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The Honorable Senator John Thune
Business Tax Reform Working Group Chairman
Senate Committee on Finance
219 Dirksen Senate Office Building
Washington, D.C. 20510

Via email: business@finance.senate.gov

The Honorable Senator Ben Cardin
Business Tax Reform Working Group Co-Chairman
Senate Committee on Finance
219 Dirksen Senate Office Building
Washington, D.C. 20510

Comments regarding IRC Section 1031 Like-Kind Exchanges

Dear Senators Thune and Cardin:

The Federation of Exchange Accommodators ("FEA"), the industry association for exchange facilitators, also known as Qualified Intermediaries, thanks you for inviting comments related to tax reform. We support the overall goals of tax reform: economic growth, fairness, efficiency, revenue neutrality, competitiveness, and investment, leading to job creation and a stronger economy. Equally important, we encourage the preservation of incentives for investment in real estate and other hard assets, equipment and machinery used by growing businesses to spur economic growth and productivity. We hope that in the lengthy, methodical process of tax reform, careful deliberation and moderation will be employed to achieve these desirable goals without creating unintended consequences of unfairness and economic stagnation. To this end, we strongly encourage retention of current law regarding IRC Section 1031 like-kind exchanges.

Since 1921, IRC §1031 like-kind exchanges have encouraged capital investment within the United States by allowing businesses to upgrade, relocate, or transition assets, in a tax-deferred manner, to better meet current business needs by enabling reinvestment of the full value of the divested assets into the continuing business. **The tax deferral benefit is predicated on the sound tax policy of continuity of investment which recognizes the fundamental unfairness of taxing a "paper" gain when there has been no cashing out or profit-taking.** This continuity of investment policy underlies other business tax deferral provisions, such as contributions of assets to partnerships and corporations.

Like-kind exchanges are relied on extensively by small businesses and taxpayers in multiple industries. The transactional activity spurred by §1031 supports jobs, taxable wages and revenue for a broad spectrum of ancillary service providers and suppliers involved in the underlying transactions, such as brokers, dealers, surveyors, appraisers, insurers, title and escrow agents, attorneys, accountants and other small businesses whose livelihood depends on the after-tax dollars of gainfully employed workers.

At its core, §1031 is fair to taxpayers of all sizes and to the government. It is neither an abusive loophole nor a tax avoidance or tax saving vehicle; it provides only a timing benefit. The deferred tax is ultimately paid; in most cases, this occurs incrementally, beginning immediately following the exchange. This is because the tax basis of replacement property is reduced by the exact amount of gain not recognized due to the exchange. The taxpayer forgoes future depreciation deductions (equal to the unrecognized gain) on the replacement property, which results in incrementally higher annual income, taxed at ordinary income tax rates. The impact of reduced depreciation is that over the life of the asset, like-kind exchanges of depreciable property are essentially revenue neutral; Treasury maintains a consistent tax position over the life of the asset, regardless of whether the taxpayer holds, sells or exchanges. Tax on any remaining unrecognized gain is collected either 1) upon sale of the replacement property, or 2) 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.

In an effort to be a productive participant in the tax reform process, a coalition¹ of 12 diverse associations representing businesses in the real estate, equipment / vehicle rental and leasing, agriculture, and exchange facilitation industries commissioned Ernst & Young LLP to do an analysis of the macroeconomic impact on the U.S. economy of repealing I.R.C. §1031 like-kind exchanges. The findings are documented in the attached March, 2015 report titled [**Economic Impact of Repealing Like-Kind Exchange Rules**](#) ("EY Study").

The **major findings**, detailed in the accompanying report, are that repeal of §1031 would cause:

- **Longer holding periods** (the "lock-in" effect), greater reliance on debt financing, and less-productive deployment of capital in the economy, resulting from higher tax burdens on business transactions.
- **Increase in the cost of capital**, discouraging investment, entrepreneurship and risk-taking, and slowing the velocity of investment.
- **Slower economic growth**, reduced levels of investments, and reduction of gross domestic product (GDP), even if the revenue generated from repeal was used to lower tax rates.
- **Concentrated burden** in those industries that rely heavily on like-kind exchanges, such as real estate, construction, truck transportation, equipment / vehicle rental and leasing with **an aggregate drop in annual GDP of \$26 billion** on the 10 most impacted industries.
- **The total impact on overall long-term U.S. GDP would be an annual drop of \$8.1 billion.**

