FEDERATION of EXCHANGE ACCOMMODATORS
The Voice of the 1031 Industry

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Sen. Orrin G. Hatch, Chairman
Senate Finance Committee
104 Hart Office Building
Washington, DC 20510

Sen. Ron Wyden, Ranking Member
Senate Finance Committee
221 Dirksen Office Building
Washington, DC 20510

Sent to Senate Finance Committee via email: taxreform2017@finance.senate.gov

Recommendations for Tax Reform

Dear Chairman Hatch, Ranking Member Wyden, and Members of the Senate Finance Committee:

In response to Chairman Hatch's request for "insight from experts and stakeholders" related to providing tax relief to middle-class taxpayers, strengthening businesses to put the economy on a better growth path and create jobs, and for removing impediments and disincentives for investment, the Federation of Exchange Accommodators ("FEA") appreciates this opportunity to provide recommendations regarding tax reform priorities. Specifically, we recommend that IRC Section 1031 like-kind exchanges, in present form, be retained in any tax reform plan because they meet the stated goals of tax reform.

At its core, IRC §1031 is a powerful economic stimulator that is grounded in sound tax policy. The non-recognition provision is premised on the requirement that the taxpayer demonstrates continuity of investment in qualifying replacement property with no intervening receipt of cash. There is no profit-taking, and at the conclusion of the exchange, the taxpayer is in the same tax position as if the relinquished asset was never sold.

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. Taxes which otherwise would be due if the transaction was structured as a sale are deferred. Qualifying assets include buildings and land, commercial, agricultural and rental real estate, aircraft, trucks, automobiles, trailers, containers, railcars, agricultural machinery, construction and oil and gas equipment, livestock, and other assets involved in a broad spectrum of industries, owned by an equally broad spectrum of taxpayers ranging from individuals of modest means and small businesses to large business entities.

Under current law, §1031 promotes capital formation and liquidity. A macro-economic impact study by Ernst & Young, and a micro-economic impact study on commercial real estate by Dr. David Ling and Dr. Milena Petrova, both published in 2015, concluded that Section 1031 removes the tax lock-in effect and permits taxpayers to make good business decisions without being impeded by negative tax consequences[1]. Like-kind exchanges stimulate economic activity and promote property improvements that benefit communities, increase property values and local tax revenues, improve neighborhoods, and generate a multitude of jobs ancillary to the exchange transactions. These studies quantified that restricting or eliminating like-kind exchanges would result in a decline in GDP of up to $13.1 billion annually, reduce velocity in the economy and increase the cost of capital to

[1] *Economic Impact of Repealing Like-Kind Exchange Rules*, Ernst & Young (March 2015, Revised November 2015) available at http://www.1031taxreform.com/1031economics/; and *The Economic Impact of Repealing or Limiting Section 1031 Like-Kind Exchanges in Real Estate*, David C. Ling and Milena Petrova (March 2015, revised June 22, 2015), available at http://www.1031taxreform.com/ling-petrova/.

taxpayers.[2] A 2016 Tax Foundation report estimated a significantly larger economic contraction of approximately $18 billion per year.[3]

Like-kind exchanges benefit the economy in a myriad of ways. Commercial real estate owners, individuals, and businesses of all sizes use like-kind exchanges to trade up from a small rental to a larger apartment building, from a factory or office space that met yesterday's needs to a business facility that positions the business for tomorrow, and to upgrade machinery, equipment or vehicles into newer assets that better meet current and future needs. Equipment and vehicle exchanges frequently take the form of trade-ins, benefitting many middle-class and small business taxpayers that are unaware that their ability to defer depreciation recapture tax emanates from Section 1031.

Farmers and ranchers use §1031 to preserve the value of their investments and agricultural businesses while they combine acreage, acquire higher grade land, or otherwise improve the quality of their operations. They rely on §1031 to preserve cash flow when they trade up to more efficient farm machinery and equipment. Farmers and ranchers trade dairy cows and breeding stock when they move their operations to a new location.

The ability to take advantage of good business opportunities stimulates transactional activity that generates taxable revenue for brokers, lenders, appraisers, surveyors, inspectors, insurers, equipment dealers, manufacturers, suppliers, attorneys, accountants and more. This transactional velocity also creates opportunities for smaller businesses to acquire entry-level facilities and used equipment from which to launch and grow their fledgling businesses.

