FEDERATION OF EXCHANGE ACCOMMODATORS

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Report on IRS Section 1031 Impact on Agriculture

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 Section 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.

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. The taxes, which otherwise would have been due from the sale, are thus deferred. These can range from relatively simple transactions involving commercial, agricultural and rental real estate to more complex transactions involving aircraft, trucks, trailers, containers, railcars, agricultural equipment, other heavy equipment, livestock and other assets. Most §1031 exchanges involve separate buyers and sellers and are not simple swaps between two parties. Under these circumstances, tax rules require the use of an independent third party Qualified Intermediary. The QI holds the sale proceeds for the benefit of the taxpayer during the exchange, disbursing funds for purchase of like-kind replacement property, and returning any unused funds to the taxpayer at the end of the exchange. Section 1031 exchanges must be completed within 180 days. Taxpayers recognize gain and pay tax on any unused funds or when they ultimately "cash out" of their property.

Current Level of Section 1031 Activity

The FEA surveyed its members in May of 2011 to obtain a quantifiable measure of the decline in overall §1031 activity between 2006 and 2010, and the nature of exchanges being facilitated (see Appendix). Overall, the drop-off has been exponential, leading one to conclude that the $42 and $47 billion tax expenditure estimates attributed to §1031 exchanges by the Joint Committee on Taxation for the periods of 2012-2016 and 2013-17, respectively, are unrealistically high. These tax expenditure estimates are 3 times the 5 year estimate for the period 2010-14. Aside of the fact that the US economy is not exploding at a 300% growth rate, for the reasons set forth below, we believe these estimates are not a reliable indicator of revenue loss.

1. **Transactional Volume and Gain Impacted by Economy.** Our membership has dropped by 60%, from 374 members in 2006 to 143 members in 2012, due to lack of business and decisions to exit the business as reported by withdrawing members. Of the 40% of professional Qualified Intermediaries that have survived, our survey indicates an 81% drop in overall activity between 2006 and 2010. Nevertheless, the 2010 Tax Expenditures report reflected virtually identical estimated tax costs, using $15.5 billion in 2006 and $15.6 billion in 2010. Although FEA members have no means by which to calculate the dollar value of actual tax deferrals taken by their clients, it is fair to conclude that if overall exchange activity

dropped by at least 81% (not taking into account the 60% drop in exchange facilitators), then there must be a corollary drop in tax deferrals. Following this logic, we posited that a more appropriate 2010-14 tax cost would be approximately $2.9 billion, just 19% of the published estimate. This conclusion is buttressed by the fact that there is simply much less gain embedded in many investments, especially real estate, so there is less potential in the near term for a §1031 transaction. Although the economy is improving, until the market fully recovers in the next several years, and depending on the individual taxpayer's position, there will be less "tax expenditure" revenue loss attributable to §1031. A projected increase of $40 billion over this discounted estimate, and a tripling of the undiscounted estimate, does not appear to be reconcilable.

2. **Depreciation.** Taxpayers benefiting from §1031 deferrals of gain and recapture tax have a significantly lower tax basis in the replacement property acquired in the exchange, so future allowable depreciation deductions are substantially reduced. A meaningful tax cost estimate should factor in the impact of depreciation, and recognize that if §1031 were limited or eliminated, the tax cost attributed to depreciation deductions would skyrocket.

3. **Economic Stimulant.** While it is no surprise that the slumping economy has severely reduced the number of exchange transactions, the viability of exchanges remains strong. As the economy improves, §1031 exchanges provide a vital engine to our economic growth. The ability to defer taxes will stem any backsliding, allowing taxpayers to preserve their current position so they may invest and reinvest with confidence in new assets that grow their businesses, industries and local economies, while making efficient use of their capital and cash flow. Most importantly, exchanges stimulate reinvestment that must remain in the United States to qualify for tax-deferral treatment.

