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Guest opinion : Dear Washington , don't simplify the tax code this way

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By Michael Shields

Rarely do the interests of real estate investors, small businesses owners, and a broad range of local entrepreneurs agree with almost a century of federal income tax policy — especially when it results in billions of dollars in taxes being paid.

But fortunately for the economy, they do.

The trouble is, this powerful economic driver is now in real danger as Congress and the Trump administration grapple with the twin dilemmas of tax reform and a threadbare federal budget proposal that would put such long-term investments and incentives at risk. Plus, small business owners stand to be hit the hardest if federal officials go too far to simplify the tax code.

For more than 90 years, like-kind exchanges (under Section 1031 of the Internal Revenue Code) have been a key enabler for small businesses and investors to expand their businesses by exchanging rental or business-use real estate for other rental or business-use real estate without an immediate tax penalty.

Just like a 401(k) or IRA where the tax payment on the gain is deferred until it’s withdrawn, like-kind exchanges make it possible for small business owners to grow and exchange their real estate as markets change and then pay the full amount of the resulting tax burden when the property is ultimately sold rather than exchanged.

For example, a landlord who sells a four-unit building, via a like-kind exchange, for an eight-unit building incrementally grows the business, while deferring the taxes. That, in turn, allows another investor into the apartment properties to maintain and improve them going forward (which, in turn, creates construction and other jobs). Once the original landlord sells the second building instead of exchanging it, the total amount of taxes owed on the gain are paid.

In 2016 alone, the reported sales volume of multifamily properties in Santa Clara County was close to $2 billion. Given that every one of the top multifamily real estate brokers in our area undertakes 1031 exchanges — and I can say that at least 50 percent of my business is based on like-kind transactions — the impact on the Silicon Valley economy is enormous. In commercial property exchanges, about 88 percent of replacement properties acquired in a like-kind exchange are eventually disposed of in a taxable sale — where the tax is eventually paid.

Today, the ability for an owner to use a 1031 as part of a strategy to exchange properties is critical. In their absence, maintenance can be deferred and repairs put off if the owner is faced with a sale where an immediate tax payment robs them of their ability to fully reinvest and grow for the long-term. With a 1031 exchange, however, a new owner will emerge to improve the property and stimulate the economy as the prior owner transitions.

Moreover, during the post-2008 economic downturn, like-kind exchanges made it possible for real estate transactions to continue to occur. But for this tool, that market would have frozen to an even greater degree, just at the time when the economy could least afford it.

A 2015 Ernst & Young study found that the failure to keep like-kind exchanges intact would result in the contraction in overall U.S. GDP of approximately $8.1 billion annually. The loss to GDP over a 10-year period was predicted to be $61 billion-$131 billion, depending on how that revenue is ultimately replaced.

As the backbone of the nation's economy, small business owners like me know what it takes for small businesses to thrive, and how — contrary to popular perception — government can help. The opposite of a Washington-run program, like-kind exchanges wisely replace mandates from bureaucrats with locally-focused and customized marketplace solutions.

For Congress and the White House the next step is clear and obvious — like-kind exchanges work just as they always have. Putting such a continuous circle of economic stimulus and liquidity at risk threatens adverse consequences, with far too little offered in return.

Michael Shields is a commercial investment real estate broker, the founder of Silicon Valley Multifamily Group, a Certified Commercial Investment Member (CCIM), a Certified California Residential Manager (CCRM), and a real estate investor. The views expressed are those of the author and do not necessarily reflect the opinions of the Silicon Valley Business Journal.