The House Republican Blueprint for Tax Reform proposals, taken as a whole, do not provide equal benefits, and are not as comprehensive, as the benefits provided to both taxpayers and our economy by §1031 like-kind exchanges. The Blueprint, released in June, 2016, proposes reduced tax rates and full, immediate expensing with unlimited loss carryforward for all investment and business-use tangible & intangible depreciable personal property assets, including real estate improvements, but not land. We understand that some policymakers believe that if these proposals are enacted, that §1031 would no longer be necessary. We disagree. Even with lower tax rates and immediate expensing, Section 1031 will still be necessary to remove friction from transactions, fill in the gaps, and prevent an increased tax burden on middle-class taxpayers.

Immediate expensing does not remove the lock-in effect on a host of real estate owners. Given that improvements would be eligible for immediate expensing, but the value allocated to land would not be deductible, it is important to recognize that land values represent approximately 30% of the value of commercial improved properties, and up to 100% of agricultural land investments. If these property owners are faced with reducing the value of their investments and life savings through capital gains tax when they sell and reinvest in other real estate, even with lower rates, they will likely hold onto these properties longer. The ability to use §1031 to defer gain recognition removes the lock-in effect, takes the government out of the decision-making process, and permits taxpayers to engage in opportunistic transactions that make good business and investment sense, and that create jobs, without fear of negative tax ramifications.

Repeal or restriction of like-kind exchanges would be especially troublesome for agricultural and commercial real estate investments in which the land value, relative to the value of improvements, is great. A taxpayer replacing low basis real estate would recognize substantial capital gains that would not be fully offset by the proposed expensing deduction for improvements on equal value replacement real estate if the improvements are minimal in value or non-existent, as in the case of agricultural land, or if the property is located in an area with high land to improvement ratios. (See examples in attached Appendix). Without additional cash to cover both the tax liability and the new investment, loss of §1031 would result in a government-induced shrinkage of agricultural and commercial real estate investment, retarding ability for growth as well as diminishing the net worth of farmers, ranchers, and real estate investors.

Like-kind exchanges make the economics work for conservation conveyances of environmentally sensitive lands that benefit our environment, improve water quality, mitigate erosion, preserve wildlife habitats, and create recreational green spaces for all Americans. Farmers, ranchers and other landowners

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[2] Ernst & Young LLP, *Economic Impact* at (v) and Ling and Petrova, *Economic Impact*, at 6

[3] *Options for Reforming America's Tax Code,* Tax Foundation (2016), p.79, available at https://taxfoundation.org/options-reforming-americas-tax-code/.

reinvest sale proceeds from conservation conveyances through §1031 like-kind exchanges into more productive, less environmentally sensitive land. These socially beneficial conveyances are dependent upon the absence of negative tax consequences.

Most taxpayers benefitting from like-kind exchanges are not ultra-high net worth individuals or large corporations. These individual taxpayers do not have use for a large net operating loss carryforward from the unused expense deduction for real estate improvements. They do not have sufficient related income to offset the expense, thus they would realize minimal benefit. These taxpayers would face a massive amount of depreciation recapture upon sale, for which they may not have sufficient liquidity, or may not have set aside enough cash to satisfy, creating further personal challenges, locking them in, and putting other wealth building options out of reach. The tax-deferral provisions of Section 1031 fill this gap by permitting full reinvestment of sales proceeds into like-kind property, thus preserving business liquidity and helping firms to create jobs.

Retiring taxpayers benefit by exchanging their most valuable asset, their farm, ranch, or apartment building, for other real estate without diminishing the value of their life savings. With a §1031 exchange, farmers and ranchers can downsize or divest their agricultural operations, landlords can eliminate the "3 Ts" of tenants, toilets and trash, and these retirees can reinvest in other income producing real estate, such as a storage unit facility or a triple net leased commercial property. The loss of §1031 would result in a direct reduction of the retirement savings of these taxpayers whose work has provided food for our nation and affordable living space for other Americans.

Unlike the Blueprint, Section 1031 provides a mechanism for asset sales and replacement purchases that bridge 2 tax years. Absent §1031, taxpayers would be forced to acquire new assets prior to year-end, or be faced with recapture tax on the Year 1 sale and less equity available for the replacement purchase in Year 2. This would create a disincentive to engage in real estate and personal property transactions during the 4th quarter, resulting in tax-driven market distortions. Seasonal businesses in particular can benefit from exchanges in which assets are divested in late autumn and replaced in early spring, at the start of the new season, thereby eliminating off-season storage and debt-service expenses, without any tax-induced cash-flow impairment.

