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Is the Future of the 1031 Exchange at Risk Under President Trump?

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By Pierre Debbas

Tax reform has been a very popular topic during the course of the election and a few months into the Trump administration. Corporate tax reform is being called to question and one in particular that can have a great impact on the real estate market is that of capital gains tax rates and 1031 transactions. President Obama during his administration had increased long term capital gains tax rates from 15% to 20% and also enacted the Obamacare Tax of 3.8% on investment income for investors making above certain income thresholds.

Under Section 1031 of the Internal Revenue Code, a real estate owner who is selling a property used solely for investment purposes, has the ability to sell that property and use all of the proceeds to acquire another property and defer gains taxes. This mechanism has been highly utilized across the country and is undoubtedly a tool that adds liquidity to the real estate market and drives appreciation of property values. The basics of a 1031 exchange are that the investor must identify the property (could be multiple) that it intends to purchase within 45 days from the date of the sale of its investment property (relinquished property) and close on that property (replacement property) within 180 days from the date of the sale of the relinquished property.

The logic behind allowing for a 1031 is that the investor is incentivized to continue investing their funds in real estate as opposed to liquidating and paying taxes. Additionally, the investor by deferring their tax obligations has a significant amount of additional liquidity to invest which leads to purchasing of multiple properties or ones of higher value than if they had had to pay the gains taxes upon the sale. At the time when the investor decides to no longer continue exchanging properties and investing their money in real estate, they pay their gains taxes which are calculated from the basis of the very first property they invested in. Thus, the value of their assets are significantly higher than if they did not utilize a 1031 exchange and at the time of liquidating those assets, the federal and state capital gains tax will be due.

Taxation can be avoided entirely if in certain circumstances, the investor passes away prior to selling their assets and their heirs receive a stepped up basis. However, according to a CNBC article (December 23, 2016 – *Like-kind exchanges could be at risk under Trump*) about 88% of 1031 exchanges eventually end up being taxed. Additionally, 1031 exchanges are most commonly utilized by individual investors and small businesses as opposed to large corporations.

What President Trump is proposing is eliminating I.R.C. 1031 entirely and in exchange for this decreasing capital gains tax rates and being able to immediately take the write-off of a property you purchase to offset your gain on the property you sold, so long as you sell and purchase in the same calendar year. In this scenario, the investor would not recognize any taxable income (assuming the value of the property purchased is same or greater value to the one sold). The logic behind Trump's proposal is that he will be allowing for a mechanism (through a write-off as opposed to exchange) to avoid capital gains taxes, however by eliminating a tax deferral mechanism in the I.R.C., he would be able to reduce gains tax rates, which theoretically would have no detrimental impact on the real estate market.

It is estimated that about 30% of the annual volume in commercial real estate transactions throughout the country are transacted using a 1031 exchange. In an increasing interest rate environment, a repeal of the 1031 exchange which has been around for over a 100 years, could have an extremely negative impact on property values. Trump's tax reform proposals could possibly be one of the most important aspects of his presidency. While he created billions of dollars in wealth in investing in real estate, one may have confidence that his tax reforms would only be beneficial to the real estate market. However, in an uncertain economic climate, the increase in changes taking place will only lead to a decline in consumer confidence and when eliminating mortgage interest expenses, 1031 exchanges and increasing rates are all on the table, it is imperative that any tax reforms are handled with the utmost level of caution.

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