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Comments: Real Estate Tax Reform Working Group – Section 1031 Exchanges

Ladies & Gentleman:

Thank you for the opportunity to address my concerns regarding Section 1031 Exchanges. By way of background, I am a Board certified Tax Attorney from Cincinnati Ohio and I have owned and operated an Exchange Company over the past 23 years in addition to my tax practice.

I am writing to express my concern regarding potential modifications to or repeal of IRC Section 1031 and ask you to consider the following reasons to reject potential modifications to or repeal of IRC Section 1031:

1. **Section 1031 is one of the most effective tax provisions in the tax code for sound economic growth for the following three reasons:**
 - a. First, by permitting a taxpayer to reinvest 100% of their equity on a tax deferred basis into similar productive business assets, the taxpayer reduce their future debt and interest expenses, increasing their cash flow, increasing their net income, and strengthening their balance sheets. This is the single most effective tax provision to wean taxpayers off excessive debt burdens.
 - b. Secondly, by permitting a taxpayer to reinvest 100% of their equity on a tax deferred basis into similar productive business assets, the taxpayer reduces the overall financial capital necessary to reinvest in newer technology which they would not otherwise be unable to afford.
 - i. A specific example of this is the trucking business where the cost of new energy efficient technology has doubled the cost of tractor units from \$ 60,000 per tractor unit in 2006 to \$ 120,000 per tractor unit in 2012 with almost no increase in trucking revenue.
 - c. Thirdly, while some might argue that much price appreciation is generated by inflationary policies, Section 1031 permits business owners and real estate investors to reposition their business assets to more productive like-kind property, change geographic locations, diversify or consolidate holdings, or otherwise transition to meet changes in business needs or lifestyle without suffering a significant reduction in wealth.
 - i. For example, in the 1970s, investors, faced with a sluggish economy and higher taxes, chose not to sell and reposition their business and investment assets, leading to a lost decade economically for the US.

- d. In contrast, **generous depreciation allowances**, which historically is the preferred method for stimulating growth fails to deliver the economic benefits delivered by Section 1031 Exchanges for the following five reasons:
 - i. **First, generous depreciation deductions are often underutilized by non-publically traded taxpayers due to:**
 1. depreciation deductions in excess of net income are wasted;
 2. all or nothing approach to election of bonus depreciation by asset class;
 3. limitations on total acquisitions for Section 179 expensing;
 4. lack of uniformity or acceptance among the various states;
 5. adjustments with net operating loss provisions;
 6. depreciation deductions not utilized lose their value over time either by reduction under the net operating loss provisions or inflation;
 7. uncertainty regarding future tax policy inhibits long term capital budgeting;
 8. alternative minimum tax provisions.
 9. In contrast, the flexibility of Section 1031 exchanges permits all of these issues with depreciation to be avoided.
 - a. In fact, the Treasury Department issued an analysis of the impact of bonus depreciation between 2001 and 2004 and determined that approximately 45% to 37% of eligible corporations did not elect bonus depreciation. The primary reasons why companies did not claim eligible bonus tax depreciation between 2001 and 2005 were:
 - i. many capital intensive firms had tax losses during this period or carried losses forward from prior tax years, therefore limiting the effectiveness or the tax benefit of bonus depreciation; and
 - ii. most states chose not to conform their tax systems to the federal change; and;
 - ii. **Secondly, unlike Section 1031, depreciation does not reduce the overall investment in fixed assets nor increase the company's rate of return on fixed assets.** Bonus depreciation shifts the deduction associated with the purchase of new assets to an earlier year. However, Section 1031 reinvests equity into new assets, dramatically lowering the total out of pocket cost of new technology and assisting taxpayers in investing in newer more expensive technology.
 1. For example, in Ohio, our trucking companies struggle to afford newer more expensive technology in trucks that has caused the

overall price of new trucks to double over the last 6 years. Section 1031 exchanges allow for a significant reduction in out of pocket costs by reducing debt, interest, taxes, repair, maintenance and higher fuel mileage. The elimination of 1031 exchanges would have a devastating effect on the transportation sector.

