FEDERATION of EXCHANGE ACCOMMODATORS
The Voice of the 1031 Industry

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Mr. Steven Rosenthal, Senior Fellow
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2100 M St., NW, 4th Floor
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Via email info@taxpolicycenter.org

Dear Mr. Rosenthal,

The Federation of Exchange Accommodators ("FEA") is the national industry association for Qualified Intermediary companies that facilitate IRC Section 1031 like-kind exchanges for taxpayers. We are very troubled by the misinformation about like-kind exchanges that has been published in numerous recent articles that attempt to explain the tax situation of Donald J. Trump. Since you have been quoted in some of these articles, we write to provide you with some practical and empirical data to dispel some common misunderstandings about how Section 1031 is used, and who benefits.

Pure real estate "developers" cannot benefit from Section 1031. Inventory is specifically excluded from §1031. Developers that merely build and sell improved real estate, along with "flippers" that rehab and sell, do not qualify for tax-deferral treatment. Qualifying properties must be held for investment or used productively in a trade or business.

Qualified Intermediaries are not Brokers. Those who facilitate Sec. 1031 exchanges are called Qualified Intermediaries, as defined by Treasury Regulations.[1] We do not put deals together, match buyers and sellers, or find properties for our clients. We are prohibited from acting as the agent of the taxpayer. Rather, following the technical rules set forth in the Treasury Regulations, we provide an administrative service, for a nominal fee, to facilitate transactions that our clients have put together. We also provide education to our clients and to the advisory community, which results in greater compliance with tax rules.

Like-kind exchanges are used by and benefit a broad spectrum of taxpayers. Like-kind exchanges allow taxpayers to exchange their property for more productive like-kind property, to diversify or consolidate holdings, and to transition to meet changing business needs. Like-kind exchanges are integral to the efficient operation and ongoing vitality of thousands of American businesses in a wide range of industries, business structures and sizes, which in turn strengthens the U.S. economy and creates jobs. These businesses—which include real estate, construction, farming, ranching, transportation, equipment / vehicle rental and leasing, and manufacturing—provide essential products and services to U.S. consumers and are an integral part of our economy.

Exchanged properties include real estate, construction and agricultural equipment, railcars, vehicles, barges and other investment and business-use assets. Exchanges of single family rental units and small apartment buildings by individuals of modest means are common. Farmers and ranchers exchange not only land, but also farm machinery and breeding livestock, permitting them to relocate or improve their operations without diminishing their cash flow. Additionally, Sec. 1031 encourages conservation

[1] 26 CFR 1.1031(k)-1(g)(4)

conveyances of sensitive lands to achieve environmental goals and provide recreational space for all Americans.

Like-kind exchanges encourage capital formation. Since 1921, like-kind exchanges have stimulated capital investment in the United States by allowing funds to be fully reinvested in the enterprise. These investments not only benefit the taxpayers making the like-kind exchanges, but also unrelated businesses upstream and downstream from the exchange transaction. Like-kind exchanges encourage the best use of real estate and fuel a new and used personal property market that significantly benefits small and mid-sized businesses. Eliminating like-kind exchanges or restricting their use would have a contraction effect on our economy by increasing the cost of capital, slowing the rate of investment, increasing asset holding periods and reducing transactional activity. Requiring the recognition of gain on like-kind exchanges would hamper the ability of businesses to be competitive in our global marketplace.

Economic impact studies have proven that like-kind exchanges stimulate the economy. A recent macroeconomic analysis by Ernst & Young found that either repeal or limitations of like-kind exchanges could lead to a decline in U.S. GDP of up to $13.1 billion annually.[2] The Ernst & Young study quantified the benefit of like-kind exchanges to the U.S. economy by recognizing that the exchange transaction is a catalyst for a broad stream of economic activity involving businesses and service providers that are ancillary to the exchange transaction, such as brokers, appraisers, insurers, lenders, contractors, suppliers, manufacturers, and others that support, augment or facilitate the exchange and the investment along with other small businesses whose livelihood depends on the after-tax dollars of gainfully employed workers.

