The Voice of the 1031 Industry

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Economic Impact of IRC §1031 Like-Kind Exchanges – Clearing Misconceptions and Setting the Facts Straight

A number of tax reform proposals, aimed at reducing the deficit, simplifying the tax code and eliminating certain tax deductions, credits and deferrals have included a call for restrictions on, or outright repeal of, Internal Revenue Code §1031. The rationales for these proposals are predicated on a number of misconceptions about like-kind exchanges, including who the primary beneficiaries of the provision are and the ultimate impact to the Treasury.

IRC §1031 is, at its core, 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 ownership in qualifying replacement property with no intervening receipt of cash. At the conclusion of the exchange the taxpayer is in the same tax position as if the relinquished asset was never sold. This valuable Section should be retained in its current form as it accurately reflects the economic reality of every exchange.

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. Taxes which otherwise would be due if the transaction was structured as a sale are deferred. Section 1031 transactions range from relatively simple “trade-ins” or 2-party “swaps,” to more complex non-simultaneous §1031 exchanges involving separate buyers and sellers. Prior to the passage of the 2017 tax act, commonly referred to as the Tax Cuts and Jobs Act (“TCJA”), qualifying assets included commercial, agricultural and rental real estate, aircraft, trucks, trailers, containers, railcars, agricultural equipment, heavy equipment, livestock and other assets involved in a broad spectrum of industries. Effective January 1, 2018, the TCJA limits the application of IRC §1031 only to real property not held primarily for sale.

The Treasury Regulations governing non-simultaneous exchanges require the use of an independent third-party Qualified Intermediary (“QI”). The QI, operating under safe harbors set forth in the Regulations and other official guidance, holds the sale proceeds for the benefit of the taxpayer during the exchange, disburses funds for purchase of like-kind replacement property, returns any unused funds to the taxpayer at termination of the exchange and promotes technical compliance of the Regulations. Section 1031 exchanges must be completed within 180 days. Taxpayers recognize gain and pay tax on any unused funds or when they ultimately sell the replacement property and “cash out” of their investment.

The Facts about Section 1031

- **Elimination of §1031 like-kind exchanges would not raise significant revenue and would be at cross-purposes with the stated goals of tax reform.** When the impacts of the economic stimulus effect of §1031 are taken into account, any revenue raised from elimination of §1031 would be negligible. Ernst & Young LLP’s 2015 Report on the Economic Impact of Repealing Like-Kind Exchange Rules found that **repeal of §1031 would cause** 1) **longer holding periods** and less-productive deployment of capital in the economy; 2) **increased cost of capital;** 3) **reduced levels of investments**; 4) **slower economic growth**; 5) a **concentrated burden** in those industries that rely heavily on like-kind exchanges and; 6) **long-term contraction in overall U.S. GDP of approximately $8.1 billion annually**. The loss to GDP over a 10 year period would be $61 - $131 billion, depending upon the “pay for” use of the repeal, including tax rate reduction.

- **Like-kind exchanges are essentially revenue neutral over the tax life of depreciable assets because gain deferred is directly offset by a reduction in future depreciation deductions available for assets acquired through an exchange.** The tax basis of newly acquired replacement property is reduced by the amount of the gain not recognized due to the exchange of the sold property. Thus, the taxpayer forgoes an equal dollar amount of future depreciation deductions on the replacement property, resulting in increased annual taxable income over time, taxed at ordinary income tax rates.

- **§1031 is not an unfair tax break for the wealthy or large corporations.** On the contrary, it is one of the few incentives available to and used by taxpayers of all sizes, including individuals, partnerships, limited liability companies, and corporations. A 2011 industry survey showed that 60% of exchanges involve properties worth less than $1 million, and more than a third are worth less than $500,000.