- iii. **Third, investment in new productive assets in conjunction with the disposal of other business assets automatically results in the netting of gains against current depreciation if Section 1031 is eliminated.** The resulting loss of future depreciation deductions to offset future debt repayments results in 150% higher taxes and a loss of cash flow due to repayment of debt with taxable operating income. This is the worst possible scenario for businesses.
 - iv. **Fourth, price increases in years in which bonus depreciation is implemented.** The same treasury study observed that in the years in which bonus depreciation is offered by the federal government, manufacturers have historically boosted their prices to levels which offset the temporary benefit of bonus depreciation. Since the manufacturer is unaware that the taxpayer is managing the purchase as an exchange, the taxpayer is free to negotiate the best price.
 - v. **Fifth, investment in new business assets is determined by client demand, not tax provisions.** The disappointing level of new durable goods purchases and manufacturing over the past 3 years, despite generous 100% bonus, 100% expensing, and 50% bonus depreciation, is a testament to the business reality that businesses decide to reinvest based on their customer's need and not tax deductions.
 - 1. The primary beneficiaries of excessive depreciation deductions are publically traded companies, especially public utilities.
 - 2. Private companies are largely unaffected by bonus depreciation due to their inability to absorb large depreciation deductions.
 - 3. For example, among our trucking clients in Ohio, over the past 3 years 78% to 82% of new truck purchases were for used trucks, which do not qualify for bonus depreciation. The financial costs of newly manufactured trucks were either too much for the trucking companies or they lacked the financial strength to borrow from lenders.
2. **Section 1031 represents 92 years of sound Tax Policy to promote reinvest of equity into US based economy for these 4 specific reasons:**
- a. **Section 1031 is one of 41 separate tax code sections** that provide where a business enterprise reinvests its capital into its business, either by merger or exchange, that this is not a suitable time to tax the transaction. This has been a successful tax policy since 1921 and has contributed to the economic strength of the US for the past 92 years.

- b. **Section 1031 is neither a loophole, nor a tax savings vehicle, but rather a powerful economic engine based on sound tax policy.**
- i. Section 1031 as a tax loophole is popular Myth #1. The bald assertion in the popular press that that Section 1031 is a tax loophole is based on a fundamental misunderstanding of tax law.
 - 1. Current tax law provides a multitude of opportunities of capital investment in return for tax deferral, tax deductions, and tax credits. To decry this occasion of tax deferral brings into question the entire construction of the tax code as an instrument of social engineering. The deferral of tax today on a sale transaction followed by the subsequent reinvestment of the very same sale proceeds into similar productive business assets does not create wealth or provide any cash with which to spend.
 - ii. Provided that each business owner continues to keep their net equity invested in the same type of productive trade or business asset, with no cash taken out, the taxpayer/ business owner is left in the same economic and tax position as if the original asset was never sold.
 - iii. In short, as further supported below, Section 1031 should not be eliminated or limited.
- c. **Section 1031 is not an unfair tax break for the wealthy or large corporations.** Section 1031 as an unfair tax break for the wealthy or large corporations is popular Myth #2.
- i. On the contrary, it is one of the few incentives available to and used by taxpayers of all sizes. A recent 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.
 - 1. For example, in our business, our exchange clients are generally small businesses and investors who would not be able to afford to reinvest in better more productive assets without Section 1031 exchanges.
 - 2. Many of our exchanges involve transactions below 100,000.00 in gross sale proceeds or below 100,000 in profits. This is not simply in the Midwest; our firm handles transactions all over the US.
 - 3. If their equity in the prior assets were taxed, they would lack the necessary funds to qualify for a new loan on the new purchase of properties.
 - 4. If their gains were taxed, they would have less equity and funds invested and would not consider selling their properties, leading to a general reduction in economic activity.
 - 5. For our clients, it is a simple matter of math; taxpayers would be worse off by selling and paying taxes. These taxpayers cannot simply borrow the funds, because, despite what banks might have you believe, bank lending has contracted significantly, especially for the small and medium sized family businesses.