Nature of Agricultural Exchange Transactions

Section 1031 is utilized by farmers and ranchers to exchange appreciated real property assets, exchange out of agricultural equipment, and exchange breeding and production livestock. Section 1031 is an important tool providing flexibility and increased economic efficiencies for farmers. Section 1031's utility is demonstrated through the following examples:

- Section 1031 is overwhelmingly utilized by land owners and operators to combine acreage, acquire higher grade land or exchange into land that is closer to business operations.
- Many older land owners look to §1031 as a retirement tool allowing them to sell their largest asset, their farm or ranch, and reinvest elsewhere without diminishing the value of their life savings.
- Section 1031 serves as a conduit for new and existing farmers and ranchers to acquire land from those who inherit farms and no longer want to farm or ranch.
- Agricultural equipment exchanges are undertaken by farmers and ranchers to acquire new assets that are more technologically advanced or better suited to their operation.
- Production livestock is exchanged under §1031 to increase the quality of the operation or to move operations from one location to another.

Internal statistics and observations from FEA members operating primarily in agricultural based markets show that with few exceptions, farmers and ranchers exchange nearly exclusively into similar farm or ranch assets. Conversely, non-farmland or commercial property owners overwhelmingly choose to exchange into non-farmland properties. In comparison to the full universe of exchange transactions, exchanges out of transitional development land into farm or

ranch assets are isolated. Academic and noted opinion leaders have stated in multiple instances that limits to §1031 will have a dramatic, negative impact on the agricultural community as a whole.

Tax Reform Implications for Agriculture

Tax reform aimed at reducing the deficit has renewed efforts to simplify the tax code and eliminate loopholes. IRC §1031 is neither a loophole, nor a tax-free or tax savings vehicle. It provides only a temporary deferral with an offsetting reduction in future depreciation deductions available for assets acquired through an exchange. Taxpayers utilizing §1031 exchanges are left in the same tax position as if they had never sold the asset and taxes are due upon the final disposition if no replacement property is acquired.

The non-recognition exchange policy is premised on the understanding that the taxpayer continues with the same qualifying investment with no intervening constructive or actual receipt of cash. This permits efficient use of capital while allowing taxpayers 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. Tax-deferred exchanges provide an important stimulus to a multitude of economic sectors, having local, national and global effect. Section 1031's benefits and implications of changes include:

- The tax deferral benefits of §1031 stimulate the agricultural economy, encouraging farmers and ranchers to exchange into more appropriate investments.
- Given the significant increases to capital gains taxes under the "American Taxpayer Relief Act," elimination of §1031 would cause a large number of land owners to hold and refrain from selling properties as a result of being "tax locked," not wanting to erode the value of their investment through higher taxes.
- Fewer land sale transactions translate into fewer jobs in the real estate, construction, title insurance, mortgage and other related industries.
- Elimination of §1031 would have a chilling effect on a variety of business transactions outside the real estate sector, including the manufacture, sales, and purchases of machinery, equipment, and leased assets.
- 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. A manufacturer, for example, cannot receive tax deferral benefits by shuttering a U.S. plant, and moving the facility to Asia. Section 1031 provides a strong incentive to multinational companies to maintain and increase investments in the U.S.
- Bottom line, without the current treatment under §1031, cash-strapped owners of business-use and investment assets could be forced to downsize their businesses if they didn't have sufficient cash to acquire replacement assets *and* pay tax on the gain or recapture of the old asset.

Section 1031 Has a Small Effect on Farm and Ranch Land Values and <u>May Actually Decrease Pressure on Land Values</u>

Prior to the recent economic crisis, stakeholders in rural communities held significant interest in §1031 because of the widespread belief that recent growth in farmland values may have, in part, been stimulated by §1031 exchanges of farmland. In response to such assertions, academic and opinion leaders have consistently stated that §1031 is a minor driver of values. <u>One study focusing on economic supply side factors found that §1031 actually decreases market prices of agricultural land as a result of land owners being willing to sell properties, given</u>

their ability to defer tax, versus holding properties and not selling for fear of paying taxes. Results from academic studies and comments from economists follow:

