Hastings Business Law Journal

Volume 3
Number 2 *Spring 2007*

Article 8

Spring 1-1-2007

Bursting the Speculation Buying Bubble: Modifications to the Capital Gains Provision and the 1031 Exchange Rule

Catherine L. Pollina

BURSTING THE SPECULATION BUYING BUBBLE: MODIFICATIONS TO THE CAPITAL GAINS PROVISION AND THE 1031 EXCHANGE RULE

*Catherine L. Pollina**

I. INTRODUCTION

The United States' commercial real estate market has been a booming business for the last few decades. Commercial real estate "includes but is not limited to properties used for industrial, commercial, medical or educational purposes and properties used for residential purposes which have more than four residential dwelling units."[1] The term captures property as diverse as retail outlets, warehouses, hotels, and apartment buildings.

The recent history of commercial real estate investing in this country is a tumultuous one, reflecting drastic changes in the economy, legislation, and even the type of real estate investor. In the early 1980s, the commercial real estate market was thriving; in fact, some experts consider it a period of "over-stimulation."[2] Investors have long recognized that investing in commercial real estate is an attractive way to diversify one's portfolio. As one expert puts it, "[r]eal estate has a risk profile closer to bonds, but it's trading as if it's equity."[3] And furthermore, "not only does real estate give investors a better current income than debt or equity, but it's safer."[4]

However, with Congress's passage of the 1986 Tax Reform Act and a

---

* J.D. Candidate, University of California, Hastings College of the Law, 2007; B.A., University of Virginia, 2002. Special thanks to Christian B. Pollina and Professor Leo P. Martinez for their extremely helpful feedback and advice.

1. EMG Corp., Industry Terms and Definitions, http://www.emgcorp.com/whatshot/dictionary.Php #AI (last visited Apr. 3, 2007).

2. Howard Menell, *Apartment Owners Wary of Tax Reform*, NAT'L REAL EST. INVESTOR (New York), Sept. 1, 2005, at 92, *available at* 2005 WLNR 14582222.

3. *Is Commercial Property Still a Good Investment?*, KNOWLEDGE@WHARTON (Philadelphia), July 27, 2005, http://knowledge.wharton.upenn.edu (search for "commercial property") (quoting Peter Linneman, Professor of Real Estate at U. Pa., Wharton School of Business).

4. *Id* (same).

subsequent recession, the boom came to an abrupt halt.[5] Real estate investors suffered staggering losses, and the economy fell into a deeper recession.[6] This downturn in the market was a strong factor in the collapse of the savings and loan industry later that decade.[7]

The 1990s told a much different story. A rapid rise of public capital in the commercial real estate market, reaching approximately $400 billion at the turn of the century, signified "one of the strongest economies and the most prosperous real estate market ever."[8] The only distinct shake-up in the market occurred during the summer of 1998, when "external events in the global capital market caused a significant increase in the real estate risk premium, despite generally sound real estate market fundamentals."[9] At this time, liquidity disappeared from the market almost instantly, and over-leveraged real estate companies collapsed or filed for Chapter 11 bankruptcy after suffering severe losses.[10]

The current situation reveals a real estate market that is surging once again. In fact, Gene Pride, a director and investment broker at Cushman & Wakefield, estimated that "$1.95 billion in offices, retail and industrial properties will change hands this year"[11] in the national real estate market.

Several forces are driving the present boom in the commercial real estate sales industry. The economy is improving and businesses are once again growing.[12] As operations expand, they hire new employees and thus typically require additional space.[13]

Furthermore, present cash flow has become a more important factor for investors. To explain this concept, some background information on investing is necessary. There are two types of investments: those where the investor will generally make money on the appreciation of the asset,[14] and those where the investor will typically make money on the income from the asset.[15]

---

5. Tax Reform Act of 1986, 100 Stat. 2085 (1986) (codified as amended in scattered sections of 26 U.S.C.). *See* Menell, *supra* note 2.

6. *See* Menell, *supra* note 2.

7. *Id.*

8. Jun Han & Antony Wood, *The New Millennium Party Isn't Over Yet*, MORTGAGE BANKING (Washington, D.C.), Feb. 28, 2000, at 20, *available at* 2000 WLNR 4121222.

9. *Id.* at 22.

10. *Id.*

11. John Rebchook, *Commercial Property in Demand*, ROCKY MOUNTAIN NEWS, Dec. 3, 2004, at 12B, *available at* 2004 WLNR 13125280.