- d. **The repeal Section 1031 imposes a significant hardship on foreign direct investment in the US economy.**
 - i. Of the 38 countries in the Organization of Economic Development, the US is the only country that imposes a tax on capital gains on the sale of trade or business assets or real estate.
 - ii. The US economy needs a significant foreign investment in our economy to offset a significant foreign account deficit, recently suggested to be about 1 billion dollars per day.
 - iii. The Section 1031 Exchanges permit foreign national investors to invest and reinvest without a tax penalty. If the US were to eliminate 1031 Exchanges, foreign national would have a significant reason to not invest further funds in the US because they must contend with significant tax liabilities that they do not incur overseas. These taxes reduce their total net return on their investments by a minimum of 25% or more.
 - iv. For example, the positive news regarding the Florida real estate market is largely due to the fact that a significant number of real estate properties are being acquired by German and South American investors. The inability to purchase, sell and reinvest without income tax may reduce the interest in investing. Further, since the annual income is taxed at higher rates overseas, followed by higher taxes on sale, none of which can be reduced by the foreign tax credit, these transactions are less attractive than investment in other countries, such as Canada to the north or other stable economic areas.
3. **Section 1031 promotes sound economic policy for these following seven reasons:**
 - a. **Section 1031 promotes efficient use of productive capital and cash flow** 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.
 - i. For example, in Ohio, trucking companies must choose between high repair and maintenance costs for their aging transportation fleets and the high cost of new equipment without the higher revenue needed to amortize the bank loans for new equipment. Without Section 1031 exchanges to provide the additional equity for the bank lending package, these companies are just as likely to close their doors and go out of business.
 - ii. Shippers reduced their rates to truck common carriers by as much as one-third during the last recession and truckers need Section 1031 exchanges to replace their aging fleets. The number of class 8 tractor-trucks produced nationally since 2006 has been substantially below replacement levels due to higher prices and uncertainty regarding new emission technology.
 - iii. Tax-deferred exchanges provide an important stimulus to a multitude of economic sectors, having local, national and global effect.
 - b. **Section 1031 exchanges contribute significantly to the turnover of the economy and promote investment in the U.S.**

- i. Section 1031 encourages owners of domestic real estate to reinvest in active U.S. real estate, rather than place their money in other passive or foreign investments that do not promote employment, reinvestment and rehabilitation of US owned property.
 - ii. An automobile manufacturer, for example, cannot receive tax deferral benefits by shuttering a US plant, and moving the facility to Asia. Section 1031 provides a strong incentive to multinational companies to maintain and increase investments in the US.
- c. **Section 1031 does not require the expenditure of funds to promote the economy.** Unlike various government programs which seek to pick winners and losers, and award grants, allowances or credits to stimulate economic growth, Section 1031 exchanges permits businesses and real estate investors to invest their own wealth into business ventures, without any additional government support. Equity invested from the sale of a prior investment does not permit additional depreciation deductions, so this is actually the most efficient fashion for the government to boost economic growth without additional government expenditure.
- d. **Section 1031 stimulates the economy** by encouraging the efficient purchase and sale of real estate and encouraging companies to replace and upgrade machinery and equipment, stimulating purchases and sales of machinery, equipment, railcars, aircraft, trucks and other vehicles sooner, because tax on the gain can be deferred.
 - i. For example in our exchange business, business owners mull over whether to reinvest in newer, more productive assets or to hold onto what they have or downsize their businesses.
 - ii. At the end of the day, the business owners will not take on more risk if their wealth is also being reduced. To take on more risk, they will need their wealth to stay the same. The sale of assets followed by reinvesting in new property does not create wealth. All of the assets are reinvested in new productive assets. Taxing the equity diminishes wealth.
- e. **Section 1031 exchanges strengthen the middle class and their businesses.** The middle class and their private enterprises provide the economic engine for growth and employment in good times and bad in the US economy. While publically traded companies and the very wealthy will always find a way to fund their asset acquisitions, the more modest private businesses and investors need 1031 exchanges to provide equity as a down payment for their asset acquisitions.
- f. **Section 1031 provides a more egalitarian society and broader distribution of asset ownership.**
 - i. Section 1031 exchanges allow the smallest investor or business to gain a foothold in society by deferring noneconomic gains. The smallest investor has the same advantages as the wealthiest investor.
 - ii. What do I mean by noneconomic gains? The sale of an over the road truck for \$ 45,000.00 followed by the purchase a new truck for \$ 130,000 does not make the independent trucker wealthier. He or she is still burdened with \$

85,000 in debt as well as crushing federal excise taxes on the purchase and operation of the truck.

