

# The Perfect Storm

## Three Factors Driving the Surge in 1031 Exchange Activity

1031

Knowledge

In the movie *The Perfect Storm*, the convergence of two large storm systems led to unusual weather conditions which ultimately resulted in the demise of the ship and its crew. In the real estate market, the convergence of much higher tax rates, a very strong commercial market, and a robust residential market has resulted in a surge in 1031 exchange activity.

Although taxpayers who own investment property have generally obtained solid gains, they are faced with a headwind of high taxation which threatens to significantly reduce investment returns. Consequently, taxpayers are actively seeking out ways to reduce their tax liability. Once again, Section 1031 of the Internal Revenue Code has emerged as a valuable tool for boosting net investment returns by reducing tax liability, and for preserving capital for reinvestment into better performing “like-kind” replacement real property. This article explores each of the three factors creating this “perfect storm.”

### FACTOR No.1: HIGHER TAX RATES

Tax rates, and their impact on a taxpayer’s net investment return, can drive investment decisions. Economist Art Laffer posited that when tax rates increase, actual tax revenues can decrease as a result of efforts by taxpayers to mitigate tax consequences. In essence, as tax rates increase, an investor’s motivation to defer or postpone immediate taxation also increases.

Many investors are surprised to find out that today they may face four different taxes and, when combined together, the aggregate impact can result in a large tax bill owed to the government:

1. Depreciation Recapture. Depreciation recapture is taxed at 25%.
2. Federal Capital Gain Taxes. Federal capital gain taxes are assessed on the remaining economic gain depending on an investor’s taxable income. Investors in the highest bracket pay at a 20% rate and a 15% capital gain tax rate applies to investors in a lower tax bracket.
3. Net Investment Income Tax. Pursuant to IRC Section 1411, an additional 3.8% surtax applies to taxpayers with “net investment income” who exceed certain threshold income amounts. The 3.8% Medicare surtax only applies to “net investment income” as defined in [IRC Section 1411](#).
4. State Taxes: Investors must also pay the applicable state tax (which can be as high as 13.3%).

### Compliments of:



HQ 800.282.1031 | NY 866.394.1031  
[apiexchange.com](http://apiexchange.com) | [info@apiexchange.com](mailto:info@apiexchange.com)

# The Perfect Storm

## Three Factors Driving the Surge in 1031 Exchange Activity

1031  
Knowledge

Single Taxpayer	Married Filing Jointly	Capital Gain Tax Rate	Section 1411 Medicare Surtax*	Combined Tax Rate
\$0 - \$36,250	\$0 - \$72,500	0%	0%	0%
\$36,250 - \$200,000	\$72,500 - \$250,000	15%	0%	15%
\$200,000 - \$400,000	\$250,000 - \$450,000	15%	3.8%	18.8%
\$400,001+	\$450,001+	20%	3.8%	23.8%

\*The 3.8% Medicare surtax only applies to “net investment income” as defined in [IRC Section 1411](#).

### FACTOR No.2: STRONG COMMERCIAL MARKETS

Currently, commercial real estate (CRE) prices nationwide are much higher than the previous market peak. Domestic commercial investors, institutions, and Real Estate Investment Trusts (REITs) continue to exhibit a strong appetite for quality commercial properties. International investors see the U.S. as a safe haven, and their demand further fuels the CRE activity. Commercial investors have strong borrowing and buying capacity, allowing them to capitalize on favorable CRE opportunities. All of this CRE activity is contributing to a substantial increase in 1031 exchange activity as CRE investors utilize 1031 to minimize the tax impacts of their transactions.

### FACTOR No.3: ROBUST RESIDENTIAL MARKETS

The recovery of residential home prices is another factor causing an increase in 1031 exchange activity. Nationwide, most markets have appreciated significantly and are close to or above the previous marketing peak. The lack of new home construction continues to propel residential home prices upward due to a lack of new inventory.

### 1031 EXCHANGES

The “perfect storm” resulting from the convergence of these three factors has led to an increase in 1031 exchange activity as investors turn to this powerful tax strategy to preserve investment equity and improve returns. This increase in activity has led to a significant increase in demand for secure, knowledgeable, and service-oriented qualified intermediary services like those offered by Asset Preservation, Inc.

### Compliments of:



HQ 800.282.1031 | NY 866.394.1031  
[apiexchange.com](http://apiexchange.com) | [info@apiexchange.com](mailto:info@apiexchange.com)

Asset Preservation, Inc. (API) is a qualified intermediary as defined in the regulations under Internal Revenue Code §1031. Neither API, its officers or employees are authorized or permitted under applicable laws to provide tax or legal advice to any client or prospective client of API. The tax related information contained herein or in any other communication that you may have with a representative of API should not be construed as tax or legal advice specific to your situation and should not be relied upon in making any business, legal or tax related decision. A proper evaluation of the benefits and risks associated with a particular transaction or tax return position often requires advice from a competent tax and/or legal advisor familiar with your specific transaction, objectives and the relevant facts. We strongly urge you to involve your tax and/or legal advisor (or to seek such advice) in any significant real estate or business related transaction. © 2018 Asset Preservation, Inc. All rights reserved.