The Voice of the 1031 Industry

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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) incrementally, beginning immediately following the exchange, through increased income tax due to foregone depreciation; 2) upon sale of the replacement asset; 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." Fundamentally, §1031 merely provides a timing benefit.

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 unfairly benefit only the wealthy and large corporations.

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. Elimination of §1031 would tax cash flow, not wealth, because tax deferral benefits are only available if the taxpayer reinvests in like-kind replacement property. Section 1031 permits efficient use of capital to preserve and manage cash flow, and also encourages U.S. businesses to reinvest in their domestic operations, rather than offshoring business activity.

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. Ernst & Young LLP's 2015 Report on the Economic Impact of Repealing Like-Kind Exchange Rules ("EY Study") found that **repeal of §1031 would cause** 1) **longer holding periods** and less-productive deployment of capital in the economy; 2) **increased cost of capital;** 3) **reduced levels of investments**; 4) **slower economic growth**; 5) a **concentrated burden** in those industries that rely heavily on like-kind exchanges, such as real estate, construction, truck transportation, equipment / vehicle rental and leasing; and 6) **long-term contraction in overall U.S. GDP of approximately $8.1 billion annually**. The loss to GDP over a 10 year period would be $61 - $131 billion, depending upon the "pay for" use of the repeal, including tax rate reduction. **The macroeconomic EY Study concluded that repeal of §1031 would be at cross-purposes with the stated goals of tax reform.**

Section 1031 is a powerful economic stimulator that contributes 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.

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

Truth: Like-kind exchanges are essentially revenue neutral over the tax life of depreciable assets 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.