FEA
FEDERATION OF EXCHANGE ACCOMMODATORS

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Report on Current IRC Section 1031 Exchange Activity

Who is 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 §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 or rental real estate to more complex transactions involving aircraft, trucks, trailers, containers, railcars, heavy equipment 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.

Current Level of §1031 Activity

The FEA surveyed its members in May, 2011 to get a quantifiable measure of the decline in overall §1031 activity between 2006 and 2010 and the nature of exchanges being facilitated (see Appendix). Overall, the drop-off has been exponential, leading one to conclude that the estimated $15.6 billion tax expenditure attributed to §1031 exchanges by the US Senate Committee on the Budget (using the same estimate as the Joint Committee on Taxation) in the Tax Expenditures Compendium for the period of 2010-2014 is unrealistically high. We believe that a more appropriate estimated tax cost is about $2.9 billion, just 19% of the 2010 estimate.

Our membership has dropped by 60%, from 374 members in 2006 to 150 members in 2011 due to lack of business and decisions to exit the business as reported by withdrawing members. Of the 40% of professional Qualified Intermediaries that have survived, our survey indicates an 81% drop in overall activity between 2006 and 2010. Nevertheless, the 2010 Tax Expenditures report reflected virtually the same estimated tax cost, using $15.5 billion in 2006 and $15.6 billion in 2010. Although FEA members have no means by which to calculate the dollar value of actual tax deferrals taken by their clients, it is fair to conclude that if overall exchange activity has dropped by at least 81% (not taking into account the 60% drop in exchange facilitators), then there must be a corollary drop in tax deferrals. This conclusion is buttressed by the fact that there is simply much less gain embedded in many investments, especially real estate, so there is less potential in the near term for a §1031 transaction. Until the market recovers in the next several years, and depending on the individual taxpayer position, there will be less "tax expenditure" revenue loss attributable to §1031.

While it is no surprise that the slumping economy has severely reduced the number of exchange transactions, the viability of exchanges remains strong. As the economy improves, §1031 exchanges will remain a vital part of our economic growth. The ability to defer taxes will stem any backsliding, allowing taxpayers to preserve their current position so they may invest with confidence in new assets. Most importantly, exchanges will stimulate reinvestment that must remain in the United States to qualify for tax-deferral treatment.

Nature of Exchange Transactions

The Tax Expenditures Compendium implies a perspective that §1031 exchanges, unlike §1033 involuntary conversion exchanges, are used primarily by sophisticated real estate investors who are restructuring their holdings into other types of properties without any tax consequences. Our recent survey indicates that this is not at all the case. Our members reported that overall, 75% of the §1031 exchanges they facilitated would meet both the tests of "like-kind" as well as the stricter standard of "similar or related in service or use" required under §1033. Survey data reflects predominantly real estate and single asset personal property exchanges. Personal property "program exchanges" involving vehicles and other smaller assets would be virtually 100% compliant with the "similar use" standard. Essentially, most taxpayers reinvest in what they know best.

Of the exchange activity reported by 70 diverse members, including some of the largest as well as some of the smallest QI companies, 36% of total transactions had an average size (as measured by gross sale price of relinquished property) of less than $500,000. Qualified Intermediaries representing 59% of total transactions reported an average sale price of less than $1,000,000 and QIs representing only 5% of total transactions reported an average deal size in excess of $2,500,000. The survey results quantify that §1031 exchanges benefit ***all*** taxpayers, the vast majority of whom are engaged in relatively modest transactions.

Tax Reform Implications

Tax reform aimed at reducing the deficit has renewed efforts to simplify the tax code and eliminate loopholes. IRC §1031 is neither a loophole, nor a tax-free or tax savings vehicle. It provides only a temporary deferral with an offsetting reduction in future depreciation deductions available for assets acquired through an exchange.

The non-recognition exchange policy is premised on the understanding that the taxpayer continues with the same qualifying investment with no intervening constructive or actual receipt of cash. This permits efficient use of capital while allowing taxpayers to shift to more productive like-kind property, change geographic locations, diversify or consolidate holdings, or otherwise transition to meet changes in business needs or lifestyle. Tax-deferred exchanges provide an important stimulus to a multitude of economic sectors, having local, national and global effect.

