



*The Voice of the 1031 Industry*

1255 SW Prairie Trail Pkwy  
Ankeny, IA 50023  
Phone: (515) 244-6515  
Fax: (515) 334-1174  
[www.1031.org](http://www.1031.org)

## Statement for the Record

### Hearing on FY2018 Budget Proposals for the Department of Treasury and Tax Reform

Committee on Finance  
United States Senate

June 1, 2017

As the Committee meets with the Secretary of the Treasury to consider budget and tax priorities, the Federation of Exchange Accommodators ("FEA") appreciates this opportunity to provide input regarding tax reform priorities and specifically, the benefits and need for retention of IRC Section 1031 like-kind exchanges, in present form, in any tax reform bill.

Although there is no specific proposal from either the Senate or the Administration currently calling for repeal or replacement of §1031, the House Ways and Means Committee is evaluating a number of proposals, set forth in the House Republican Conference's "A Better Way" document released in June, 2016. Better known as the House Republican Blueprint for Tax Reform, it 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.

**The Blueprint 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.** Even with lower tax rates and immediate expensing, Section 1031 will still be necessary to remove friction from transactions and fill in the gaps.

**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 commercial, agricultural and rental real estate, aircraft, trucks, automobiles, trailers, containers, railcars, agricultural equipment, heavy 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<sup>1</sup>. 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 taxpayers.<sup>2</sup> A 2016 Tax Foundation report estimated a significantly larger economic contraction of approximately \$18 billion per year.<sup>3</sup>

**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 upgrade machinery, equipment or vehicles into newer assets that better meet current and future needs. 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.

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 defer depreciation recapture tax 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.

**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 on average, 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 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. 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

---

<sup>1</sup> *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/>.

<sup>2</sup> Ernst & Young LLP, *Economic Impact* at (v) and Ling and Petrova, *Economic Impact*, at 6

<sup>3</sup> *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.

**Many 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.

**Retiring taxpayers benefit by exchanging their most valuable asset, their farm, ranch, or apartment building, for other real estate that doesn't require a 24/7/365 workday, 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 4<sup>th</sup> 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.

Appraising 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 taxpayer with a clear incentive 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.<sup>4</sup> 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

---

<sup>4</sup> 26 CFR 1.1031(k)-1

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.

- 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 that would not otherwise benefit from the proposed Blueprint.** 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,

Stephen Chacon, President, Federation of Exchange Accommodators  
Vice President, Accruit, LLC  
1331 17<sup>th</sup> St., Suite 1250  
Denver, CO 80202 (303) 865-7316, [stevec@accruit.com](mailto:stevec@accruit.com)

Suzanne Goldstein Baker, Co-Chair, FEA Government Affairs Committee,  
Executive Vice President & General Counsel, Investment Property Exchange Services, Inc.  
10 S. LaSalle St., Suite 3100  
Chicago, IL 60603 (312) 223-3003, [suzanne.baker@ipx1031.com](mailto:suzanne.baker@ipx1031.com)

Brent Abrahm, Co-Chair, FEA Government Affairs Committee  
President, Accruit, LLC  
1331 17<sup>th</sup> St., Suite 1250  
Denver, CO 80202 (303) 865-7301, [brenta@accruit.com](mailto:brenta@accruit.com)

Max A. Hansen, Co-Chair, FEA Government Affairs Committee,  
President, American Equity Exchange, Inc.  
P. O. Box 1031  
Dillon, MT 59725 (406) 683-6886, [max@irc1031x.com](mailto:max@irc1031x.com)