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The Voice of the 1031 Industry

January 16, 2014

Senator Max Baucus, Chairman
Senate Finance Committee
511 Hart Office Building
Washington, DC 20510

Senator Orrin G. Hatch, Ranking Member
Senate Finance Committee
104 Hart Office Building
Washington, DC 20510

Re: Staff Discussion Draft: Cost Recovery and Accounting

Dear Senators Baucus and Hatch:

The Federation of Exchange Accommodators ("FEA") thanks you for inviting comments related to the goals of business tax reform. While comments were requested regarding whether the IRC §1031 tax-deferred like-kind exchange rules should be retained for real property and intangible property, the FEA supports retention of existing law for tangible personal property as well. We urge you to retain IRC §1031 in the law's present form because §1031:

1. Is consistent with goals of efficiency, neutrality, fairness and simplicity within the tax system,
2. Promotes business decisions that stimulate U.S. job creation and the U.S. economy,
3. Is not unnecessarily complex and does not pose an administration problem for either the IRS or taxpayers, and
4. Provides a better deferral benefit than the proposed depreciation pooling structure.

We hope that in the lengthy, methodical process of creating tax reform, careful deliberation and modification will be employed to achieve the goals of efficiency and simplification without creating unintended consequences of unfairness and complexity.

The FEA is the industry association for exchange facilitators, also known as Qualified Intermediaries ("QI"). FEA member companies facilitate tax-deferred exchanges of investment and business use properties under IRC §1031 for taxpayers of all sizes, from individuals of modest means to high net worth taxpayers and from small businesses to large corporations.

While the FEA continues to support the goals of tax reform, we are also hopeful the tax reform process will take into consideration the enormous benefits that Section 1031 exchanges provide to the US economy. Property exchanges promote transactional activity that results in jobs and taxable income that, in turn, fuel other businesses. Tax-deferred exchanges are one of the few incentives available to and used by taxpayers of all sizes. Section 1031 has been in the Internal Revenue Code since 1921 and is based on sound tax policy predicated on continuity of investment by the taxpayer. It has been subjected to Congressional scrutiny multiple times, each time being retained, affirming the importance of §1031. We look forward to continuing to work with the Senate Finance Committee to insure that §1031 exchanges remain an important stimulant to our economy.

The FEA respectfully asks that you consider the following:

- **Repeal of §1031 Will Not Increase Fairness**

Section §1031 is fair and it is working well for a broad spectrum of taxpayers at all levels, in all lines of business, including individuals, partnerships, limited liability companies and corporations. An industry survey showed that 60% of exchanges involve properties worth less than \$1 million, and more than a third are worth less than \$500,000.

Section 1031 exchanges structured under the IRS regulatory safe harbors using professional Qualified Intermediaries 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.

- **Repeal of §1031 Will Not Further Simplification or Efficiency**

Section 1031 has already been greatly simplified through publication of Regulations, Rulings, and other guidance issued over the past several decades. FEA members are professional exchange facilitators for whom acting as a Qualified Intermediary is a core business. Exchange facilitators function as unofficial gate keepers for the IRS, promoting compliance with the technical requirements for proper exchange treatment. Professional exchange facilitators are subject matter experts who simplify §1031 by guiding their clients and their tax advisors through the process, providing proper documentation, holding funds, and other services. Repeal of like-kind exchanges would result in greater complexity and expense because history and human nature have taught us that taxpayers will spend more in legal fees to develop more complicated ownership structures to avoid or defer recognition of taxable gain.

- **Section 1031 Does Not Pose any Administration Problems for the IRS**

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. Determination of whether the rules have been complied with is not complicated.

- **Section 1031 is a Powerful Economic Stimulator**

Section 1031 exchanges contribute to the velocity of the economy by stimulating a broad spectrum of real estate transactions which generate taxable income and tax revenue through real estate commissions, insurance premiums, financial services and increased property taxes. Non-real estate economic sectors are also stimulated because §1031 encourages companies, small businesses, farmers and ranchers to replace and upgrade machinery and equipment, thus stimulating purchases, sales and manufacturing of construction and agricultural machinery, equipment, railcars, aircraft, trucks, cars, marine vessels and other assets. Section 1031 provides significant benefits to taxpayers of all sizes with a "trickle down, spillover" economic stimulus to a myriad of industries and small businesses across the country. It allows recognition of gain on the sale of qualifying assets to be deferred by using the proceeds from the sold asset to buy replacement assets of the same kind or class. This deferral benefit permits efficient use of capital to preserve and manage cash flow, encouraging U.S. businesses to reinvest in their domestic businesses, rather than offshoring business activity.

- **Repeal of Section 1031 will cause a Decline in Real Estate Values**

Anecdotal evidence suggests that at least 25% of commercial real estate sale transactions involve §1031 exchanges. A substantial volume of sales transactions involving agricultural property also utilize §1031 exchanges. These types of real estate are highly illiquid assets. It is difficult to make a profit with real estate ownership. Repeal of §1031 will have a chilling effect upon real estate investment. Without the tax-deferral incentive, many transactions will be abandoned or delayed, causing stagnation in the real estate marketplace and blight in neighborhoods. Investors will be more inclined to invest into more liquid, non-real estate investments in which profits can be more readily realized.