12. *Id.*

13. *Id.*

14. Stocks are a good example of this kind of investment. With stocks, an investor realizes his profit once he sells.

15. Bonds are a good example of this kind of investment. With bonds, a company borrows money from an investor and semi-annually pays back a certain amount of money (percentage of the principal plus interest) to the investor until the company has paid off the money it has borrowed. Therefore, the

Commercial real estate provides the investor the ability to make money on both the appreciation of the property as well as on the income generated by the property (in the form of monthly rent). This latter form of income represents a present cash flow.[16] Real estate is an attractive investment because it generates present cash flow during the holding period, whereas most other investments generate cash only upon sale.

The danger is that real estate prices are growing faster than the economy itself.[17] The resulting problems and a potentially effective solution will be discussed in this paper. In Part II, I will address how the existing investment climate has led to a potentially dangerous trend of speculative buying. In Part III, I will analyze the concerns this trend presents. Part IV is a discussion of the current tax controls that are in place that affect the commercial real estate market. I present my proposal for a modification of the tax code affecting commercial real property as a potential remedy for the current situation in Part V, and the following two sections discuss the intended effects of this proposal as well as its justification. In Part VIII, I respond to potential objections to my proposal. Finally, Part IX concludes that my proposal would be an effective solution to the current dangers of speculative buying in the commercial real estate market.

II. EXISTING INVESTMENT CLIMATE IN THE COMMERCIAL REAL ESTATE INDUSTRY

Over the past several years, a disturbing trend has emerged in the commercial real estate industry in the United States. Beginning in 2002, commercial real estate has seen an upward trend in speculative buying in the marketplace.[18] Speculative buying occurs when buyers purchase commercial real estate based on the speculation of appreciation of future value instead of using an analysis of the property's income fundamentals.[19]

The current state of the American economy lends itself to this particular trend. Interest rates have been relatively low over the past few years due to a number of factors, including a weaker stock market.[20] In

---

investor is receiving a present cash flow over that period of time.

16. The actual definition of cash flow is "the net operating income of a property minus its debt service." OfficeFinder, Glossary of Real Estate Terms, http://www.officefinder.com/glossary.html#C (last visited Feb. 1, 2007).

17. *See* Rebchook, *supra* note 11.

18. Matt Valley, *Commercial Lending Volume Remains Flat*, NAT'L REAL EST. INVESTOR (New York), Sept. 1, 2002, at 9, *available at* www.nerionline.com (search "Commercial Lending Volume Remains Flat").

19. *See Is Commercial Property Still a Good Investment?*, *supra* note 3.

20. Press Release, Urban Land Institute, Emerging Trends in Real Estate 2006: Steady Capital Keeps Markets Stable, But Looming Transition to Less Robust Returns Raises Concerns (Nov. 2, 2005), *available at* http://www.uli.org (follow "Press Releases" hyperlink, then follow "Browse ULI

such an investment climate, many investors consider commercial real estate to be a better alternative investment to fixed-income securities (for example, bonds and annuities) because commercial real estate generally represents a stronger present income.[21]

The danger is that the long-term income potential on these properties is now relatively low. At the national level, the average rent in 2005 was $15.42 a foot, a decrease from $28.92 in 2000.[22] As a result, many industry experts are concerned that properties have been highly overvalued by investors.

Regardless, buyers continue to purchase potentially overvalued properties, ignoring the cash flow figures, and instead relying on the expectation that the property will appreciate in the future as the primary source for their return on investment.[23] For instance, as one expert notes, some buyers will look at a property with 45 percent vacancy and purchase it as if it were 90 percent occupied.[24] Consequently, the prices they pay for these properties are not justified by the properties' current income levels.

One expert goes so far as to declare that the increase in the commercial real estate sales market is occurring at a time when market fundamentals—such as lease and occupancy rates—are almost as bad as they were during the energy crash of the mid-1980s.[25]

Additionally, capitalization rates ("cap rates") have fallen as interest rates fall. A cap rate is defined as the yield on a piece of commercial real estate.[26] It is reflected as "a ratio of income (rent minus certain regular expenses) to [purchasing] price and is widely used to calculate the rate of return a buyer can expect"[27] for a given property.[28]

Investors prefer high cap rates, as they signify a higher return on investment.[29] Historically, the cap rate for commercial real estate has averaged 9 percent.[30] Today's average cap rate is around 5-6 percent,[31]

Press Releases" hyperlink).

21. *Id.*

22. *See Is Commercial Property Still a Good Investment?*, *supra* note 3.