- Owners of domestic real estate are encouraged by the tax benefits to reinvest in U.S. real estate, rather than place their money in other or foreign investments. An automobile manufacturer, for example, cannot receive tax deferral benefits by shuttering a US plant, and moving the facility to Asia. §1031 provides a strong incentive to multinational companies to maintain and increase investments in the US.
- The tax deferral benefits of §1031 serve to stimulate the manufacturing economy, encouraging companies to replace and upgrade machinery and equipment, stimulating

purchases and sales of machinery, equipment, railcars, aircraft, trucks and other vehicles sooner, because tax on the gain can be deferred.

- Elimination of §1031 would have a chilling effect on a variety of business transactions, including sales and purchases of real estate, machinery, equipment and leased assets.
- Without the tax incentive, many transactions will be put off, and real estate values will be further eroded.
- Fewer transactions also translate into fewer jobs in the §1031 exchange industry, and in the real estate, construction, title insurance, mortgage and other related industries, equipment lease financing, vehicle and heavy equipment manufacturing, after-market alteration, customization and installation industries.
- At the end of the economic chain, fewer transactions ultimately result in fewer jobs at local restaurants, dry cleaners and other local small businesses that generate revenue from the after tax dollars of employed workers.
- Bottom line, without the current treatment under §1031, cash-strapped owners of business-use and investment assets could be forced to downsize their businesses if they didn't have sufficient cash to acquire replacement assets *and* pay tax on the gain or recapture of the old asset.

Tax Simplification

Proposals have been made in the past to "simplify" IRC §1031 by shifting to a rollover which would result in more complexity for taxpayers, eliminate the value provided by the QI, and reduce the compliance rate for §1031 transactions. QIs create and provide necessary form documentation for a §1031 exchange, serve as a resource to taxpayers and their advisors, and as unofficial gate-keepers for the IRS. The FEA strongly opposes transition to a "rollover" as unneeded, less user-friendly and more costly to taxpayers; problematic from an enforcement standpoint, creating uncertainty in the process; and having the potential to foster unintentional abuse, resulting in a revenue negative situation for the IRS. Ultimately such a proposal would put QIs out of business, harming predominantly small businesses that provide customers a useful service at a reasonable price.

- Professional Qualified Intermediaries provide technical services beyond the mere holding of taxpayers' exchange funds.
- Our members are subject matter experts in the realm of §1031 exchanges, providing information, education and training to taxpayers and their accountants, attorneys, financial advisors and real estate brokers. Many FEA members have attorneys, accountants and industry-credentialed Certified Exchange Specialists® on staff.
- QIs routinely inform taxpayers and their advisors of the rules related to like-kind exchanges, including whether proposed transactions will meet the standards to qualify for exchange treatment, and whether particular properties are like-kind.
- QIs typically are paid a small fee to facilitate a specific exchange and do not usually receive any fees for all of the educational and resource services provided to the advisor community and to taxpayers.
- The QI safe harbor provides a substantial free benefit to the government because QIs promote compliance with the technical requirements for proper exchange treatment, without which, tax revenue would decrease through improperly claimed §1031 treatment and increased auditing costs.

Summary

Section 1031 provides significant benefits to taxpayers of all sizes with a "trickle down" economic stimulus effect on a myriad of industries and small businesses across the country. Given the current economy and forecasts over the next few years, a realistic estimate of the tax cost of §1031 is insignificant to deficit reduction. Eliminating or restricting §1031 would not make a meaningful impact upon tax reform or tax simplification and would do more harm than good.

Appendix

FEA Member Analysis of 2010 IRC Sec. 1031 Exchange Activity		
	Number	Percentage
Total # of Members 2006	374	
Total # of Members 2011	150	
Drop in Members 2006-2011	224	60%
Number of Respondents / Percent of FEA Members	70	47%
Total # of Exchanges 2006	47319	
Total # of Exchanges 2010	9004	
Percentage drop off 2006-2010		81%
2010 Transactions average sale < $100,000	690	8%
2010 Transactions average sale $100,000 - $249,999	350	4%
2010 Transactions average sale $250,000 - $499,999	2198	24%
2010 Transactions average sale $500,000 - $749,000	1693	19%
2010 Transactions average sale $750,000 - $999,999	318	4%
2010 Transactions average sale $1,000,000 - $2,499,999	3225	36%
2010 Transactions average sale $2,500,000 - $4,999,999	432	5%
2010 Transactions average sale $5,000,000 - $10,000,000	0	0%
2010 Transactions average sale > $10,000,000	0	0%
No Average Sale data	98	1%
Percentage of Transactions Meeting "Similar Use" Standard		75%

Note: Survey data reflects predominantly real estate and single asset personal property exchanges. It does not include program exchanges of relatively low cost personal property assets, such as vehicles or heavy equipment.