Green Street
Commercial Mortgage Alert
THE WEEKLY UPDATE ON REAL ESTATE FINANCE & SECURITIZATION

Big Groups Wary of Tax Hit on Small Players

It's an issue that unites the institutional giants and the "moms and pops."

Small, private investors are the most common users of like-kind exchanges, which allow sellers to defer capital-gains taxes on property sales if proceeds are invested in another property. But their activity helps support liquidity throughout the sales and lending markets, pros say, so the industry at large has an interest in fending off President **Joe Biden's** proposal to eliminate the tax break for all but the smallest transactions.

A study commissioned by industry groups last fall concluded that the strategy, under Section 1031 of the IRS Code, is used in roughly 10% to 20% of all commercial real estate transactions, with an average size of just over $2 million. Those small to mid-size deals provide a steady flow of opportunities for banks and other lenders, including conduit shops.

While the largest commercial MBS loans are unlikely to be affected by the proposed tax change, bankers say small loans are key to rounding out and diversifying conduit pools.

"This is something people are losing sleep over," said **Justin Ailes,** managing director for government relations at the **CRE Finance Council,** noting that conduit lenders don't want to lose any transactions as they rebuild their business in the aftermath of the pandemic.

In an analysis last month, **Bank of America** said "unintended consequences" of eliminating the capital-gains referral "could curb investors' willingness to purchase new properties, lead to higher leverage on properties purchased in an effort to maximize returns, or decrease investors' desire to invest in and improve the assets they currently own."

Industry pros say the change could chill the time-worn practice of buying small buildings, fixing them up and rolling sale profits into bigger buildings.

"This is how so many investors get started — through sweat equity, buying a single-family home and fixing it up and exchanging it for a small building and moving up," said **Karlin Conklin,** a principal at **Investors Management Group.** The firm has parlayed the strategy into 4,000 apartment units in the Southeast and West. Conklin cited the industry study's finding that about 40% of like-kind exchanges involve rental housing. "That is how we have built our housing stock in this country," she said.

The tax strategy also helps fuel purchases of net-lease properties, which are seen as safe, stable investments by family offices and other private-capital investors. **Alex Sharrin,** a managing director who heads **JLL's** net-lease platform, said research by his company shows about 30% of net-lease transactions involve Section 1031. Nonetheless, he said, JLL believes eliminating the benefit would have only a modest impact on dealflow, with hold periods shrinking by about 8%.

He said the mere announcement by Biden last month that he wanted to limit 1031 exchanges appeared to prompt a surge of selling. "Private capital tends to be emotional in spirit," he said. "A lot of decisions are made on headlines, so we're already seeing the near-term surge. In the long term we predict slightly diminished liquidity."

At the moment, a change in Section 1031 is one of many proposals to pay for infrastructure spending and Biden's social agenda under discussion in the House Ways and Means Committee. House Speaker **Nancy Pelosi** (D-Calif.) has said she'd like to see an infrastructure bill on the House floor by July 4.

Bill Killmer, a senior vice president for legislative and political affairs at the **Mortgage Bankers Association,** said he was "encouraged" by some 200 virtual meetings the group's members had with lawmakers last week to provide input on the practical implications of such changes.

"We have our guard up, but there are a lot of folks who understand the positive impact that 1031 has on affordable housing and related transactions," he said. ❖