23. *See Id.*

24. *See Id.*

25. *See* Rebchook, *supra* note 11.

26. Lauren Foster, *No End to Office Space Debate: A Drop in "Cap Rates" Has Property Market Participants Jittery*, FIN. TIMES (LONDON), Sept. 9, 2003, at 25, *available at* 2003 WLNR 8161836.

27. *Id.*

28. For instance, say an investor pays $1 million for the property. Each month, he receives cash back in rent from that property. If his income is $100,000 per year (rent minus expenses), then he has a ten percent income each year. This is the cap rate—the annual return on the investment.

29. *See* Foster, *supra* note 26, at 25.

30. Roger Thompson, *Rebuilding Commercial Real Estate*, HARV. BUS. SCH. WORKING KNOWLEDGE, Jan. 9, 2006, *available at* http://hbswk.hbs.edu (search for "rebuilding").

31. *Id.*

another indication that the income on these properties does not justify what buyers are paying for them.

Interest rates are also a huge factor in this equation. As a rule, high interest rates can weaken the real estate market by raising borrowing costs.[32] Consequently, investors will demand higher cap rates in order to make the transaction profitable.[33] Recently, however, interest rates have been at near historic lows.[34] The Federal Reserve has increased rates gradually this year, at about one-quarter point per quarter,[35] but this may not be enough to curb the speculative buying frenzy.

Capital in the market is another factor that is affecting the commercial real estate industry.[36] Given the limited supply, the current high demand for commercial real estate as an investment has driven prices up.[37] According to one commentator, "[t]he momentum of record-low interest rates for borrowers, coupled with an investor flight to real estate, ran head-on into increasingly weak fundamentals in the property sectors."[38] In New York City, for instance, higher property values "appear to be related to a generalized rush to acquire real estate, [rather] than to any great improvement in the income-producing capability of those buildings."[39] This nationwide trend is predicted to continue into 2007.[40]

Furthermore, the existence of different grades of buyers investing in the market has further aggravated the situation. All types of buyers—institutional, public and private—are eager to invest in commercial real estate because of lackluster stock and bond markets.[41] For example, high net worth individuals, many of whom lost a significant amount of money during the dip in the stock market in 2000, are a growing group of investors who are eager to recoup via commercial real estate investing.[42]

Pension funds and insurers have also added commercial real estate to their portfolio of assets.[43] Institutional investing in commercial real estate

---

32. *See Is Commercial Property Still a Good Investment?*, *supra* note 3.

33. *Id.*

34. *See* Han & Wood, *supra* note 8.

35. Robin Sidel & Clint Riley, *Regional Banks in a Rate Whirl—As Customers Chase Better Yields, Firms Like City National Cite Expectations of a Profit Squeeze*, WALL ST. J., July 10, 2006, at C1.

36. Capital is defined in this context as "wealth in the form of money or property owned by a person or business." WordNet, Princeton University Cognitive Science Laboratory, http://wordnet.princeton.edu/perl/webwn?s=capital (last visited Apr. 3, 2007).

37. *See* Foster, *supra* note 26, at 25.

38. *See* Valley, *supra* note 18, at 9.

39. David Seifman, *Real Estate's Shaky Foundation*, N.Y. POST, Mar. 23, 2005, at 10.

40. *See* Emerging Trends in Real Estate 2006, *supra* note 20.

41. *See* Rebchook, *supra* note 11.

42. *Id.*

43. Todd Davenport, *Commercial Real Estate's Rate Challenge*, AM. BANKER (New York), Dec. 27, 2004, at 7, *available at* 2004 WLNR 15581850.

for portfolio diversification adds the strength of a $10 trillion market.[44] In fact, even those who are new to the market can realize dividends of 3 to 10 percent from quality properties.[45] As a result, these investors have looked at real estate, specifically commercial real estate, as a safer alternative to securities.[46]

These various groups, as well as individuals now investing in commercial real estate, have two distinct effects on the market. First, the addition of new investors interested in properties adds to demand.[47] Second, many of the newcomers are unsophisticated buyers and as a result have added to the speculative buying craze.[48] Instead of considering the long-term income potential of an asset, they are looking at a quick turnaround in profit.[49] They engage in a practice known to the industry as "flipping," or buying and selling the property after a brief holding period based on such fluctuating variables as interest rates.[50] The high prices they are paying for their properties are not justified by the present cash flow.[51] Rather than concerning themselves with the income fundamentals, these investors aim to buy and sell quickly at a higher price and recognize a large capital gain[52] in the process.

