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A RECIPE FOR DISASTER

Eating The Seed Corn: Congress Proposes Repealing Section 1031

Options Under 1031 Benefit All Parties, Including The IRS

By Joseph Darby | Nov 22, 2015 Reprints | Print

Everyone understands that "eating your seed corn" is a *really* bad idea.

But the U.S. Congress, ever tempted by a (tax) free lunch, is contemplating the repeal of Code Section 1031, a provision that serves as the economic seed corn for a huge portion of the U.S. economy.

Thanks to 1031, U.S. businesses can replace old equipment without being whacked with a crippling tax bill. This encourages manufacturing companies to upgrade their facilities, permits car-rental companies to maintain a newer (safer) fleet, allows airlines regularly to buy new aircraft, and enables businesses to "trade up" in real estate when they outgrow their facilities. All good stuff.

On the other hand, if you tax something, you get inevitably less of it. And rest assured that if you impose a heavy tax on trading old equipment for new equipment, you will get less new equipment. Who thinks that's a good idea?

In fact, 1031 is a uniquely sensible and focused tax provision that encourages U.S. businesses to replace worn-out assets, which benefits everyone concerned – employees, customers, vendors and shareholders – not to mention the biggest beneficiary of all, the IRS.

The Internal Revenue Code is a partnership agreement between the federal government and every taxpayer, and though it is unquestionably complex, the premise is simple: Please send approximately 40 percent of your net income every year to Washington. A repeal of 1031 would discourage upgrade transactions and hurt the economy – and no one is more punished by stagnant economic growth than the IRS. Eating your seed corn is a recipe for disaster.

Short Dollars Go A Long Way

According to a recent Senate Finance Committee analysis, Code Section 1031 is the third-largest corporate “tax expenditure,” costing the Treasury $11.7 billion in 2014. By comparison, employer contributions for health care (a non-taxable benefit) cost $143 billion, the reduced tax rate on dividends and capital gains cost $96.5 billion, and the exclusion for contributions to retirement plans cost $70.9 billion.

In this context, 1031 represents short dollars that go a long way toward growing the economy. An Ernst & Young macroeconomic study recently concluded that eliminating 1031 (to “pay” for reducing the corporate tax rate to 25 percent) would result in an $8.1 billion reduction in U.S. economic activity in every future year.

The U.S. income tax was adopted in 1913, and the predecessor to 1031 was adopted in 1921, making it almost as old as the income tax itself. Congress back then was concerned with the “lock-in effect;” namely, that businesses would retain aging equipment or unproductive real estate if upgrades came with a biting tax cost.

For example: A corporation has fully depreciated equipment worth $10 million and wants to reinvest that $10 million into new equipment. Under 1031, that is a no-brainer. But if upgrading is taxable, the corporation owes $4 million in taxes (at a 40 percent combined tax rate), and has just $6 million left for replacement property. To replace fully without 1031, the taxpayer needs $14 million – $4 million for taxes and $10 million for replacement property. Absent 1031, economically rational upgrades are discouraged.

But even if the taxpayer can finance the extra $4 million in up-front taxes, the government does not get to keep $4 million – far from it. The taxpayer depreciates the $10 million paid for the replacement property, and over five years enjoys $4 million in tax savings. Thus, repealing 1031 provides negligible benefit to the IRS – even if it “wins,” it loses.

By contrast, under 1031, if $10 million of replacement equipment is purchased, the carryover tax basis is zero, there is no additional depreciation and so the taxpayer pays about the same amount of taxes over time (assuming constant rates) with or without 1031. But upgrading regularly grows the economy: the taxpayer is more profitable, the equipment vendor pays its employees and its vendors, and the “multiplier” effect creates a ripple of wealth creation – and 40 percent of that additional wealth flows to the IRS. Make no mistake: 1031 makes the IRS richer.

On the real estate side, a typical exchange generates significant (taxable!) revenues for professionals and service providers, creates construction and landscaping jobs, and triggers state and local transfer taxes and increased property taxes. A recent microeconomic study by Professors David Ling and Milena Petrova found that taxpayers invest, on average, 33 percent more into replacement property acquired through 1031 than non-exchanging buyers.

Repealing 1031 is like eating the seed corn: It confers minor short-term gratification in return for devastating long-term consequences.

There ain’t no such thing as a free lunch.

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