FEDERATION of EXCHANGE ACCOMMODATORS
The Voice of the 1031 Industry

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CC:PA:LPD:PR (REG-107892-18)
Courier's Desk
Internal Revenue Service
1111 Constitution Avenue NW
Washington, D.C. 20224

The Honorable David J. Kautter
Assistant Secretary of Tax Policy
U.S. Department of Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

The Honorable William M. Paul
Chief Counsel (Acting)
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: Comments to REG-107892-18 and Proposed §1.199A-2(c) with respect to the meaning of unadjusted basis immediately after acquisition of qualified property (UBIA of qualified property) under new section 199A(h)(2)

Dear Assistant Secretary Kautter and Chief Counsel Paul:

The Federation of Exchange Accommodators ("FEA") appreciates the opportunity to submit comments pursuant to REG-107892-18, Qualified Business Income Deduction, (the "Proposed Regulations"). The FEA is the only national trade association organized to represent professionals who facilitate like-kind exchanges under section 1031. Members include Qualified Intermediaries ("QIs") and affiliated professionals (tax and legal counsel, TIC sponsors, banks, real estate brokers, etc.).

The FEA respectfully requests that the final guidance issued under section 199A clarify and confirm that the unadjusted basis of property immediately after acquisition (UBIA) for like-kind exchange-acquired property include the original unadjusted cost basis of the exchanged or relinquished property, without any reference to the depreciated or adjusted basis.

Proposed Regulations

Section 199A was enacted as part of the Tax Cuts and Jobs Act (TCJA) to provide non-corporate businesses with a lower effective tax rate that approximated the reduction in the corporate rate. In so doing, Congress

sought to provide tax relief to all qualified business income regardless of whether it was earned by a corporation or a passthrough entity. The inclusion of a specific passthrough deduction in the TCJA reflects not only the current bill's legislative history, but also the long legislative history leading up to the TCJA passage, as Congress sought a solution to the "passthrough problem" that had prevented earlier tax bills from advancing. The combined histories demonstrate a strong Congressional desire and intent that robust passthrough tax relief must accompany tax relief for corporations. The legislative record further demonstrates that passthrough business relief was frequently cited as the central pillar leading to the enactment of the TCJA.

Appropriately, the Proposed Regulations recognize that section 199A was intended to broadly benefit a wide spectrum of businesses, with exclusions for certain service business income. As noted on page 54, the proposed regulations state: "Most importantly, section 199A is a new Code provision intended to benefit a wide range of businesses, and taxpayers need certainty in determining whether their trade or business generates income that is eligible for the section 199A deduction." This specific language is used to support the rationale for a more tailored approach to the definition of specified service trades or businesses (SSTB), but we believe it is appropriately analogized more broadly to reflect the intent for section 199A to benefit non-corporate businesses broadly. The FEA believes the updated guidance should reflect this broad intent, including the rules pertaining to passthrough business owners with like-kind exchange-acquired qualifying property. This is not to request special treatment, but rather equal treatment that maintains a level playing field with corporations and other passthrough businesses.

IRC Section 199A(h)(2) provides Treasury with the direction to determine and define the UBIA of property acquired in a like-kind exchange. The Proposed Regulations approach to UBIA is clarified through Example 2 of sec. 1.199A-2(c)(4), which states that UBIA of the replacement property acquired in a like-kind exchange is the ***adjusted*** ("carryover") basis of the relinquished property at the time of the exchange. This treatment is distinguished from the qualified property in Example 1, which provides that the UBIA of the property is its original section 1012 cost basis "regardless of any later depreciation deductions under section 168(a) and resulting basis adjustments under section 1016(a)(2)."

Recommendation: The UBIA of the replacement property should be the actual, ***unadjusted*** basis immediately after the acquisition of the relinquished property by the taxpayer on the placed-in-service date, rather than the ***adjusted*** basis at the time the relinquished property is exchanged into the replacement property, plus any new capital invested.

The end result of the Proposed Regulations' use of the adjusted basis for like-kind exchange-acquired replacement property is overly harsh and runs counter to the underlying purpose of sections 199A and 1031, which was affirmatively retained for real estate. The ability to defer gain under section 1031 is completely separable and reflects a different Congressional priority of promoting capital formation when there is continuity of business investment. We agree that the general 1031(d) carryover basis rule is completely appropriate for measuring capital gain recognition and allowable depreciation in like-kind exchange transactions. However, as the Proposed Regulations have been drafted, the same cannot be said of its use in the context of testing the section 199A deduction eligibility.[1]

In section 1031, Congress provided that the replacement property should "step in the shoes" of the exchanged property. Following this general scheme and the nonrecognition principles of section 1031, the UBIA of the replacement property should be the UBIA of the relinquished property, rather than the adjusted basis for the exchanged property, plus any new investment. This approach would also be consistent with the "step in the shoes" rule for determining the depreciable period under section 199A. We believe that for the sake of administrative simplicity and consistency, Treasury and the IRS should revisit their UBIA definition to provide that the UBIA of the exchanged property remains as its unadjusted cost basis without reduction for any depreciation.