The EY Study shows that without like-kind exchanges, businesses and entrepreneurs would have less incentive and ability to make real estate and other capital investments. The immediate recognition of a gain upon the disposition or "trade-in value" of property being replaced would impair cash flow and could make it uneconomic to replace old assets with new assets more

¹ The Section 1031 Like-Kind Exchange Coalition members: Alternative & Direct Investment Securities Assn., American Car Rental Assn., American Rental Assn., Associated Equipment Distributors, Equipment Leasing and Finance Assn., Federation of Exchange Accommodators, International Council of Shopping Centers, Inc., Iowa Soybean Assn., National Assn. of Real Estate Investment Trusts, National Association of REALTORS®, National Multifamily Housing Council, The Real Estate Roundtable

suitable to the current needs of the business. Requiring recognition of gain on like-kind exchanges would hamper the ability of businesses to be competitive in our global marketplace.

The EY Study concludes that repeal of §1031 would be at cross-purposes with the stated goals of tax reform. Repeal would impact the U.S. economy adversely by discouraging investment, causing a reduction in GDP, a contraction in the economy, and would unfairly burden certain industries and taxpayers. Moreover, a reduction in GDP would result in less tax revenue, thus, repeal of §1031 would not be revenue neutral in the long run.

In light of the quantified data from the study, please consider the following:

- **Section 1031 is a powerful economic stimulator, encouraging investment in small and medium-sized growing businesses, thereby promoting U.S. job growth.** 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 vehicles, machinery and equipment. This transactional activity stimulates 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 significant spillover economic stimulus to a myriad of industries and small businesses across the country. **This deferral benefit permits efficient use of capital to preserve and manage cash flow, and also encourages U.S. businesses to reinvest in their domestic operations, rather than offshoring business activity.**
- **Elimination of §1031 would tax cash flow, not wealth, and would inhibit capital formation.** Section 1031 promotes continuity of investment by the taxpayer without reducing cash flow available for business growth. 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; instead, profits are 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 the owner of a productive asset directly reduces the cash flow available for reinvestment into other productive assets thereby hindering capital formation.
- **Repeal of §1031 would cause a decline in real estate values.** A significant amount of commercial, industrial, multi-family and agricultural real estate transactions involve §1031 exchanges. These types of assets are highly illiquid, making it difficult to generate a profit and requiring long-term investment. Repeal of §1031 would have a chilling effect on real estate investment. Without the tax-deferral incentive, many transactions would be abandoned or delayed, causing stagnation in the real estate marketplace and blight in neighborhoods. Investors would be motivated to invest in more liquid, non-real estate investments in which profits can be realized sooner. Additionally, a decline in real estate values would imperil the U.S. banking system through reduction of value of real estate loan collateral, potentially 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.

- **Section 1031 is not administratively difficult for either the IRS or taxpayers.** Like-kind exchanges conducted within the regulatory safe harbors under §1031 using professional Qualified Intermediaries 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. Professional Qualified Intermediaries are subject matter experts who simplify §1031 by guiding clients and their tax advisors through the process, providing proper documentation, holding funds, and offering other services. Qualified Intermediaries function as unofficial gate keepers for the IRS, promoting compliance with the technical requirements for proper exchange treatment.
- **The definition of like-kind is well understood.** Section 1031, enacted in 1921, and Treasury Regulations in effect since 1991 provide specific frameworks for determining whether assets are “like-kind” and specifically provide that real estate within the U.S. is not like-kind to real estate located abroad. Similarly, personal property assets used predominantly within the U.S. are not like-kind to the same type of asset to be used predominantly in a foreign country. Simply put, §1031 encourages reinvestment in the U.S. and in U.S. operations.

In conclusion, the Federation of Exchange Accommodators strongly urges you to consider the enormous benefits that Section 1031 exchanges provide to the US economy, and the harm that would come from removing this powerful engine from our economy.

Should you have any questions or wish to discuss, please do not hesitate to contact any of us.

Sincerely,

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