III. DANGER OF THE CURRENT SPECULATIVE BUYING BUBBLE

With respect to the abandonment of financial fundamentals, one might ask: So what? What difference does it make if some investors are not investing wisely in the commercial real estate market? In fact, some observers would disagree that this is a problem at all. They argue that property values are not too high in relation to income.[53] They contend that the recent fall in cap rates is justified by the decline in interest rates.[54] From their perspective, because now is a cheaper time to finance a property, an investor needs less income to generate a profit.[55] As one expert points out, "'If I'm earning 9% on a portfolio of assets and I can borrow at under

---

44. Dean MacFarlan, *Commercial Realty Investing Requires Groundwork*, INVESTMENT NEWS (New York), Aug. 9, 2004, at 23, *available at* 2004 WLNR 1755815.

45. *Id.*

46. *Id.*

47. Sana Siwolop, *A Rush to Commercial Property*, N.Y. TIMES, Oct. 26, 2005, at 8.

48. *Id.*

49. *Id.*

50. John Waggoner, *Thinking of Investing in Real Estate? Get Real*, USA TODAY, June 17, 2005, at 3B.

51. *See* Siwolop, *supra* note 47, at 8.

52. Capital gains can be defined as short- or long-term profits from the sale of assets. *See* ROBERT W. HAMILTON & JONATHAN R. MACEY, CORPORATIONS INCLUDING PARTNERSHIPS AND LIMITED LIABILITY COMPANIES 134 (9th ed. 2005).

53. *See* Foster, *supra* note 26, at 25.

54. *Id.*

55. *Id.*

6.5%, I've got to take advantage of that opportunity.'"[56]

Yet the concern with this trend, and the main argument of this paper, is that the speculative buying bubble could have a long-term destabilizing effect on the American economy, and the current tax controls are insufficient to contain this problem.

Most commercial real estate loans are short-term, meaning that as interest rates rise, unless income rises at a similar rate, investors run the risk of defaulting on their loans.[57] The default could occur when the property's income is no longer sufficient to cover its increasing debt service.[58] Presently, many commercial real estate loans are three- or five-year fixed-rate loans, with a large or "balloon" payment due at the end of the term.[59] Rather than make this large payment, most owners opt to refinance, which they must do at then current market rates.[60]

In effect, this type of loan works similarly to an adjustable-rate mortgage because the investor's cost of capital is continually changing and tends to reflect the current market rates.[61] The risk occurs in a climate of rising interest rates where this increasing debt service eventually outpaces a property's income, potentially forcing a default on the loan.

Consider the above example to illustrate this problem: a property, originally financed at 6.5 percent, is currently earning 9 percent income. Although there is income produced by the spread between revenue and debt service, in a period of rising interest rates, when the investor refinances at the end of his loan term, the spread could disappear or even turn negative. As a result, three years after the property is purchased, the property could have a negative cash flow and potentially force the investor to default on the loan. At an aggregate level, the resulting defaults could seriously harm lending institutions.

In a speech last year aimed at American lending institutions, Federal Reserve Governor Bies stated

> Credit risk has been the leading cause of bank failures over the years and remains the biggest risk for most financial institutions . . . In particular, in the commercial and residential real estate sectors, we worry that borrowers could become increasingly speculative, buying beyond their means and hoping for asset price appreciation—whether they are buying

56. *See* Valley, *supra* note 18, at 9 (quoting David Twardock, president of Newark, N.J.-based Prudential Mortgage Capital).

57. Dana Hedgpeth, *Hotels are Full Up with Debt Problems: Chains, Lenders Discuss Overload*, WASH. POST, Nov. 3, 2001, at E01.

58. *Id.*

59. REIDepot.com, Real Estate Glossary, http://www.reidepot.com/Glossary/b.html (last visited Apr. 3, 2007).

60. *Id.*

61. *See* Hedgpeth, *supra* note 57.

> for their own use or strictly for the sake of investment. We worry that competitive pressures could drive banks to lower their underwriting standards, implicitly encouraging such speculation. And we worry that, in the inevitable downturn, credit quality could deteriorate to the extent that some banks could experience significant losses.[62]

Governor Bies defined commercial real estate lending as "real estate loans in which the primary source of repayment is derived from the rental income or sale proceeds of commercial property" and noted that this type of asset has historically been very volatile.[63]

In fact, we have seen this trend before in an investment market in the United States. In the late 1990s, many stocks similarly demonstrated artificially high values that were not justified by their companies' income fundamentals.[64] As we are witnessing today in the commercial real estate market, many stocks were overvalued as the result of speculative buying.[65] When this bubble burst, it had a multi-tiered effect on the market: values declined, consumers became less willing to spend, and borrowers did not have assets sufficient to back up their debts.[66] Ultimately, "this decline in value leads to an economic slowdown or recession."[67] Thus, the ultimate concern with overvaluation in the commercial real estate market is a potential destabilizing effect on the economy.