Treasury rules that reflect that a like-kind exchange represents a continuation of investment rather than a current acquisition would be consistent with the legislative history and purpose of section 1031. Congress enacted section 1031 to delay the immediate recognition of capital gains so long as the value of the relinquished property (sale proceeds including debt) continued to be invested by the business owner in qualifying property. Section 1031 is premised not only on the tax policy of continued investment and the legislative intent of increasing transactional activity and investment, but also on avoiding the unfairness of taxing a paper gain when the taxpayer remains invested and there has been no "cashing out." It is a provision designed to stimulate investment and to determine timing for recognition of gain on capital investments. Thus, for the purpose of testing the unadjusted basis, the "acquisition" of the relinquished property should be when that property was actually acquired, rather than the exchange date.

[1] Section 1031(d) provides that the "basis" of a replacement property is the "basis" of the relinquished property (as adjusted for recognized gain or loss and money received). Under the TCJA, depreciable property will have "two bases"—UBIA for purposes of section 199A and adjusted basis for other purposes. Following a like-kind exchange, the replacement property should take the two bases (UBIA and adjusted) of the relinquished property as its own two bases.

For certain business owners above the specified income threshold, the definition of UBIA will be the primary determining factor for whether they are eligible for the section 199A deduction or will be unable to deduct otherwise eligible qualified business income (QBI). This is particularly true for non-corporate real estate businesses for which Congress added the UBIA capital limitation test. Congress included the capital limitation test to supplement the former section 199A wage test based on the recognition that real estate and other capital intensive businesses likely would not have paid sufficient wages to qualify under the wage limitation. The record shows that Congress did not intend to limit the deduction for critical economic sectors, such as real estate.

The Proposed Regulations, as currently drafted, would disadvantage passthrough business taxpayers with like-kind exchange-acquired qualified property by requiring them to take a significantly reduced basis in the replacement property based upon the depreciated carryover basis of the relinquished property. Importantly, for taxpayers who have owned the qualifying business property for a significant period of years or who have taken advantage of accelerated depreciation, requiring the carryover of the reduced, adjusted tax basis to the replacement property would, in all likelihood, result in the elimination of any meaningful deduction of their QBI under Section 199A.[2]

The proposed rule will discourage like-kind exchanges for passthrough business taxpayers by providing an incentive to simply retain the property to achieve a greater amount of UBIA. This outcome would slow real estate transactions and could reduce liquidity in the real estate market and inhibit needed capital investments and improvements. 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, generates taxable income and jobs. From a tax and economic policy perspective, a section 199A eligible taxpayer should be no better or worse off with respect to UBIA as a result of engaging in a congressionally-encouraged transaction.

Section 199A is an operating business income tax benefit, enacted as a way to provide non-corporate businesses with a lower effective rate that approximates the corporate rate reduction. The final regulations

[2] The capital limitation calculation under Sec. 199A(b)(2)(B) uses 2.5% of UBIA of qualified business property plus 25% of qualified business wages paid. Assuming a taxpayer has an actual cost basis in relinquished real property of $1 million and no W2 wages, the taxpayer would be eligible for a maximum $25,000 deduction, relative to this asset, under Sec. 199A. If the taxpayer's adjusted basis after a period of years was $500,000, the maximum Sec. 199A deduction would still be $25,000. However, after exchanging into a $1 million replacement property, the QBI deduction would be reduced by half, to $12,500, under the proposed regulations that would require use of the adjusted carryover basis for UBIA. Under the proposed rule, the passthrough taxpayer would have to acquire replacement property worth at least 50% more than the relinquished property, $1.5 million, adding an additional $500,000 of new capital, just to maintain the same $25,000 QBI deduction. This is a significant penalty for taking advantage of Sec. 1031 benefits, and is a strong inducement to forego the transaction altogether and retain the relinquished property.

should consider and give effect to the tax policy and legislative purposes underlying both of these individual code sections. Relative to the current Proposed Regulations, a rule defining the UBIA of the replacement property as the UBIA of the relinquished property, plus any new capital invested, rather than the adjusted, carryover basis, better reflects the statutory construction and Congress's intent. Moreover, this suggestion takes a more neutral approach, in which a taxpayer would be no better or worse off with respect to UBIA as a result of engaging in a nonrecognition transaction. The rule in the Proposed Regulations does not pass this test, as taxpayers will always have a lower UBIA for replacement property under the proposed regulation than they had in their relinquished property.

Thank you for your consideration of this request. We appreciate the opportunity to submit these comments and would welcome the opportunity to meet with you to discuss our letter in greater detail or to assist in any way that would be helpful. Please contact any of the below should you wish to discuss.

Respectfully submitted,

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