- **Decline in Real Estate Values caused by Repeal of §1031 would Imperil the U.S. Banking System**

A drop in real estate values creates a reduction in equity value that, in turn, cascades into devaluation of collateral for loans which causes a technical default under a commercial loan agreement. Most commercial real estate loans have 3 to 7 year terms. If the property value has dropped when the loan is due for renewal, the debt/equity (i.e. "loan to value") ratio will be upside down, and the owner (borrower) will be required to add more capital (i.e. the approved loan amount will be reduced requiring a partial pay down). Under the best of circumstances, this results in an inability for the owner to increase his portfolio through investment in other real estate, because he must use that capital for the existing real estate. Under the worst of circumstances, when the owner lacks the capital now required to maintain the existing real estate loan, that loan will be pushed into foreclosure, causing a further reduction in value, not only for that parcel, but for other properties in that neighborhood. Banks have rebuilt their commercial real estate loan portfolios since the recession and the banking system is finally strong and able to make new loans. These loan portfolios are based upon the assumption that capital remains static. Elimination of §1031 like-kind exchanges for real estate would create an overall decline in real estate values, causing the banking system to return to the

unstable condition of the 2009 recession and with it, a lack of available credit, further stifling real estate transactions.

- **Elimination of §1031 Would Tax Cash Flow, not Wealth.** §1031 permits a continuity of investment by the taxpayer without reducing cash flow available for growth of the business. The value of assets exchanged, whether farmland, commercial or rental residential real estate, machinery, equipment, vehicles or other business-use or investment assets, remains invested in the taxpayer's business. **The taxpayer doing a §1031 exchange is not taking any profit from this transaction; it is being plowed back into the business.** This is in stark contrast to taxing the gain on the sale of stock for other securities. Stocks and other securities are relatively liquid, third party investments in someone else's business. Section 1031 exchanges are available only to direct owners of business-use or investment assets, which by their nature, are illiquid. Taxing third party investors on their profits from the sale of stocks does not impact the cash flow or operation of the business; but a tax to the direct owner of a productive asset directly reduces the cash flow available for reinvestment into other productive assets.
- **Elimination of §1031 Will Not Raise Significant Revenue**
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 relinquished (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.
- **Longer Depreciation Schedules Introduced by Pooling Unfairly Impact Taxpayers that are Taxed at Individual Rates**
Unlike corporations, farmers, ranchers, real estate owners, and others holding assets in pass-through entities will be unfairly and negatively impacted by substantially reduced depreciation deductions coupled with individual tax rates that will be higher than the targeted 25% corporate rate. The effect of the depreciation pools is that depreciation for many assets will exceed the life of the asset. For example, farm equipment purchased at a cost of \$300,000 which under current rules would be subject to 7 year MACRS, would be fully depreciated in its 8th year of ownership. That same unit of agricultural equipment, under the Pool 2 proposal, would not be fully depreciated until its 30th year of ownership, long after its useful life has ended. The combination of present MACRS depreciation rules with §1031 exchanges provides a stronger cash flow benefit and therefore, a stronger economic stimulus to businesses. Elimination of §1031 with a transfer to a pooling depreciation method will cause these individual taxpayers and small businesses to retain assets longer, since there is a reduced cash flow incentive to reinvest.
- **Depreciation Pooling Increases Complexity**
Future investments will be constricted due to cash flow constraints introduced by a new method of depreciation. Business owners have already invested in significant technologies to allow for assets to be tracked individually for business as well as tax reasons. Introducing a pooling requirement would require additional investments to maintain pooling in addition to their existing single asset tracking applications which would still be required for other purposes.

Equipment lessors price leases using an assumption of a short-term MACRS depreciation. The tax impact of essentially never-ending depreciation will make leases very difficult to price, and will require the asset to continue to be individually tracked to account for the exact amount of depreciation allocable to that specific leased asset. Leasing software would have to be completely rewritten to migrate to a pooled pricing and depreciation environment.

Economic policy efforts focus on encouraging investment in productive assets, encouraging additional borrowing by qualified investors, increasing the velocity of transactions, redeploying underutilized or idle assets, and discouraging fearful contraction and cash hoarding. Section 1031 encourages growth by mandating reinvestment in like-kind assets, increasing job growth and ordinary income generated by additional capital investment. It discourages the hoarding of capital and penalizes profit taking by taxing value taken out of the economy. Section 1031 directly impacts jobs. The transactional activity stimulated by §1031 results in jobs in the real estate, construction, title insurance, mortgage, banking, equipment lease financing, vehicle and heavy

equipment rental and manufacturing, after-market alteration, customization and installation industries. Fewer transactions ultimately result not only in fewer jobs in these industries, but also indirectly at factories, restaurants, dry cleaners and other local small businesses that generate revenue from the after tax dollars of employed workers.

In conclusion, §1031 not only serves the goal of tax reform, it provides a strong incentive for economic growth and investment at home, in the United States. The FEA believes that §1031 like-kind exchanges should be retained in present form as part of the tax code, and continue to be available for exchanges of qualifying tangible and intangible personal property and real property assets. If you have any questions, or wish to discuss any of these matters, please contact any of us.

Sincerely,