- **Elimination of §1031 would tax cash flow, not wealth, because tax deferral benefits are only available if the taxpayer reinvests in like-kind replacement property.** Section 1031 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. The value of assets exchanged, whether farmland, commercial or rental residential real estate,remains invested in the taxpayer's business. **The taxpayer doing a §1031 exchange is not taking any profit from this transaction; proceeds from the sale of relinquished assets must be reinvested in qualifying replacement assets.** This is in stark contrast to taxing the gain on the sale of one stock for another stock. Stocks are relatively liquid, third party investments in someone else's business. §1031 exchanges are available only to direct owners of business-use or investment assets, which by their nature, are illiquid. Taxing third party investors on their profits from the sale of stock does not impact the cash flow or operation of the business; but a tax to the direct owner of a productive asset directly reduces the cash flow available for reinvestment into other productive assets.

- **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, generate jobs and taxable income through business profits, wages, commissions, insurance premiums, financial services, and discretionary spending by gainfully employed workers.

- **Taxes are not eliminated. At some point the tax gets paid.**

    - **Most replacement properties are disposed of through a taxable sale, not through a subsequent like-kind exchange.** Professors David Ling and Milena Petrova reported in their Economic Impact of Repealing or Limiting Section 1031 Like-Kind Exchanges in Real Estate (2015) that 88% of real estate properties acquired through an exchange are later sold in a taxable transaction, and because of lower debt and greater capital investment rates, **the taxes paid on sale of these properties are significantly greater than that of non-exchanged properties.**

    - **Section 1031 exchanges structured under the Treasury Regulations safe harbors are neither tax savings vehicles nor "abusive tax avoidance schemes."** Rather, they are legitimate transactions utilizing an important tax planning tool. Payment of tax occurs: 1) incrementally, beginning immediately following the exchange, through increased income tax due to foregone depreciation; 2) upon sale of the replacement asset; or 3) 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**. It should also be noted that taxpayers utilizing §1031 exchanges include corporations and other business entities that cannot "take the gain to the grave."

- **The Congressional purposes for which Section 1031 was enacted in 1921 are even more relevant today in our global economy.** Two of the primary purposes: 1) to avoid unfair taxation of ongoing investments in property and 2) to encourage active reinvestment, are both even more relevant today in our global economy than they were in 1921. The third purpose disclosed by the legislative history, administrative convenience, i.e. "the difficulty of valuing exchanged property," ceased to be relevant to the policy underlying the statute in 1924. Moreover, §1031 has survived repeated Congressional scrutiny because 1) it is based on sound tax policy that prevents taxation of gain (or deductions for losses) when there is continuity of investment and no cashing out, and 2) it stimulates the economy through transactional activity.

- **The definition of "like-kind" is well understood**. **Section 1031 is neither administratively difficult for either the IRS or taxpayers, nor is it abusive.** Treasury Regulations in effect since 1991 provide specific frameworks for determining whether assets are "like-kind." Like-kind exchanges conducted within the regulatory safe harbors under §1031 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.

- **§1031 promotes efficient use of productive capital and cash flow:** §1031 allows **t**axpayers 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.

- **§1031 exchanges contribute significantly to the velocity of investment in the U. S. economy.** §1031 stimulates not only real estate transactions, but also, prior to the enactment of the TCJA, encouraged companies to replace and upgrade machinery and equipment, promoting purchases and sales of machinery, equipment, railcars, aircraft, trucks and other vehicles sooner, because tax on the gain can be deferred. It is important to note, however, that the extension of bonus depreciation as well as the expanded expensing provided by IRC Section 179 for non-real estate asset classes will be gradually phased out and eliminated by 2026. 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.

- **Elimination of §1031 would have a chilling effect on real estate, manufacturing and other business transactions.** Both the macroeconomic Ernst & Young LLP and the microeconomic Ling & Petrova studies referenced above concluded that without the tax incentive, many transactions would be delayed or abandoned, and real estate values would erode.

- **§1031 stimulates the agricultural sector.** Farmers and ranchers use §1031 to combine acreage or acquire higher grade land or otherwise improve the quality of their operations. Retiring farmers are able to exchange their most valuable asset, their farm or ranch, for other real estate without diminishing the value of their life savings.

