031, Investor would demand a higher sales price to obtain a reasonable return on its investment in the 50 acres. Thus, §1031 helps keep the costs of development in check.

Apartment Company builds an apartment complex on the portion of the 50 acres it acquires from Investor. Apartment Company's business model is to build apartments and hold and manage for several years while bringing in tenants and establishing a stable rental base. Once rents have stabilized, Apartment Company sells the apartments to JV, a professionally managed venture, perhaps a DST, REIT, or real estate joint venture with investors from across the spectrum. Apartment Company prefers to reinvest the proceeds in other real estate that it can improve, and §1031 frees up Apartment Company's funds for reinvestment.

JV owns and manages the apartments for a number of years until the property becomes dated. JV is not in the business of renovating or repurposing property, so when its property becomes dated and in need of renovation, it typically sells the property to a venture that specializes in renovation. JV is in the business of managing apartments, so it will be looking for another apartment complex to manage with the proceeds it receives on the sale of apartments. As with the other prior owners, JV is willing to sell the apartments because it can use the proceeds to buy other apartments to manage, and with §1031, it can sell the existing apartments and buy the replacement without having its capital eroded by an immediate tax liability.

This simple illustration shows how real estate moves through a typical life cycle. It also shows how §1031 helps free up the property at each phase of the real estate life cycle and demonstrates that specialization can help with the improvement, management, and maintenance of the property. At each phase, the owners have specialized skills, knowledge, and relationships that help with the efficient and effective management of the property. The movement of property from one owner to another at each phase allows groups that might otherwise be excluded from real estate ownership to have the opportunity to participate in the various ownership phases.

CAPITAL AGGREGATION

Joint ventures also aggregate capital, bringing together capital from various sources, including loans from institutional lenders and investments from investors ranging from institutional investors to individuals. The wealth of individual investors can vary over a fairly large spectrum and the amount of investments can vary from thousands of dollars to tens of millions of dollars or more. For private joint ventures, the type of investor is usually limited to those that come within the exceptions to the securities registration requirements. But for those regulations, a broader group of investors could participate in many types of real estate ventures and join with others who invest and reinvest in real estate.

The ability of joint venture sponsors to bring capital together from various sources allows them to deploy their specialized knowledge and skills and pro-

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vide a quality real estate product and a reasonable return for investors. The aggregation also allows various types of investors to join together in real estate ventures. For investors who are not qualified to invest in private real estate joint ventures, they can consider investing in publicly traded REITs to receive benefits of investing in real estate.

Capital aggregation undermines the myth that big high-dollar properties only benefit the very wealthy. Even in relatively large investments, some of the investors may invest thousands of dollars, not hundreds of thousands or millions of dollars. The venture itself may hold property valued in the tens of millions or more, but that value is divided among the lender and investors. While the venture itself may realize significant gain on the disposition of the property, that gain is used to pay interest on the loan and return the loan principal. Any remaining capital is distributed to the investors or, in the case of a §1031, reinvested in like-kind real estate. Some investors on a transaction with a multi-million-dollar realized gain may have a share to the proceeds from such transaction valued in the thousands or tens of thousands. Arguably, tax law should treat them the same way it treats others who individually invest smaller amounts in real estate.

Real estate ventures allow investor who do not have sufficient wealth to invest on their own to invest in professionally managed ventures. Section 1031 applies equally to all investors, so even in larger ventures, §1031 benefits all investors as they redeploy capital in a new investment, and perhaps multiple similar investments. A limit on the application of §1031 could penalize investors who join ventures that might be subject to tax if the gains to such ventures exceed an arbitrary limit. Investors may, therefore, look to invest in smaller properties, which could adversely affect the supply of real estate. Because the tax benefits of §1031 apply to all investors in a joint venture, it does not disproportionately benefit the wealthy.

Capital aggregation and specialization also allow real estate joint ventures to obtain favorable costs of capital, which helps increase the investors' return, providing the opportunity for more average investors to obtain more favorable rates than may be available from typical investment sources. The savings of lower costs of capital can also be passed along to end users.

THE ANGEL WE KNOW

This examination of the real estate life cycle shows that §1031 plays an integral and beneficial role in real estate development, improvement, and ownership, providing benefits to end users and investors. The consequences of limiting §1031 are not fully known or appreciated, but consider some possible outcomes.