IV. DESCRIPTION OF THE CURRENT TAX CONTROLS THAT ARE IN PLACE

Currently there are tax controls in place to help regulate the problems described in the previous section that can arise in commercial real estate. Like any other income-generating marketplace, the commercial real estate industry is subject to various laws and regulations at both the federal and state levels. Because the scope of this paper covers speculative buying and its effects on our nationwide economy, I will limit my discussion to the relevant federal taxes.

A. CAPITAL GAINS TAX

Almost everything that is owned or used for either personal or investment purposes is a capital asset.[68] When someone sells or exchanges

62. Susan Schmidt Bies, Governor, Bd. of Governors of the Fed. Reserve Sys., Remarks at the North Carolina Bankers Association 109th Annual Convention (June 14, 2005), *available at* 2005 WLNR 9726759 (US FED. NEWS, June 14, 2005.).

63. *Id.*

64. *See* Han & Wood, *supra* note 8, at 20.

65. *See Is Commercial Property Still a Good Investment?*, *supra* note 3.

66. Gene Steuerle, *Will the Revenues Last?*, TAX NOTES TODAY, Sept. 14, 1998, *available at* 98 TNT 177-81 (LEXIS).

67. *Id.*

68. Internal Revenue Service, Tax Topics - Topic 409 Capital Gains and Losses, http://www.irs.gov/

a capital asset, the difference between the amount he paid for it and his selling price is a capital gain or loss.[69] Capital gains and losses are classified as "long-term" if the taxpayer held the property for more than one year and "short-term" if he held it for one year or less before selling it.[70] The time that the property is held in possession by the owner is known as the holding period.[71] A short-term capital gain is taxed as ordinary income.[72]

Typically, the applicable income tax rate on short-term capital gains is approximately 35 percent for high net worth individuals and investing institutions.[73] If an investor has held the property for longer than a year, the gain from the sale of the asset is classified as a long-term gain. In this case, rather than 35 percent, the maximum rate is 15 percent on a long-term capital gain.[74]

B. THE "1031 EXCHANGE"

Internal Revenue Code section 1031(a)(1) states that

> No gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind which is to be held either for productive use in a trade or business or for investment.[75]

Furthermore, this provision requires that the investor file paperwork identifying the new property within forty-five days of initiating the change.[76] Finally, the investor has 180 days from the time he sells his property until he closes on the new property.[77]

In other words, according to § 1031, or the "1031 exchange" (as it is commonly referred to among professionals), as long as a seller reinvests his profits within a certain time period after selling his commercial property, he will not be immediately taxed on the capital gains. Therefore, an investor can defer any capital gains tax by reinvesting in "like-kind property,"[78] recognizing significant gains over time through the financial

---

taxtopics/tc409.html (last visited Apr. 3, 2007); *see* I.R.C. § 1221(a) (2000).

69. Internal Revenue Service, Tax Topics - Topic 409 Capital Gains and Losses, http://www.irs.gov/taxtopics/tc409.html; *see* I.R.C. §§ 1222(1), 1222(3) (2000).

70. Internal Revenue Service, Tax Topics - Topic 409 Capital Gains and Losses, http://www.irs.gov/taxtopics/tc409.html (last visited Apr. 3, 2007); *see* I.R.C. §1223(1) (2000).

71. *See* Internal Revenue Service, SALES AND OTHER DISPOSITIONS OF ASSETS (Publication 544) 33 (2006), *available at* http://www.irs.gov/pub/irs-pdf/p544.pdf.

72. *Id.* at 26-35; *see also* I.R.C. §§ 1245(a)(1), 1250(a) (2000).

73. Internal Revenue Service, 2005 TAX RATE SCHEDULES, *available at* http://www.irs.gov/forms pubs/article/0,,id=133517,00.html (last visited Apr. 3, 2007).

74. *Id.*

75. I.R.C. § 1031(a)(1) (2000).

76. *Id.* § 1031 (a)(3).