- **§1031 is used to promote conservation and environmental policies.** Grants of conservation easements can be structured as tax-deferred exchanges, facilitating government and privately funded programs designed to improve water quality, reduce soil erosion, maintain wetlands and sustain critical wildlife habitat. These exchanges also enable landowners to acquire replacement farm or ranchland in less environmentally sensitive locations.

  Prior to the passage of the TCJA, §1031 permitted high volume owners of personal property assets, such as cars, trucks, tractors, trailers, heavy equipment, rail cars, mining and agricultural equipment, to preserve cash flow and increase transactional volume. Unlike real estate assets, which *appreciate* in value, gain on personal property business use assets is derived by calculating the difference between the fair market value of the used equipment and its *depreciated* tax basis. The impact of bonus depreciation, intended to stimulate manufacturing and sales by allowing a disproportionately large first year depreciation deduction of the value of the asset, has left taxpayers with artificially low tax basis on relatively young equipment. Without §1031, an equipment leasing company that wishes to *replace* equipment that has a zero tax basis would lose approximately 40% of the value of the sold asset to taxes. This would result in a direct reduction of cash flow available for purchase of new equipment. Owners and lessors of equipment and fleets utilize §1031 safe harbor guidelines to appropriately manage nonrecognition of gain when assets are replaced, preserving cash flow, and preventing a forced downsizing of the business.

- **Absent the deferral permitted under §1031, cash-strapped owners of business-use and investment assets could be forced to downsize their businesses, farms, ranches, real estate holdings, and qualified asset holdings** if they don't have sufficient ***additional*** cash flow to acquire replacement assets ***and*** are required to pay tax on the gain or depreciation recapture of the old asset.

- **An overall decline in real estate values caused by elimination of §1031 would cause further challenges to the banking system and a reduction of available credit, further stifling economic activity.** A drop in real estate values creates a reduction in equity value that, in turn, cascades into devaluation of collateral for loans which results in technical defaults under commercial loan agreements. Most commercial real estate loans have 3 to 7 year terms. If the property value has dropped when the loan is due for renewal, the debt/equity (i.e. "loan to value") ratio will be upside down, and the owner (borrower) will be required to add more capital (i.e. the approved loan amount will be reduced requiring a partial pay down). Under the best of circumstances, this results in an inability for the owner to increase his portfolio through investment in other real estate, because he must use that capital for the existing real estate. Under the worst of circumstances, when the owner lacks the capital now required to maintain the existing real estate loan, that loan will be pushed into foreclosure, causing a further reduction in value, not only for that parcel, but for other properties in that neighborhood.

Summary

Internal Revenue Code Section 1031 provides significant benefits to taxpayers of all sizes with direct and indirect economic stimulus effect on a myriad of industries and small businesses across the country. Economic policy efforts today focus on encouraging investment in productive assets, encouraging additional borrowing by qualified investors, increasing the velocity of transactions, redeploying underutilized or idle assets, and discouraging fearful contraction and cash hoarding. Section 1031 encourages just this type of growth by mandating reinvestment in like-kind assets, increasing ordinary income from additional investment in higher value assets and job growth, discouraging the hoarding of capital and penalizing profit taking by taxing value taken out of the economy. ***Section 1031 not only encourages reinvestment over profit taking, it provides a strong incentive to keep that investment at home, in the United States.***

About 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.

The FEA has a long history of efforts to simplify the practice of §1031 exchanges for all parties. The FEA has proposed modifications to Treasury Regulations and issuance of Revenue Rulings and Revenue Procedures to provide clarity and safe harbors to confusing, "grey" areas of §1031 practice. The FEA and its members have submitted comments in response to IRS Notices and Requests and have proposed §1031 projects for inclusion in the annual IRS Business Plan. The FEA has observed that even though there has been no formal "simplification" of §1031 and the Regulations since 1991, the guidance issued over the past two decades, with input from FEA members, has clarified the rules and eased the burden for taxpayers using tax deferred exchanges. The FEA will continue to review the regulations and statute to identify potential opportunities to make the exchange process simpler and more effective for taxpayers while maintaining fiscal soundness for the US Treasury.