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Republican tax proposal keeps 1031 exchanges…for now

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Republican efforts to rewrite the U.S. tax code got a shot in the arm on Tuesday when the Senate Budget Committee voted to send the $1.4trn package to the Senate floor for a vote later this week. While the current proposals haven't touched 1031 exchanges, it's possible that this popular and long-lived legislation could be on the table as Congress works to hammer out a final tax bill.

"Initially, 1031 exchanges were thrown out there for elimination and it's too early to know what Congress is going to come back with as the proposals get revised," said **Pierre Debbas**, a partner at law firm **Romer Debbas**. Estimates are that anywhere from 60-75% of all commercial real estate transactions involved 1031 exchanges. "If 1031 exchanges are eliminated, it could have a crippling effect on the commercial real estate market," he added.

Should 1031 exchanges be eliminated, there are other possible incentives that could be written in. "One possibility is for investors to start taking deprecation on day one of an acquisition to offset the gains of the sale. But the question is how fast investors would be able to come around to the new concept. 1031 exchanges are more than 100 years old and are a proven mechanism," Debbas said.

Another factor that could affect commercial real estate is a proposal to cut the cap on mortgage interest deductions on newly purchased homes. At this point, it's possible for a married couple to deduct interest on mortgages of $1m or less. The current plan would cap that level at $500,000, with state and local property tax deductions capped at $10,000. "A mortgage interest deduction is a huge component to sparking demand in the residential real estate market," Debbas said.

As is often the case, the Manhattan luxury residential market works by its own rules. "In Manhattan, the mortgage deduction is a non-factor for luxury condos, which are often fueled by a high volume of cash buyers with a level of affluence that is not concerned about tax deductions on mortgage interest," Debbas said. "It will have a detrimental effect on any other area of the country."

As Congress works to hammer out a final plan, Debbas said factors to follow include potential changes to the capital gains tax rates, the reduction of corporate taxes, and the possibility of reducing the pass-through income rate. "If tax rates were theoretically reduced from 35% to 15%, that would presumably free up more capital, drive up values, and create a high level of liquidity in the marketplace for commercial real estate," he said.

The final factor to be aware of the possibility that the legislation won't be passed. "The stock market is having a robust year in part because people are very bullish on the impact that tax reform will have on corporations. If that legislation gets thrown out of the door, the question becomes what will happen to the stock market, which we all know is directly linked to the real estate market?" Debbas said.