77. *Id.*

78. *Id.*

principal of compounding.[79]

This tax advantage is very well regarded in the industry and should be preserved.[80] One tax expert notes that like-kind exchanges permitted by this tax law are an important part of the commercial real estate market because it is a "critical mechanism that enables property owners to efficiently attract and reinvest capital."[81]

Still, the speculative buying trend in the commercial real estate market is fueled by this tax benefit. According to one professional, where a taxpayer is in a position to suddenly buy or sell a property, the "exchange timing rules put pressure on the taxpayer's ability to conduct his due diligence on property that the taxpayer would like to sell."[82] In other words, if the investor only has 180 days to complete the exchange, he is under pressure to expedite the complicated analysis[83] of the new property that is necessary to determine if he will buy and at what price. Consequently, some investors, in their eagerness to utilize the 1031 exchange and defer capital gains, ignore the income-producing ability of the property.[84]

V. PROPOSAL: A CAPITAL GAINS TAX STRUCTURE SPECIFICALLY APPLICABLE TO REAL PROPERTY AND A MODIFICATION OF THE 1031 EXCHANGE

It is clear that the current trend of speculative buying of commercial real estate has a potentially destabilizing effect on our nation's economy, and that the current tax laws, specifically those surrounding the 1031 exchange, tend to promote this type of behavior. While taxes are not necessarily intended as a deterrent to speculative buying, it is obvious that the tax system does have a very real and measurable effect on the behavior of investors.

My proposal to address the current situation, and consequently to encourage intelligent investment in the commercial real estate market, features two components. Both involve only a modification to the current tax code. First, I suggest that Congress add a new section to the capital gains provisions that classifies real estate differently than other investment

79. Compounding is defined as "the process of earning interest on interest". Commerce Mutual Investment Club, Investment Terms, http://www.commerceinvest.com/Education/terms/TermPages/C.htm (last visited Apr. 3, 2007).

80. *See* Menell, *supra* note 2.

81. *Id.*

82. Thomas V. Glynn, *Just-in-Time Delivery—Can Modern Inventory Techniques Solve Timing Problems in Like-kind Exchanges?*, 19 REAL EST. TAX DIG. 3 (2001).

83. This in-depth analysis would generally include consideration of the cash flow predictions given the vacancy in the market, rent values over time, as well as other expenses.

84. Mary Umberger, *So You Think You Can Make Millions: Housing Boom, Wall Street Blues Have Americans Flipping Properties for Profit*, CHI. TRIB., Sept. 19, 2004, at C1.

vehicles. The new section would lengthen the holding period of real property to five years for long-term capital gains purposes.

This different treatment of real property would be more reflective of the existing differences between commercial real estate and stock or similar securities (which will be discussed below). By lengthening the holding period, this provision would encourage investors to retain their property for a longer period of time in order to realize the benefits of long-term capital gains. As a result, investors would also be forced to conduct a closer analysis of cash flow fundamentals of property, or otherwise risk lower returns and possibly even default on their debt.

Next, I propose that Congress limit the applicability of the 1031 exchange to long-term capital gains. Consequently, those who invest in commercial real estate with the intention to engage in flipping would still be allowed to do so but would not be able to defer the tax on the capital gains using the 1031 exchange.

VI. JUSTIFICATION FOR COMMERCIAL REAL ESTATE'S SEPARATE TREATMENT FROM OTHER INVESTMENT VEHICLES IN THE TAX CODE

This proposal does urge separate treatment in the tax code for commercial real estate. However, both the legislative history and the liquidity differences between the real estate market and the stock market lend themselves to this differential treatment.

A. DIFFERENCES IN LIQUIDITY OF THE ASSET

Liquidity is defined as "the ability to buy or sell large quantities of an asset quickly and at low cost."[85] There are several reasons why commercial real estate is a far less liquid asset than a security. First, the sale or exchange of commercial real estate is a larger and more complex transaction than the sale of a stock and generally involves higher dollar volumes in any given transaction.[86] Because of the capital requirement, there are fewer buyers and sellers in the real estate market, and thus it is more difficult for the seller to identify buyers.[87]

Second, the Securities Exchange Commission ("SEC") regulates the securities market.[88] The SEC requires strict disclosure of all significant

---

85. Tarun Chordia, Asani Sarkar & Avanidhar Subrahmanyam, Common Determinants of Bond and Stock Market Liquidity: The Impact of Financial Crises, Monetary Policy, and Mutual Fund Flows 1 (Dec. 11, 2001) (unpublished staff report, on file with Federal Reserve Bank of New York), *available at* http://www.newyorkfed.org/research/staff_reports/sr141.pdf.