Without the benefit of §1031, perhaps real estate owners would adapt by retaining ownership and paying third parties to provide functions that owners currently provide, such as improvement, management, and renovation. By locking in ownership in that manner, the quality of real estate product may diminish because non-specialist multi-phase owners' awareness of the nuances of the various phases of the real estate life cycle may not be as acute as the awareness gained by specialization afforded in our current system.

Without §1031, the benefits of the various phases of ownership would accrue to a single owner instead of the myriad owners that participate in the real estate life cycle under the current system. By freeing property from the lock-in effect, §1031 helps bring property to its highest and best use, and it allows a more diverse segment of society participate in real estate ownership.

While estimates may suggest that limiting §1031 would increase tax revenues, the relatively small amount of tax revenue to be collected if §1031 were repealed could pale in comparison to revenues lost through a slow down in real estate activity. The lock-in effect would also limit the amount of revenue as continued ownership would not generate taxable gain. The lock-in effect also has larger social ramifications, as it limits the segment of the population who are able to participate in real estate ownership.

The effect of §1031 on real estate prices is uncertain. Some may claim that §1031 drives up real estate prices because investors who have sold property will pay extra for existing properties to obtain the tax benefits of §1031. But as §1031 relieves the lock-in effect, it makes more real estate available increasing the supply of real estate. The benefits of available real estate could surpass the possible deleterious effect the supply of §1031 proceeds has on real estate prices. Principles of supply and demand suggest that the absence of §1031 would reduce supply of available real estate and drive up the costs of real estate.

If the benefits of limiting §1031 are uncertain and the odds of improvement no better than a coin toss (the other believes the economy with §1031 would not be better than the current system), the decision should weigh in favor of retaining §1031. This could be a situation where the devil we know (or in this case, the angel we know) is better than the devil we don't know. The only problem with that realization is that a careful examination of §1031 shows it to be mostly benevolent, so this is more of a matter of the angel we know is better than the devil we don't know. Thus, the choice is simple — retain §1031 with no limit on its application.

THINGS TO CONSIDER

Despite these redeeming qualities of §1031, the analysis must consider whether §1031 precludes or

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excludes members of society from the benefits it confers. In particular, the analysis must consider whether §1031 benefits marginalized communities, is neutral with respect to marginalization, or helps reduce it. Arguably, putting property to its highest and best uses should benefit all of the society, including marginalized communities. The real estate life cycle of housing for marginalized communities should benefit from §1031 in the same manner other property does. Nonetheless, attention could be given to determine the extent to which providers of housing to marginalized communities benefit from §1031 and pass those benefits on to end users of the property.

The benefits §1031 provides to investors are only available to members of society with sufficient savings to invest in real estate. Members of society who lack resources sufficient to take advantage of tax breaks for retirement plans would also lack resources to take advantage of §1031. This problem is much broader than §1031. Effort must be directed to help include a larger percentage of the population in investment opportunities that benefit from §1031.

The limit restricting many people from investing in real estate joint ventures lies with securities laws enacted to protect the public. Perhaps those rules should be reconsidered to determine if there is a way for real estate ventures to draw capital form larger groups of investors. Many sponsors of real estate joint ventures would welcome the opportunity bring in capital from a larger percentage of the population and to pass the benefits that their other investors obtain on to that larger group. Until any such changes happen, investors have the option of investing in REITs, which can exchange properties under §1031. Some investors have also grown real estate portfolios by starting with a rental condominium and working up to duplexes and then into apartment complexes. Section 1031 thus can apply to all investors, and its scope could be expanded by changes in other areas of the law.

Societal values of inclusion should factor into decisions related to tax, and repealing §1031 could deleteriously affect efforts to be more inclusive. The real estate industry and §1031 industry more particularly includes many institutions that are socially conscientious and working to be more inclusive and to diversify their numbers. A repeal of §1031 would undoubtedly negatively affect those institutions. Any work that those institutions are doing to include underrepresented segments of the population would be lost. Instead of dismantling the institutions that are advancing social values, the government could work with them to establish policies that help further societal objectives and bring better real estate products to all members of society and similarly provide investment opportunities to more people. Maintaining and improving the current system would appear to be the best way to preserve current benefits and advance other objectives.

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