FEA Letter to Treasury commenting on the Presidents 2015 Budget Proposal limiting 1031 exchange deferral for real estate.

March 20, 2014

Jacob J. Lew, Secretary of the Treasury

Department of the Treasury

1500 Pennsylvania Avenue, NW Washington, D.C. 20220

Room 3330

Dear Secretary Lew,

I am writing today as the President of the Federation of Exchange Accommodators ("FEA"), the industry association for §1031 exchange facilitators, also known as Qualified Intermediaries ("QI"). I am also a small business owner, providing QI services from our office in Gainesville, Virginia.

The FEA supports the goals of tax reform: to achieve a simpler, fairer, and flatter tax code that is more efficient and results in greater financial growth, job creation, and a strengthened economy. We realize that reform requires well-reasoned change. We also believe that achieving meaningful reform starts with preserving existing incentives for investment that are proven tools used to spur economic growth and productivity.

The tax deferral benefit provided by §1031 provides a powerful engine to stimulate the U.S. economy. Like-kind exchanges promote transactional activity that results in job creation and taxable income that, in turn, fuels other businesses, from neighborhood shops to mid-sized employers and larger corporations.

I would like to specifically address the President's Budget proposal to "Modify Like-Kind Exchange Rules for Real Property". The Proposal offers several "reasons for change". Unfortunately, those reasons are based on faulty premises that do not reflect the current applications and benefits of §1031.

First, the proposal alleges that there is "little justification for allowing deferral of the capital gain on the exchange of real property". To the contrary, at its core the justification for deferral of the capital gain is one of basic fairness.

The Proposal suggests that the "difficulty in valuing exchanged property is a primary historical justification for 1031 deferral", then concludes that such justification is no longer valid because determining relative valuation is no longer an issue. As a practical matter, it is difficult to believe that the parties to a transaction would not have had a sense of the relative value of the exchanged properties. It is factually correct that the initial codification of the exchange concept in 1921 involved a "readily realizable market

value" test. However, the vagueness inherent in that test led to its elimination in a 1924 amendment to the tax code, as stated in the House Committee report:

The provision is so indefinite that it cannot be applied with accuracy or with consistency. It appears best to provide generally that gain or loss is recognized from all exchanges, and then except specifically and in definite terms those cases of exchanges in which it is not desired to tax the gain or allow the loss. This results in definiteness and accuracy and enables a taxpayer to determine prior to the consummation of a given transaction the tax liability that will result. (Committee Reports on Rev. Act of 1924, reprinted in Int.Rev.Cum.Bull.1939-1 (Part 2), p. 250.)

The House Ways and Means Committee again discussed the unfairness inherent in taxing a paper gain, while the taxpayer continued his investment by exchanging for like kind property:

In other words, profit or loss is recognized in the case of exchanges of notes or securities, which are essentially like money; or in the case of stock in trade; or in case the taxpayer exchanges the property comprising his original investment for a different kind of property; but if the taxpayer's money is still tied up in the same kind of property as that in which it was originally invested, he is not allowed to compute and deduct his theoretical loss on the exchange, nor is he charged with a tax upon his theoretical profit. The calculation of the profit or loss is deferred until it is realized in cash, marketable securities, or other property not of the same kind having a fair market value.' (House Ways and Means Committee Report, reprinted in Int.Rev.Cum.Bull.1939-1 (Part 2), p. 564.)

That analysis demonstrates the basic fairness that is the core of §1031. The taxpayer makes an initial investment in real estate. Subsequently the taxpayer may move that investment, changing its form but not its essence. A two flat investment property becomes a six flat, which becomes a strip mall, then a shopping center. As long as the taxpayer stays invested in real estate and does not cash out, any gain is deferred. When the asset is liquidated and the investment ends, the proper tax is paid, as it should be. Imposing a tax on a continuing investment could not be more contradictory to economic stimulus and growth.

Another justification for deferring capital gains is the key role §1031 plays in promoting investment in the United States. In its recent summary, "The Tax Reform Act of 2014, Fixing Our Broken Tax Code So That It Works For American Families and Job Creators," the House Ways and Means Committee recognized the problem of investors leaving the U.S., stating that "Our outdated international tax system actually encourages American businesses to keep profits and jobs outside of America." (Page 9).

Section 1031(h) specifically provides: "Real property located in the United States and real property located outside the United States are not property of a like kind." Thus real estate within the United States cannot be exchanged for foreign real estate. The deferral benefit available under §1031 directly stimulates reinvestment in
U.S. communities and businesses, promoting job growth within our own borders.

Second, the Proposal states that three party exchanges facilitated by a QI are complex, and were not contemplated when §1031 was enacted. The concept of a tax-deferred exchange was new in 1921, and like many new ideas the concept has evolved in ways that may not have been contemplated at their inception. Part of the evolution is the role of the QI. As part of its service, the QI takes the complexity out of a transaction. The Qualified Intermediaries, many of whom are attorneys, CPAs or Certified Exchange Specialists®, use their expertise to guide taxpayers through the process. Some people look upon the QI as an unofficial enforcement arm of the IRS, promoting technical compliance so that their clients' exchanges will qualify for tax-deferred treatment.

Third, the Proposal suggests that "the ability to exchange unimproved real estate for improved real estate encourages permanent deferral by allowing taxpayers to continue the cycle of tax deferred exchanges." [emphasis added]. There is no explanation as to why there is a distinction regarding the exchange of unimproved for improved. Further, that assertion simply does not survive under analysis.

Although some individual taxpayers do die holding exchanged property, the suggestion of wide spread "permanent deferral" does not hold up. Many exchanges are done by entities, which cannot die. Even for individuals, the odds that a significant number of exchangers will hold their replacement properties for their entire lives are quite low. The gain does not go away. At some point the tax is paid. Payment occurs: 1) upon sale of the replacement asset; 2) incrementally, through increased income tax due to foregone depreciation; 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.

Rather than a "permanent deferral" we suggest that §1031 promotes a "permanent investment". The benefit available under §1031 requires that the taxpayer maintain their investment. So long as they stay invested in like-kind property, their capital gains taxes are deferred. When they end their investment they must also pay the tax.

There is further evidence that tax deferral under §1031 is based on the continuity of investment by the taxpayer. Section 1031 is a mandatory provision, not elective. Deferral applies equally to losses as well as to gains. Why would §1031 deferral apply to losses, if not for the continuity of investment?

Finally, the Proposal places an artificial limit on the amount of real estate gain that qualifies for deferral, while claiming to preserve "the ability of small businesses to generally continue current practices and maintain their investment in capital".

The Proposal offers no justification for the suggested limit. The implication is that the ability of small businesses to "generally" continue their investments is good, but that investments that result in a larger amount of paper gain are bad and should be taxed. We would suggest that all investment in the U.S. is good and that artificially limiting long term investment to grab nominal tax dollars in the short term does not make economic sense.

Section 1031 has stood the test of time, from 1921 through the present. It is inherently fair and encourages investment that is vital to the U.S. economy. For the reasons set forth above we urge that the Proposal to modify the like-kind exchange rules for real property be rejected.

Sincerely,

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cc: Mark J. Mazur, Assistant Secretary for Tax Policy