86. *See* Foster, *supra* note 26, at 25.

87. *See Is Commercial Property Still a Good Investment?*, *supra* note 3.

88. *See generally* U.S. Sec. & Exch. Comm'n, The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation, www.sec.gov/about/whatwedo.shtml (last visited Apr. 3, 2007).

information about every publicly traded security.[89] Commercial real estate does not fall under similar regulation. Therefore, this transparency of information is not required, and in many cases is not available, for many commercial properties. Thus, the commercial real estate market is not nearly as efficient and the values of the assets are not as easy to define.[90] Real estate "simply isn't the kind of quick-in, quick-out investment that Wall Street is fond of."[91]

B. PRECEDENCE FOR DIFFERENT TREATMENT IN THE TAX CODE

The tax code provides evidence that Congress has recognized that real property is a distinct asset from securities. Congress established this precedence with the "1031 exchange," which only applies to real property.[92] The notes following this provision show that the main policy of the section is the "non-recognition of gain or loss in transactions where neither is readily measured in terms of money and where in theory the taxpayer may have realized gain or loss but where in fact his economic position is the same after as before the transaction."[93]

Additionally, the goal of the 1031 exchange is to prevent the inequity of "forcing the taxpayer to recognize a paper gain which was still tied up in a continuing investment of the same sort."[94] In so many words, Congress recognized that investments in real property are different than those in the stock market, and therefore are afforded different tax benefits in the Code.

VII. INTENDED ECONOMIC EFFECTS OF THIS PROPOSAL

Today, the United States economy is not growing at the accelerated pace that it did in the late 1990s. The existence of fewer jobs has reduced the demand for space. Consequently, rents have declined, which limits buildings' ability to generate revenue. Yet investors continue to overvalue properties and invest based on the expectation of appreciation.

At a macro-economic level, this is not the first time we have seen this pattern. The 1980s collapse of the savings and loan (S&L) industry was fueled by very similar market forces. At the time, real estate was a hot investment vehicle. Much of the growth in S&L assets between 1982 and 1985 was concentrated in commercial real estate lending.[95] Concurrently,

---

89. *Id.*
90. *See* Davenport, *supra* note 43, at 7.
91. *See Is Commercial Property Still a Good Investment?*, *supra* note 3.
92. I.R.C. § 1031(1) (2000).
93. Century Elec. Co. v. Comm'r, 192 F.2d 155, 159 (8th Cir. 1951).
94. Jordan Marsh Co. v. Comm'r, 269 F.2d 453, 456 (2d Cir. 1959).
95. FED. DEPOSIT INS. CORP., 1 HISTORY OF THE EIGHTIES—LESSONS FOR THE FUTURE 167-188, 184 (1997), *available at* http://www.fdic.gov/bank/historical/history/167_188.pdf.

banks were also investing heavily in commercial real estate loans.[96] These institutions became very aggressive: in order to be competitive and generate business, the lending industry offered increasingly favorable loan terms. One FDIC study summarizes the atmosphere at this time:

> [T]hese high-risk, speculating institutions raised the cost of funds marketwide and encouraged risk taking by competitors. . . . Capital was invested in geographic areas, like Texas, where real estate was being developed far beyond the market's ability to absorb it. This oversupply contributed to the eventual bust in real estate values and slowed economic recovery. Throughout the decade, losses in the S&L industry continued to mount as the decline in real estate values deepened and affected various regions of the country.[97]

Because the income on properties did not keep pace with interest rates, eventually borrowers defaulted on their loans and banks had to repossess many over-valued properties. As a result, hundreds of lending institutions went bankrupt.

The S&L crisis of the 1980s and early 1990s resulted in the greatest collapse of United States financial institutions since the Great Depression.[98] From 1986 to 1995, more than 1,000 thrifts with total assets exceeding $500 billion failed.[99] Government resources were unable to withstand the overwhelming number of failures, and United States taxpayers were required to back up the commitment extended to insured depositors of the failed institutions.[100] As of December 31, 1999, the S&L debacle had cost taxpayers approximately $124 billion and the S&L industry another $29 billion, for an estimated total loss of approximately $153 billion.[101]

Furthermore, the Congressional Budget Office, in its study titled *The Economic Effects of the Savings & Loan Crisis*, determined that "losses among thrifts reduced Gross National Product by a total of $200 billion between 1981 and 1990."[102] The primary source of this lost wealth was depreciated real estate.[103] In addition to lost wealth, lenders became more cautious in the wake of the S&L crisis, making it harder for developers to finance new projects. As a final blow, the public had lost confidence in

---

96. *Id.* at 185.

