Investors Are Flooding Sun Belt Markets With 1031 Exchanges After Selling On The Coasts

January 27, 2021 | Jarred Schenke, Bisnow Atlanta (https://www.bisnow.com/author/jarred-schenke-5711) (mailto:jarred@bisnow.com)

President Joe Biden's election was a warning sign to Josh Eitingon that the 1031 exchange's days may be numbered. And that is pushing him and his clients to look to Sun Belt markets for their next commercial real estate investments.

Eitingon, the co-founder of DXE Properties, said he sees the pressure to sell properties and reinvest the proceeds through the 1031 exchange program mounting over the next 12 to 24 months as the industry waits for Biden to propose his campaign promise of tax reform (https://www.bisnow.com/national/news/capital-markets/bidens-proposed-1031-exchange-repeal-could-do-more-harm-than-good-105438).

“I think there is some added urgency now more than ever if you were considering a sale,” Eitingon said.

Like-kind exchanges, also called 1031 exchanges, allow real estate investors to sell one asset — in many cases apartment buildings or single-tenant retail properties — and funnel those proceeds into buying similar assets within 180 days. By doing so, investors can avoid paying capital gains taxes.

Tax reform and its effects on 1031 exchanges are part of the growing motivation some investors are expressing when making moves, especially when selling properties in high-cost, high-tax markets along the West Coast and Northeast and into more business-friendly and lower-cost-of-living environments in the Sun Belt.

“Some of them are definitely operating under the guise that 1031 won't be a viable option anymore," Berkadia Director Matt White said.

While 1031 exchange investments nationwide dropped along with the rest of investment sales nationally due to the coronavirus pandemic last year, activity is on the upswing again. Politics is playing a part in that.

The threat of higher taxes in the future prompted by the Biden administration has real estate investors second-guessing expensive markets like New York and San Francisco where taxes are already high, Mag Mile Capital CEO Rushi Shah said.

“When you have $3 [trillion] to $4 trillion in fiscal stimulus … when that type of spending occurs, the taxes you have to be able to fund it at some point will need to go up,” Shah said. “The darling markets of the new paradigm [is] low taxes. The Sun Belt.”

Investors who make use of 1031 exchanges also are being lured to Sun Belt markets for many of the same reasons their institutional brethren have been buying up properties in cities like Atlanta, Phoenix, Dallas and Houston: They tell present-day America's growth story.

The 18-state region stretching from the Southeast to the Southwest now accounts for half of the U.S. population, and it is expected to reach 55% by 2030, according to a 2019 Clarion Partners report (https://www.clarionpartners.com/News/CPNewsLibrary/Clarion%20Partners-Thought%20Leadership-The%20Rise%20of%20the%20Sun%20Belt_April_2019.pdf), citing a combination of its own and Moody's Analytics' research.

The Sun Belt has long been the fastest-growing part of the country, accounting for 75% of the U.S. population growth over the past 10 years. Over the next decade, Sun Belt states are expected to add another 19 million residents, while non-Sun Belt states will only grow by 3 million, according to Clarion Partners.

“We, in general, have seen the flow of capital moving from Gateway markets to smaller cities. And there's been a significant flow of capital to lower-tax states, like Texas, like Arizona and like Florida,” Marcus & Millichap Senior Vice President of Research John Chang said.

There is a benefit to buying in the Sun Belt market after selling in more expensive ones: The investment capital can go further for 1031 investors, Eitingon said.

Eitingon's firm, DXE Properties, recently sold a Cincinnati Class-C apartment property and funneled the proceeds into a 106-unit North Atlanta apartment complex that was of higher quality.

Commercial real estate sales fell sharply in 2020 due to the pandemic. By the second quarter of last year total transaction volume in the U.S. dropped 64% year-over-year, according to Real Capital Analytics (https://www.rcanalytics.com/usct-overview-yir-2020/). Although sales activity began to recover since then, deal volume was still off 32% for all of 2020.

But investment activity in the Southeast, mid-Atlantic and tertiary markets in the Midwest experienced less of a transaction pullback than cities on the West Coast and in the Northeast, according to RCA. Prices for properties in Sun Belt cities like Atlanta, Houston, Phoenix, Dallas and Nashville continued to rise last year, while falling in major gateway markets like Manhattan, Chicago and Los Angeles, RCA found.

“We absolutely have seen an uptick in 1031 exchanges,” Kay Properties and Investments Vice President Alex Madden said.

Madden highlighted a client who sold a 57-unit apartment complex in San Francisco, took her proceeds and purchased a partial interest in six different apartment complexes in the Southeast.

“If she had purchased a comparable property in San Francisco, she might have only been making 2% to 3% on her money, where she is making 5 to 6.5% in another part of the country,” he said.

Billy Ross, CEO of SellThatFloridaHouse.com, a 1031 exchange investor focused on the Florida residential market, also said he's seeing a flood of investors selling in places like California, New York and New Jersey and into Florida.

“You can really conflate this with COVID easily, because it's definitely an exacerbating force,” Ross said. “But that was a catalyst for things that were going to happen anyway.”

Some are unsure whether 1031 investors are being motivated by potential changes to the program under the Biden administration. The Biden administration has proposed eliminating the 1031 exchange program by (https://joebiden.com/caregiving/) “rolling back unproductive and unequal tax breaks for real estate investors with incomes over $400K and taking steps to increase tax compliance for high-income earners.”

Such a move, the administration maintains, will help fund his $775B plans for caregivers, education and an aging workforce. But in its first week, the administration has yet to propose a plan to Congress, and it is unclear when that could happen as it has focused on coronavirus-related legislation.

If changes are made to the 1031 program, or if it is eliminated, investment sales could take a sharp drop with investors holding onto properties for longer periods of time, some experts maintain.

“We're all kind of in a wait-and-see [mode],” Madden said.

Many feel Biden likely won't tackle tax reform, including altering or eliminating the 1031 exchange program, until later this year at the earliest.

“I have not seen a big rush to the finish line yet,” Chang said. "I think there's a lot of investors who are taking a wait-and-see attitude. The assumption is we'll have some warning and it won't be retroactive."

But once that clarity comes, all bets are off.

“If it comes apparent that they are changing or eliminating the tax rules, there will be a surge in 1031 exchanges,” Chang said.

CORRECTION, JAN. 27, 5:40 P.M. ET: *A previous version of this story misidentified the locations and size of apartments DXE properties purchased in its 1031 exchange. The story has been corrected and updated.*

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