April 12, 2013

House Committee on Ways and Means
Via Email: tax.reform@mail.house.gov

Re: A proposal to reform *IRC § 1031* like kind exchanges

Dear Congressmen, Congresswomen and Staff:

I serve as Chief Counsel to Madison Commercial Real Estate Services, LLC and its affiliated companies, and I serve as Senior Counsel to Madison Exchange, LLC, which acts as a qualified intermediary in *IRC § 1031* like kind exchanges. The most important part of my job is to assist our clients to correctly structure and conduct their like kind exchanges. I am a member of the Certified Exchange Specialist® Council of the Federation of Exchange Accommodators. Our council grants certifications to people who work principally in the exchange accommodation business and who have demonstrated professional competence in the law and practice of *IRC § 1031* exchanges. I am also chairman of the Council's examination committee, and I am a member of the Federation of Exchange Accommodator's tax advisory committee.

I have thought of a possible change in tax law relating to *IRC § 1031* that I believe could have significant positive impact on the US economy without any added tax burden and without a reduction in tax revenue. In fact, the long term impact on US tax revenues should be positive because it would encourage investment in and improvement of US real property. Therefore, I hope my suggestion will be attractive to both Republicans and Democrats.

It is my understanding that there is a massive amount of revenue invested overseas by US taxpayers who would like to repatriate those funds, but they cannot do so without recognizing US tax on substantial built in gains. Globally changing the tax policies that have created this problem would be extremely difficult, and I do not think it is likely that Congress wants to undertake that work at this time. However, the small change that I am proposing should help return some capital to the US in a significant and controlled fashion.

IRC § 1031(h)(1) provides that US real property is not like kind to foreign real property. The rationale for this distinction is two-fold. The first (and principal) rationale for making this distinction is that we do not want to encourage US money to be expatriated by exchanging US real property for foreign real property that is later sold outside of the power of the IRS to track the sale or to effectively collect the taxes owed. The second rationale for the distinction is that US real property is not taxed like foreign real property, which creates a sufficient difference

1125 OCEAN AVENUE, LAKEWOOD, NJ 08701 • PHONE 866.500 MADISON • FAX: 866.501.MADISON
INFO@MADISONCRES.COM • WWW.MADISONCRES.COM

between those two classes of property so that it may be fair to say that they are not really like kind. The first rationale obviously does not apply in the case where foreign real property is exchanged for US real property. The second rationale may justify a distinction between US and foreign property, but it does not actually require that such a distinction be made.

Therefore, my proposal is to consider permitting exchanges of foreign property for US property, but continuing to prohibit exchanges of US property for foreign property.

I often have had to explain to clients who want to sell foreign property that they have three options. (1) They can sell the foreign property and pay the US capital gains tax. (2) They can exchange the foreign property for foreign replacement property. (3) They can continue to hold the foreign property. It is my experience that the overwhelming majority of my clients avoid selling the foreign property if it means paying the US tax. Therefore, the tax is not collected and the value of the foreign real estate is not invested in the US economy. That is a *lose/lose* result for the United States.

If taxpayers were allowed to exchange foreign real estate for US real estate under *IRC § 1031*, the positive effects on the US economy would be obvious and significant. The pool of investors in US real estate is expanded. The aggregate capital invested in the US is increased. The likelihood of tax eventually being collected on currently unrecognized profits is maximized. Investment in construction of improvements to real property in the US is stimulated. Taxpayers who own real property for their own business purposes are encouraged to conduct those activities in the US. On the other hand, the change is small enough that it does not upset the general tax regime that distinguishes between US and foreign investment.

Some taxpayers, no doubt, will take advantage of the opportunity to exchange foreign property for US property in cases where they otherwise would have sold their foreign property and paid the tax. However, since IRC 1031 provides for tax deferral, not tax avoidance, and since exchangers sacrifice depreciation over time in order to secure non-recognition of current capital gains, and since my experience informs me that most taxpayers will adjust their behavior to avoid paying the tax in cases where they want to exchange, it is my current belief that the effect on tax revenue would be zero or even slightly positive (because of reduced depreciation), without taking into consideration the stimulative effect on the US economy.

I would like to say a little about the importance of IRC 1031 to the smooth functioning of the real property segment of our economy. Unlike securities, real estate is not particularly liquid. It is expensive to buy and to sell. Physical and financial due diligence is required. Brokers, attorneys, title insurance, mortgage expenses and transfer taxes bring average real estate transaction costs to more than 10% of the gross sales price. Since real estate transactions are usually heavily leveraged, on average, those costs amount to 25% or more of the cash equity

1125 OCEAN AVENUE, LAKEWOOD, NJ 08701 • PHONE 866.500 MADISON • FAX: 866.501.MADISON
INFO@MADISONCRES.COM • WWW.MADISONCRES.COM

initially invested. Therefore, it is not surprising that real estate investments tend to be held for a long time, that the gains on those investments often dwarf all other income for the tax year (potentially pushing taxpayers into top tax brackets), and that IRC 1031 exchanges have become the most reliable strategy to ease the daunting prospect of paying a huge tax on a one-time gain. In my experience, many, many sales simply would not happen if the sale triggered tax recognition of gains.

I believe that IRC 1031 is an indispensable tool for injecting liquidity into the real estate market. If taxpayers were to lose confidence in the continued protection of *IRC § 1031*, there would be a severe chilling of real estate investment and development. If *IRC § 1031* were actually eliminated, real estate prices would drop sharply, foreclosures would rise, and there would be no benefit to the US Treasury.

Respectfully submitted,

Lee David Medinets, Chief Counsel

1125 OCEAN AVENUE, LAKEWOOD, NJ 08701 • PHONE 866.500 MADISON • FAX: 866.501.MADISON
INFO@MADISONCRES.COM • WWW.MADISONCRES.COM