97. *Id.* at 186.

98. Timothy Curry & Lynn Shibut, *The Cost of the Savings and Loan Crisis: Truth and Consequences*, 13 FDIC BANKING REV. Dec. 2000, at 26-35, *available at* 2000 WLNR 4526041 (Westlaw).

99. *Id.*

100. *Id.*

101. *Id.*

102. CONGRESSIONAL BUDGET OFFICE, CONGRESS OF THE U.S., THE ECONOMIC EFFECTS OF THE SAVINGS AND LOAN CRISIS 3 (1992).

103. Louis Uchitelle, *Ripples from a Bailout: From Income Lost to Real Estate Gained, The Savings and Loan Crisis Leaves Scars*, N.Y. TIMES, Aug. 13, 1989, at 1.

depositing with the FDIC.[104]

By encouraging the use of financial fundamentals in real estate investing, my proposal would help curb the behavior of speculative buyers, which historically has led to a destabilizing effect on the economy. In addition, by eliminating the capital gains tax advantages on short-term investing, investors would be forced to pay more attention to the property's long-term income potential. As a result, speculative buying based on interest rates and other short-term market variables would be limited. Arguably, the decrease in speculative buying in the commercial real estate market would reduce the potential default on loans resulting from poor income fundamentals and unrealistic expectations of appreciation.

VIII. RESPONSE TO POTENTIAL OBJECTIONS TO THIS PROPOSAL

As expected with any proposed modification to the tax code, there will be objections from those who are affected. An investor may respond to this proposal by suggesting that it limits his ability to defer capital gains using the 1031 exchange. As mentioned earlier, the commercial real estate market is less liquid than the securities market. In order to take advantage of the preferential treatment in § 1031, the investor must hold the property for at least five years. As a result, one could contend that my proposal would cause the commercial real estate market to become even less liquid.

My response to this concern is that in the current state of the real estate market, there is more capital than product.[105] In other words, there are more dollars looking for real estate than there are properties available for sale.[106] Consequently, one could argue that in reality, the real estate market is actually too liquid.

In any market where demand outpaces supply, the result is that prices become inflated. Therefore, while my proposal would decrease the liquidity of commercial real estate to some degree, in the existing climate, that change could be considered a positive one.

Another potential concern may be raised regarding those investors who are forced to sell quickly, generally when they need the money from the sale.[107] In the majority of these situations, the sellers are not seeking to make an exchange on the property,[108] and therefore would not take advantage of the 1031 exchange option. These sellers are not included in the targeted group of investors who are currently engaging in flipping.

---

104. Jerry Knight, *Behind the Continuing Savings and Loan Crisis, a Crisis of Public Belief*, WASH. POST, Feb. 28, 1989, at C3.

105. *See* Siwolop, *supra* note 47.

106. *Id.*

107. *See* Valley, *supra* note 18.

108. *Id.*

Thus, because this modification would not apply to them, they are not losing out on any benefit.

IX. CONCLUSION

For the past several decades, commercial real estate has typically been a highly profitable investment in America. Because commercial real estate generates a present cash flow, as well as the opportunity for significant capital gains, it is a highly attractive alternative investment to most securities, which traditionally only provide one benefit or the other. As the number and type of investors anxious to diversify their portfolio dive into this market, certain trends emerge that reflect the inexperience and lack of sophistication of some of these investors. Currently, speculative buying has become extremely prevalent in nearly every real estate market across the nation.

For all these reasons, speculative buying is not good for the economy. As we saw in the 1980s with the S&L collapse,[109] this type of behavior raises the risk of loan defaults which, in the aggregate, could potentially result in a destabilizing effect on the American economy.

In an effort to avoid a similar disaster, modifications need to be made to the tax code as it applies to real estate. By lengthening the holding period of real property to five years for long-term capital gains purposes, and subsequently limiting the applicability of the 1031 exchange to long-term capital gains, the speculative buying trend could be significantly curbed. As a result, investors would be encouraged to use greater care in evaluating the income fundamentals of a property, lending institutions would not be at risk to suffer from massive loan defaults, and, finally, the commercial real estate market can continue to grow in a healthy, productive manner.

---

109. *See Is Commercial Property Still a Good Investment?*, *supra* note 4.