A microeconomic study by Professors David Ling and Milena Petrova, focused on commercial real estate, supports that without like-kind exchanges, businesses and entrepreneurs would have less incentive and ability to make real estate and other capital investments.[3] The immediate recognition of a gain upon the disposition of property being replaced would impair cash flow and could make it uneconomical to replace that asset. This study further found that taxpayers engaged in a like-kind exchange make significantly greater investments in replacement property than non-exchanging buyers.

Both studies support that jobs are created through the greater investment, capital expenditures and transactional velocity that are associated with exchange properties. A $1 million limitation of gain deferral per year, as proposed by the Administration[4], would be particularly harmful to the economic stream generated by like-kind exchanges of commercial real estate, agricultural land, and vehicle / equipment leasing. These properties and businesses generate substantial gains due to the size and value of the properties or the volume of depreciated assets that are exchanged. A limitation on deferral would have the same negative impacts as repeal of Section 1031 on these larger exchanges. Transfers of large shopping centers, office complexes or hotel properties generate economic activity and taxable revenue for architects, brokers, leasing agents, contractors, decorators, suppliers, attorneys, accountants, title and property / casualty insurers, marketing agents, appraisers, surveyors, lenders, exchange facilitators and more. Similarly, high volume equipment rental and leasing provides jobs for rental and leasing agents, dealers, manufacturers, after-market outfitters, banks, servicing agents, and provides inventories of affordable used assets for smaller businesses and taxpayers of modest means. Turnover of assets is key to all of this economic activity. Without Section 1031 there would be much less liquidity in the real estate market as taxpayers refuse to sell and pay the tax, creating stagnation and a "lock in" effect which would be detrimental to the economy.

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[2] Ernst & Young, *Economic Impact of Repealing Like-Kind Exchange Rules,* (March 2015, Revised November 2015), at (iii), *available at* http://www.1031taxreform.com/wp-content/uploads/Ling-Petrova-Economic-Impact-of-Repealing-or-Limiting-Section-1031-in-Real-Estate.pdf.

[3] David Ling and Milena Petrova, *The Economic Impact of Repealing or limiting Section 1031 Like-Kind Exchanges in Real Estate* (March 2015, revised June 2015), at 5, *available at* http://www.1031taxreform.com/wp-content/uploads/Ling-Petrova-Economic-Impact-of-Repealing-or-Limiting-Section-1031-in-Real-Estate.pdf.

[4] *General Explanations of the Administration's Fiscal Year 2017 Revenue Proposals*, at 107, *available at* https://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2017.pdf

<u>Tax is ultimately paid on the overwhelming majority of exchanged properties.</u> Professors Ling and Petrova studied more than 1.6 million real estate transactions over an 18 year period and concluded that 88% of replacement properties acquired in a §1031 exchange were ultimately disposed of through a taxable sale, not a subsequent exchange. Moreover, the data disclosed that 34% of exchanges incur some tax in the year of the exchange.[5] Bear in mind that gain is recognized to the extent that any cash or non-like kind property is received.

<u>In summary, there is strong economic rationale, supported by recent analytical research, for the like-kind exchange provision's nearly 100-year existence in the Code.</u> 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. Like-kind exchanges are relied on extensively by small and mid-sized businesses and taxpayers in multiple industries. The transactional activity supports jobs, taxable wages and revenue for a broad spectrum of ancillary service providers and suppliers. Limitation or repeal of section 1031 would deter and, in many cases, prohibit continued and new capital investment. These adverse effects on the U.S. economy would likely not be offset by lower tax rates. Finally, like-kind exchanges promote uniformly agreed upon tax reform goals such as fairness, economic growth, job creation and increased competitiveness.

Please feel free to contact any of us should you wish to discuss.

Sincerely,

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[5] Ling and Petrova, *Economic Impact*, at 5, 10.