Retention of §1031 in present form eliminates potential expensing abuse. The proposal to fully expense real estate improvements in the year of acquisition, with an unlimited carryforward, provides a tremendous incentive at acquisition for a taxpayer to inflate the value of improvements, so as to maximize the write-off. Conversely, upon sale, there would be great incentive to minimize the value of the buildings and over-allocate value to the land, thus minimizing recapture tax on the improvements at ordinary income tax rates, and benefiting from lower capital gains tax rates on the land.

The appraisal process is not an exact science. There are different methodologies, and a considerable amount of subjectivity, particularly when there is a scarcity of market activity and relevant data upon which to rely. Given the multiple variables that can impact land and structure values, appraisals can vary widely. A motivated taxpayer could easily game the system to maximize tax benefit and minimize taxes owed on disposition. Section 1031 eliminates this conflict and simply encourages reinvestment of the full value.

Professional Qualified Intermediaries simplify like-kind exchanges and promote compliance with tax laws. Treasury Regulations provide rules and a safe harbor for taxpayers engaging in non-simultaneous exchanges under §1031 that involve different buyers and sellers.[4] In these delayed, multiparty exchanges (which constitute the majority of like-kind exchanges), the taxpayer is prohibited from having receipt of or control over the sale proceeds from the relinquished property prior to receiving replacement property, or termination of the exchange.

The Qualified Intermediary ("QI") is the independent third party that receives the sale proceeds from the relinquished property buyer, holds and safeguards the funds for the benefit of the taxpayer, and then disburses the funds to the seller of the replacement property. Although a QI occasionally takes title to the exchanged properties, typically the QI is only assigned into the chain of contracts, and the safe harbor treats the transaction, for tax purposes, as if the exchange occurs between the QI and the taxpayer. Agents, such as the taxpayer's attorney, accountant, broker or employee, and parties related to the taxpayer, are disqualified from acting as a Qualified Intermediary.

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[4] 26 CFR 1.1031(k)-1

- Professional Qualified Intermediaries facilitate §1031 like-kind exchanges, for a nominal fee, by providing necessary documentation, and by holding, safeguarding and disbursing the exchange funds for qualifying like-kind replacement property.

- FEA member QIs are subject matter experts in §1031 exchanges. Our members serve as a valuable resource to taxpayers and their advisors, providing a simple, streamlined process, and promoting compliance with tax rules.

- Qualified Intermediaries do not act as brokers, deal makers or advisors to the taxpayer - doing so would disqualify them from serving as a QI.

- Qualified Intermediaries are subject to exchange facilitator laws in nine states.

Capital intensive businesses rely upon like-kind exchanges and affordable access to debt to build and expand. Both tax-deferral and interest deductibility are important economic drivers that stimulate transactional activity, capital investment and growth in the United States.

In summary, like-kind exchanges remove friction from business transactions and stimulate economic activity. Section 1031 facilitates opportunistic investment of capital and community improvement. Like-kind exchanges assist the recycling of real estate and other capital to its highest and best use in the marketplace, thereby creating value and improving economic conditions for local communities, rural and urban. Landowners and other businesses would be disadvantaged if they had neither the option of a tax deferred like-kind exchange nor expense deductions for asset acquisition and interest on related debt.

We are grateful for the opportunity to cooperatively work with you and your staff to provide productive, constructive, practical input toward achieving the goal of a fairer, simpler, pro-growth tax reform plan.

Sincerely,

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APPENDIX

1) 1031 Exchange v. Immediate Expensing – Moderate Tax State

Bruce, a small business owner, purchased an office building in 1988 in Columbus, OH for $349,000 and has a tax basis of $97,000 prior to closing. Bruce used part of the building for his business and rented the remainder of the building to other small businesses. He recently sold the building for $1,235,000.

Sale Price:	$1,235,000
Closing Costs:	$ 58,000
Net Sale Price:	$1,177,000
Total Taxable Gain:	$1,138,000
Depreciation Recapture:	$ 252,000
Capital Gain:	$ 886,000

Under 1031: Bruce can reinvest in replacement property worth $1,235,000, roll his existing tax basis into the new property, and defer all capital gain and recapture taxes at both federal and state levels.