- iii. Ohio has 22,000 **trucking companies** and is at the forefront of the trucking industry due to its proximity to the population of the US.
 - 1. Of those trucking companies less than 1% of the companies have in excess of 200 trucks.
 - 2. More than 95% of these companies have 20 or fewer trucks. These companies have been the hardest hit by lending restrictions and need 100% of their equity in their existing trucks to reinvest in new trucks. With little or no financing available now and in the foreseeable term, trucking businesses need 1031 exchanges to recapitalize their businesses and to replace their aging fleets.
 - 3. Without 1031 exchanges these companies will simply sell out to the large publically traded trucking companies, further concentrating economic activity and wealth into the hands of a few.
- iv. If Congress wants to slow the rapid accumulation of wealth by the top 1% of the nation's elite, Congress will maintain and expand Section 1031 exchanges.

g. Section 1031 stimulates the agricultural economy.

- i. Farmers and ranchers use Section 1031 to combine acreage or acquire higher grade land or otherwise improve the quality of the operation.
- ii. Due to the high cost of land and volatile booms and busts of the farming economy, it is very risky for farmers to make long term bets on the purchase of land.
- iii. As a son, grandson and great grandson of Ohio farmers, I know first-hand the difficulty of having enough capital to invest and reinvest in Ohio farmland. While I would have welcomed the opportunity to continue operating an Ohio farm, I could see as a young man that the cost of farmland was simply too high.
- iv. Without Section 1031, the opportunity for private farmers to invest and reinvest in farmland will be too great and the long tradition of family farms will quickly be snuffed out in favor of large corporate farms. Most of the 1031 exchanges we handed for our farmer clients involved simply repositioning far flung tracts so that they could be closer together.
- v. 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.

4. Section 1031 results in increased tax receipts now and in the future for these three reasons:

- a. **Section 1031 exchanges increases reinvestment in the economy giving rise to a host of taxes,** such as
 - i. higher income taxes on higher profits due from newer more productive assets,
 - ii. higher income taxes cause by a reduction in depreciation deductions,

- iii. higher excise taxes and sales taxes on purchase and sale of manufactured equipment, goods and services,
 - iv. higher transactional taxes on the purchase and sale of real estate,
 - v. higher real estate valuations with resulting higher local real estate receipts which supports local schools and local government; and
 - vi. higher taxes when the owner cashes out of their investments.
- b. **Section 1031 provides only a temporary deferral; taxes are not eliminated.**
- i. Gain will be recognized and taxed when the taxpayer sells and effectively “cashes out” of the asset.
 - ii. While critics state that the tax might somehow be avoided, that belies the actual practice of the past 23 years. When a business owner or real estate investor gets older they almost always sell their actively managed business investments. Generally the heirs have little or no interest in managing the business of their parents from a distance.
- c. **Gain deferred reduces future depreciation deductions available for assets acquired through an exchange.**
- i. The tax basis of newly acquired replacement property is reduced by the amount of the gain not recognized due to the exchange of the relinquished (sold) property.
 - ii. 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.
 - iii. In fact, the elimination of Section 1031 would result in a substantial increase in depreciation deductions and reduced income tax revenue for the government.
5. **Section 1031 promotes general economic recovery for these 6 reasons:**
- a. **Elimination of Section 1031 would have a chilling effect on real estate and other business transactions.** Prior to the recession, the vast majority of commercial real estate transactions were handled as 1031 exchanges.
 - i. For example, in our exchange business, the primary business consideration for a client whether to accept an offer to sell their commercial property is whether one or more acceptable replacement properties are available.
 - ii. Without Section 1031 exchanges, many transactions, including sales and purchases of real estate, machinery, equipment and leased assets will be delayed or abandoned, and real estate values will be further eroded.
 - b. **Lower growth leads to lower employment.** Fewer transactions also translate into fewer jobs not only in the Section 1031 exchange industry, but also in the real estate, construction, title insurance, mortgage and other related industries, equipment lease financing, vehicle and heavy equipment rental and manufacturing, after-market alteration, customization and installation industries. Fewer transactions ultimately result in fewer jobs at factories, restaurants, dry cleaners and other local small businesses that generate revenue from the after tax dollars of employed workers.

