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Section 1031 Tax Deferred Exchanges: Implications of the Biden Proposal



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On April 28th, 2021, President Biden revealed a slew of tax proposals. One of these proposals involved curtailing the use of a long-standing planning tool — the Tax Deferred Like-Kind Exchange. Flowing from Section 1031 of the Internal Revenue Code, Section 1031 exchanges are a key component of the investment real estate market, especially for small to mid-size investors. Section 1031 exchanges have long been credited with increasing investment in real estate, increasing deal velocity in real estate, and allowing many small businesses and investors to expand and grow their respective businesses.

Under President Biden's proposals, Section 1031 would be modified to abolish the use of Section 1031 for deferring gains over $500,000. It is also important to know that a second Biden proposal would affect the world of 1031 exchanges as well. President Biden has proposed eliminating the step up in basis at death. The result of this change would be the elimination of one key advantage of the Section 1031 exchange—allowing individual investors to essentially make the tax deferral permanent if they choose to hold the replacement property until they die. The combined effect of these changes would drastically reduce the viability of 1031

exchanges for many commercial real estate transactions. A 2020 report from the National Association of Realtors found that 12% of sales transactions involved a like-kind exchange between 2016 and 2019. Eliminating or reducing 1031 exchanges would diminish prices for commercial property since the tax deferral premium that allowed for a higher ask has been significantly undermined or even eliminated. The Federation of Exchange Accommodators articulately and succinctly identified its negative policy implications in **this** article on April 28, 2021.

From a legal standpoint, we will have to wait to see the actual language that affects Section 1031, but the suggested changes raise the following issues or options:

- With a threshold of $500,000, greater scrutiny and analysis will be necessary regarding what expenses reduce gains. There has been some controversy regarding the inclusion of certain expenses versus characterization as boot. This discussion will become more acute as parties attempt to fit under the $500,000 gain mark.
- Tenancy in Common, Series LLCs, and Condominiums will be used as workarounds. Investors may wish to carve their real property into smaller portions so as to run a series of smaller exchanges that fit under the gain limit. This will further complicate large deals and potentially bring back many of the problems of syndication.
- Investors may shift to other options with less deal velocity, such as Qualified Opportunity Zone Funds (unless those are limited).
- Investors may be driven towards Section 721 Exchanges (“UPREIT” exchange) which involves an exchange of property for units in a Real Estate Investment Trust. These are not as efficient as 1031 exchanges, but may provide an alternative in the market.
- Investors may experience pressure to complete exchanges in the calendar year 2021.

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