Under Immediate Expensing: If Bruce buys a property for $1,235,000 with an improvement value of 70% and a land value of 30%, Bruce would be able to expense $864,500 (attributable to the building). The expense deduction would offset the depreciation recapture and a portion of capital gain, but Bruce would still owe capital gains tax on the remaining gain of $273,500. Bruce would have to pay $58,800 in combined Federal and Ohio taxes.

At the same improvement / land ratio, Bruce would have to buy property worth $1,630,000, 32% greater than the property he sold, in order to avoid an immediate tax liability. If Bruce doesn't have sufficient cash for the additional $395,000 investment, or to pay the $58,800 taxes, he would have to borrow more or acquire a less valuable property, and suffer a tax-driven shrinkage of his investments.

2) 1031 Exchange v. Immediate Expensing – High Tax State

Tim the Mechanic purchased a tract of land in Fontana, CA with an automotive shop and three small single family rental units on it in 1996 for $148,000. Tim has operated the automotive shop there for 21 years and has a basis (before closing costs) of $101,000. The current contract price for the property is 980,000.00.

Sale Price:	$980,000
Closing Costs:	$ 50,000
Net Sale Price:	$930,000
Total Taxable Gain:	$829,000
Depreciation Recapture:	$ 47,000
Capital Gain:	$782,000

Under Section 1031: Tim can reinvest in replacement property worth $980,000, roll his existing tax basis into the new property, and defer all capital gain and recapture taxes at both federal and state levels.

Under Immediate Expensing: If Tim reinvests in replacement property worth $980,000 in which the improvements are worth 65% of the total value and land is 35%, Tim would be able to expense $637,000 (attributable to the building). The expense deduction would offset the depreciation recapture and a portion of capital gain, but Tim would still owe capital gains taxes on the remaining $192,000. Tim would owe $56,640 in combined Federal and California taxes.

At the same improvement / land ratio, Tim would have to buy property worth $1,277,000, more than 30% greater than the property he sold, in order to avoid an immediate tax liability. If Tim doesn't have sufficient cash for the additional $297,000 investment, or to pay the $56,640 taxes, he would have to incur more debt or acquire a less valuable property. His tax-induced choices would be to over-invest in a property more expensive than his business requires, or suffer a forced shrinkage of his investment and net worth.

3) Impact of Immediate Expensing – Rental Home Investment

An investor purchases a rental home for $200,000. He puts $50,000 down in equity and finances the rest of the purchase with a $150,000 loan. At the time the property is purchased the land is 30% and the improvements are 70% of the total value. He fully expenses the improvements, worth $140,000, leaving a tax basis of $60,000. He holds the property for 7 years during which time it appreciates by 35%. He sells the property for $270,000.

Sale transaction under proposed Blueprint immediate expensing:

Sale Price:	$270,000
Closing Costs:	$ 23,000
Net Sale Price:	$247,000
Total Taxable Gain:	$187,000
Profit:	**$ 47,000**

Taxes Owed at the time of Sale:	
Depreciation Recapture @ 33% on $140,000*	$46,200
Capital Gains @ 16.5% on 47k	$ 7,755
Total Federal Tax	**$53,955**
State Taxes @ 6%	$11,220
Total Federal and State Taxes:	**$65,175**

**Note: Recapture under the Blueprint is assumed to be at ordinary income tax rates. If the preferential rate of 25% on real estate recapture was retained, the recapture tax would total $35,000. Total federal taxes would be $42,755 and total combined state and federal taxes would be $53,975.*

Immediate Expensing: Investor could reinvest in replacement property worth $270,000 and the expense deduction for the replacement improvements would offset total taxable gain. But if investor wanted to sell and reinvest in a savings account or securities, the significant depreciation recapture due to immediate expensing would result in federal taxes consuming all profit on the sale. Combined state and federal taxes would erode the investor's original equity, creating a negative return on investment. The rental home would have to appreciate by at least 50% just to break even on total taxes.

This would create a significant tax lock-in effect. To make a decent profit, over and above the tax liability, an investor would be ill-advised to sell a property with less than 100% appreciation in value. To avoid negative tax consequences and loss of net worth, investors would be encouraged hold onto their properties, or to keep buying properties at ever higher prices and flipping them so that the new immediate expensing offsets the taxes. Lock-in results in reduced transactional activity, and flipping results in a bubble, neither of which is good for the economy.