- A 2012 report from the new Financial Stability Oversight Council, as well as analysis from the American Enterprise Institute, conclude that the primary factors driving land prices include high commodity prices, low interest rates, increasing crop yields, favorable crop export conditions, biofuels policy and investors seeking alternatives resulting from recent past poor performance of other asset classes and the desire to purchase real and productive assets as a hedge against inflation.
- In response to concerns about §1031's impact on land values, the USDA's Economic Research Service commissioned a study on the topic. While researchers were unable to locate micro-data to define the impact of §1031 on land values, the following related conclusions were drawn:
    - Section 1031 is an important vehicle for landowners of farmland who wish to "roll over" or maintain their investment in farmland.
    - "Outside investors" exchanging non-agricultural land for farmland are relatively insignificant, in terms of both volume and value, and therefore, the impact of speculative purchases of farmland is economically insignificant.
    - Data evidences that §1031 exchanges are not driving the price pressure on farmland.
    - 95% of farmland exchanges involved the exchange of farmland for farmland.
    - Average deferred gain is substantially greater for farmland than for other types of real estate, making the value of §1031 greater for farmers than non-farmers.
- As a follow up to the USDA's study on §1031, University of Nebraska-Omaha Economics Professor, Steven Shultz, published a 2011 study in *The Appraisal Journal* addressing the impact of §1031 on agricultural land values. Professor Shultz specifically concluded that IRC §1031 exchanges were found to play a minor role in farmland prices.
- As a follow up to the University of Nebraska-Omaha study, Texas A&M University researches conduced a study focusing on §1031's impact on the supply side of agricultural land transactions. Studies up to that point focused on the demand side effects of §1031. Texas A&M's researchers specifically determined that §1031 reduces land values since it serves as an incentive for land owners to sell agricultural land versus the alternative of choosing to hold properties for fear of tax consequences. In other words, §1031's positive impact on increasing supply outweighs any demand pressures §1031 buyers may cause.
- Iowa farmland is at the heart of the land value debate. In conducting an annual survey of Iowa farmland values, Iowa State University Economics Professor Michael Duffy has consistently stated that §1031 is a small factor in the analysis. More recent studies have not mentioned §1031 as a factor in rising farmland values.
- Iowa State University Professors Neil Harl and Roger McEowen have both cautioned that extreme care should be taken with §1031 given its significant positive impact on farmers.

Summary

Section 1031 provides significant benefits to owners of farm and ranch land providing them with flexibility and increased economic efficiencies. The "spillover" and "trickle down" economic stimulus effects on a myriad of agriculture related industries, including REALTORS®, equipment manufacturers and livestock producers, are substantial. The repeal or restriction of §1031 would have a dramatic, negative impact on the agricultural community as a whole. Given the extraordinary connection between the value of farmland and farmers' economic well-being, any

policy changes that may hurt farmers and those involved in the agricultural industry should be avoided. Given the current economy and forecasts over the next few years, a truly realistic estimate of the tax cost of §1031 is insignificant to deficit reduction, after factoring in 1) the loss of revenue generated by its economic stimulant spillover benefits, and 2) the increased tax cost of depreciation deductions. Eliminating or restricting §1031 would not make a meaningful impact upon tax reform or tax simplification, and would do substantially more harm than good.

Appendix

FEA Member Analysis of 2010 IRC Sec. 1031 Exchange Activity		
	Number	Percentage
Total # of Members 2006	374	
Total # of Members 2011	150	
Drop in Members 2006-2011	224	60%
Number of Respondents / Percent of FEA Members	70	47%
Total # of Exchanges 2006	47319	
Total # of Exchanges 2010	9004	
Percentage drop off 2006-2010		81%
2010 Transactions average sale < $100,000	690	8%
2010 Transactions average sale $100,000 - $249,999	350	4%
2010 Transactions average sale $250,000 - $499,999	2198	24%
2010 Transactions average sale $500,000 - $749,000	1693	19%
2010 Transactions average sale $750,000 - $999,999	318	4%
2010 Transactions average sale $1,000,000 - $2,499,999	3225	36%
2010 Transactions average sale $2,500,000 - $4,999,999	432	5%
2010 Transactions average sale $5,000,000 - $10,000,000	0	0%
2010 Transactions average sale > $10,000,000	0	0%
No Average Sale data	98	1%
Percentage of Transactions Meeting "Similar Use" Standard		75%

Note: Survey data reflects predominantly real estate and single asset personal property exchanges. It does not include program exchanges of relatively low cost personal property assets, such as vehicles or heavy equipment.