FEDERATION of EXCHANGE ACCOMMODATORS
The Voice of the 1031 Industry

1255 SW Prairie Trail Parkway
Ankeny, IA 50023
Phone: (515) 244-6515
Fax: (515) 334-1174
www.1031.org

Myth v. Truth: Addressing Former Chairman Camp's "Tax Reform Act of 2014" Repeal of §1031 Like-Kind Exchanges

Former Ways and Means Chairman Camp's comprehensive discussion draft, "The Tax Reform Act of 2014," called for complete repeal of IRC §1031 like-kind exchanges. The draft's rationale for repeal was that gains essentially may be deferred for decades, and ultimately escape taxation entirely if the property's basis is stepped up to its fair market value upon the death of the owner. The rationale also suggested that the current rules have no precise definition of "like-kind," which often leads to controversy with the IRS and provides significant opportunities for abuse. Below is a response to these assertions, or "1031 Myths," accompanied by corrections to additional misconceptions surrounding like-kind exchanges.

Myth: Section 1031 allows taxpayers to avoid capital gains taxes, and to defer gain indefinitely until the gain and related tax are eliminated at death.

Truth: Under §1031, taxes are deferred—not eliminated. At some point the tax gets paid. Section 1031 exchanges structured under the IRS regulatory safe harbors are neither tax savings vehicles nor "abusive tax avoidance schemes." Rather, they are legitimate transactions utilizing an important tax planning tool. Payment of tax occurs: 1) upon sale of the replacement asset; 2) incrementally, through increased income tax due to foregone depreciation; or 3) by inclusion in a decedent's taxable estate, at which time the value of the replacement asset could be subject to estate tax at a rate more than double the capital gains tax rate. It should also be noted that taxpayers utilizing §1031 exchanges include corporations and other business entities that cannot "take the gain to the grave."

Myth: The absence of a precise definition of "like-kind" is administratively difficult for the IRS and creates the opportunity for abuse.

Truth: The definition of "like-kind" is well understood. **Section 1031 is neither administratively difficult for either the IRS or taxpayers nor is it abusive.** Treasury Regulations in effect since 1991 provide specific frameworks for determining whether assets are "like-kind." Like-kind exchanges conducted within the regulatory safe harbors under §1031 are straight-forward transactions that follow a well-understood set of rules, procedures and documents. Taxpayers claiming tax-deferral treatment must report certain information on IRS Form 8824 with their tax returns.

Myth: The Congressional purpose for §1031 is no longer relevant.

Truth: Section 1031 was enacted in 1921 for two primary purposes that are even more relevant today in our global economy. When Congress enacted the like-kind exchange statute in 1921, the legislative history makes clear that there were three main purposes. The two primary purposes: 1) to avoid unfair taxation of ongoing investments in property and 2) to encourage

active reinvestment, are both even more relevant today in our global economy than they were in 1921. The third purpose, administrative convenience, i.e. "the difficulty of valuing exchanged property," ceased to be relevant to the policy underlying the statute in 1924. Moreover, §1031 has survived repeated Congressional scrutiny because 1) it is based on sound tax policy that prevents taxation of gain (or deductions for losses) when there is continuity of interest and no cashing out, and 2) it stimulates the economy through transactional activity.

Myth: Like-kind exchanges are used only by the wealthy or well connected.

Truth: Like-kind exchanges are used by a broad spectrum of taxpayers at all levels. Section 1031 is fair, benefitting taxpayers of all sizes in all lines of business, including individuals, partnerships, limited liability companies, and corporations. A 2011 industry survey concluded that 60% of exchanges involved properties worth less than $1 million, and more than a third were worth less than $500,000. Exchanged properties include real estate, construction and agricultural equipment, railcars, vehicles, ships and other investment and business-use assets. Tax deferral benefits are only available if the taxpayer continues their investment by acquiring like-kind replacement property.

Myth: Elimination of §1031 like-kind exchanges will raise significant revenue.

Truth: When the impacts of the economic stimulus effect of §1031 are taken into account, any Treasury revenue raised from elimination of §1031 would be negligible. The most recent repeal score from the Joint Committee on Taxation estimated that elimination of §1031 would raise approximately $40.9 billion over 10 years. This ignores that §1031 is a powerful economic stimulator, encouraging investment in small and medium sized growing businesses, thereby promoting U.S. job growth. Section 1031 exchanges contribute to the velocity of the economy by stimulating a broad spectrum of transactions which, in turn, generate jobs and taxable income through business profits, wages, commissions, insurance premiums, financial services, and discretionary spending by gainfully employed workers. This transactional activity raises state, local and federal tax revenue through transfer, sales and use taxes and increased property taxes.

Myth: § 1031 like-kind exchanges get the double benefit of deferral and depreciation.

Truth: With respect to depreciable assets, like-kind exchanges are essentially revenue neutral because gain deferred is directly offset by a reduction in future depreciation deductions available for assets acquired through an exchange. The tax basis of newly acquired replacement property is reduced by the amount of the gain not recognized due to the exchange of the sold property. Thus, the taxpayer forgoes an equal dollar amount of future depreciation deductions on the replacement property, resulting in increased annual taxable income over time, taxed at ordinary income tax rates.