FEA
FEDERATION OF
EXCHANGE
ACCOMMODATORS

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

IRC Section 1031 Impact on Commercial / Industrial Real Estate

About the FEA

The Federation of Exchange Accommodators ("FEA") is the industry association for professional exchange facilitators, also known as Qualified Intermediaries ("QI"). FEA member companies facilitate tax-deferred exchanges of investment and business use properties under IRC Section 1031 for taxpayers of all sizes, from individuals of modest means to high net worth taxpayers and from small businesses to large entities. Members represent a broad spectrum of the industry, ranging from small, privately held businesses to large, publicly traded companies and banks, located in small towns to large cities across the nation.

Internal Revenue Code Section 1031

Since 1921, Federal tax law under IRC §1031 has permitted a taxpayer to exchange business-use or investment assets for other like-kind business use or investment assets without recognizing taxable gain on the sale of the old assets. The taxes, which otherwise would have been due from the sale, are thus deferred. These can range from relatively simple transactions involving commercial, agricultural and rental real estate to more complex transactions involving aircraft, trucks, trailers, containers, railcars, agricultural equipment, other heavy equipment, livestock and other assets. Most §1031 exchanges involve separate buyers and sellers and are not simple swaps between two parties. Under these circumstances, tax rules require the use of an independent third party Qualified Intermediary. The QI holds the sale proceeds for the benefit of the taxpayer during the exchange, disbursing funds for purchase of like-kind replacement property, and returning any unused funds to the taxpayer at the end of the exchange. Section 1031 exchanges must be completed within 180 days. Taxpayers recognize gain and pay tax on any unused funds or when they ultimately "cash out" of their property.

Implications of Tax Reform for 1031 Exchanges

Congressman Dave Camp, Chair of the U.S. House of Representatives Committee on Ways and Means, has formed a bipartisan tax reform working group charged with the task of fact finding and information gathering about present law. Group members will be examining eleven subjects, which include real estate tax matters. The working group members are soliciting stakeholder input for their group(s). Section 1031, along with other expenditure sections of the Internal Revenue Code will be on the table as a potential revenue raiser for tax reform. The information received by Chairman Camp in this process will likely serve as a blueprint for tax reform proposals going forward. The window for influencing the working groups is small since the deadline for submissions is April 15, 2013.

Senator Max Baucus, Chair of the Senate Finance Committee has indicated he has his own initiative to gather suggestions for tax reform. He is conducting informal discussions with members of his Committee to arrive at ideas for tax reform.

The Joint Committee on Taxation released its report of federal tax expenditures in which it estimates that Section 1031 like kind exchanges will cost $42 billion over the 5 year period 2012-2016. This estimate makes §1031 exchanges a likely target as a potential revenue raiser for tax reform. This has significant implications for transactions involving commercial and industrial property.

Issues Specific to Commercial / Industrial Property

Commercial and industrial property is attempting to recover from the deepest value recession since the Great Depression. Property values in the commercial / industrial sector have not rebounded as quickly as the general housing market. As a result, political leaders, property owners, realtors and other professionals are continually discussing ways to encourage investment in commercial / industrial property and increase the volume of transactions. Section 1031 exchanges have historically been the vehicle that has insured continued investment in commercial / industrial property. It has allowed investors in this sector to upgrade and expand their facilities, redeploy assets to other geographical areas, capitalize on new labor pools, and the like. At the same time, §1031 requires that the exchange funds received from the sale of domestic real estate be reinvested within 180 days in property within the United States. A repeal or any restriction of §1031 as part of tax reform or budget legislation will adversely impact the commercial / industrial property sector.

There are misconceptions about Section 1031 exchanges that threaten the viability of this important investment strategy:

- **Exchanges are routinely used by the Middle Class.** Section 1031 is not an unfair tax break used only by the wealthy or large corporations. On the contrary, it is one of the few incentives available to and used by taxpayers of all sizes. Exchange industry data indicates that the majority of exchanges involve properties worth less than $1,000,000. These types of properties are typically those of small investors and small "main street" businesses who are vital to a vibrant economy.

- **Exchanges do not divert tax revenue.** When a taxpayer reinvests their capital in a new commercial / industrial property from an exchange out of a property that has already been depreciated, they cannot "restart" depreciation. Capital gain tax may be deferred but additional depreciation is either not available or substantially limited. This foregone depreciation creates tax revenue to the government. This is especially the case if a taxpayer has used cost segregation on components of a property to accelerate what would be long term depreciation on the life of a building as a whole.

- **Section 1031 is not a loophole.** The Section has been part of the Tax Code since 1921 and has withstood scrutiny for nearly a century. There have been efforts to modify or restrict the Section which have failed in large part due to the fact that policy makers realize the adverse impact those modifications or restrictions would have on the economy.

Section 1031 exchanges have a positive impact on the U.S economy:

- **Section 1031 encourages reinvestment in the U.S.** Investors who are selling commercial / industrial U.S. property must reinvest in U.S. property and not property in foreign countries. This encourages companies contemplating production changes or expansion to reinvest in bigger, better facilities in the U.S. rather than shuttering U.S. facilities to move to a cheaper foreign labor market.

- **Section 1031 enhances borrowing power.** If investors cannot use Section 1031 on the sale of commercial / industrial property and use sale proceeds to pay the tax, their assets available for reinvestment are diminished. This impedes their borrowing power which may be essential for enlarging or improving the property into which they are investing. Exchanging preserves the monies available for reinvesting and many investors are able to leverage themselves into the new investment property by borrowing funds to acquire bigger, better properties. This has a positive trickle-down effect for the banking industry, the building trades, supplier and other main street businesses.

- **Section 1031 lessens the impact of recent losses.** The economic downturn that took place from 2008 to the present resulted in property investors losing up to 40% of the value of their properties in many areas of the country. Commercial / Industrial properties still have not rebounded from that downturn. By deferring the payment of capital gain tax and the 3.8% surcharge on sales of commercial / industrial property taxpayers are motivated to use exchanges to preserve the wealth they have left.

- **Section 1031 encourages investors to increase their reinvestment.** Since Section 1031 requires investors to exchange into an equal or greater investment in equity and debt to get 100% tax deferral they often use loaned funds to leverage their investment. This results in healthy interaction with lenders and further investment in America.

- **Section 1031 increases taxable income streams.** By preserving reinvestment values in an exchange, taxpayers maintain higher income streams which are typically taxed annually at higher income tax rates than the capital gains tax paid only once.

Summary

The benefits to the U.S. economy of tax deferred exchanges of property, including commercial / industrial property, far outweigh any perceived loss of immediate tax revenue. Much of the perceived tax revenue yielded by eliminating §1031 is mitigated by depreciation deductions not currently available after exchanges. If §1031 is eliminated, depreciation deductions will increase, reducing the benefit of the elimination of §1031 exchanges. Section 1031 exchanges are a proven benefit to investors in the commercial / industrial property sector which in turn invigorates the economy at large. ***Section 1031 not only encourages transactional activity and reinvestment over profit taking, it provides a strong incentive to keep that investment at home, in the United States.***