c. Elimination of Section 1031 taxes cash flow not wealth.

- i. As businesses and real estate investors struggle to deleverage over the past several years, the repeal of Section 1031 would throw this process into chaos. Full repayment of debts at the closing table followed by full taxation of the equity will savagely reduce the amount of funds that can be reinvested into the replacement property. Investors faced with not being able to finance a new purchase of assets without the equity funds they were planning to reinvest will simply stop purchasing and selling business assets.
- ii. Section 1031 permits a continuity of investment by the taxpayer without reducing cash flow available for growth of the business. The value of assets exchanged, whether farmland, commercial or rental residential real estate, machinery, equipment, vehicles or other business-use or investment assets, remains invested in the taxpayer's business.
- iii. Taxing cash flow is contrary to almost 100 years of tax policy.
- iv. The taxpayer doing a Section 1031 exchange is not taking any profit from this transaction; it is being plowed back into the business.
- v. 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. Section 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.
- vi. Section 1031 permits 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. Many of these productive assets are depreciated over a 5 year MACRS schedule. The impact of bonus depreciation, intended to stimulate manufacturing and sales by allowing a first year depreciation deduction of 50% - 100% of the value of the asset, has left taxpayers with artificially low tax basis, and large built-in gains.
- vii. For example, an equipment leasing company that wishes to replace equipment purchased in 2010 already has a zero tax basis in that equipment, and would lose 40% of the value of the sold asset to taxes if Section 1031 were not available.
- viii. This would result in a direct reduction of cash flow available for purchase of new equipment. Owners and lessors of equipment and fleets utilize Section 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.

- d. Without the current treatment under Section 1031, cash-strapped owners of business-use and investment assets could be forced to downsize their businesses, farms, ranches, real estate holdings, etc. if they don't have sufficient additional cash flow to acquire replacement assets and pay tax on the gain or depreciation recapture of the old asset.
- e. Section 1031 provides significant benefits to taxpayers of all sizes with a "spillover" 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, absorbing and redeploying difficult assets, and discouraging fearful contraction and cash hoarding.
- f. 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.

6. The current suggested repeal or modification provisions below reflect a general misunderstanding of how Section 1031 exchanges.

- a. A proposal to eliminate Section 1031 exchanges reflects a gross misunderstanding of the goal and purpose of Section 1031 within the national economy and its tremendous success in generating economic growth in the economy without subsidy from the federal treasury for the reasons stated herein.
- b. Restricting Section 1031 exchanges to a two party exchange from the current 3 party exchanges would effectively eliminate Section 1031 exchanges.
 - i. In a typical exchange, property owner A wishes to sell an apartment building. He contracts with Buyer B to purchase the apartment building at the best price both can agree on. A then uses those funds to find another desirable apartment building from Seller C. That is a free market example of willing sellers and willing purchasers with any impediment. In the case of a two party exchange, A must find an individual that not only wants his building but is also willing to offer his or her building in trade. The chance that both parties will have similarly priced properties with the same amount of debt and both parties will be attracted to the properties is remote at best. In the 23 years of handling exchanges, we have handled a handful of such exchanges and they always involved contiguous farmland. This would eliminate virtually all exchanges as a financial tool to promote growth and enhance financial stability.

- c. **Replace the current role of Exchange Intermediary with an election by the taxpayer.** The problem with eliminating the role of the Qualified Intermediary would create an administrative nightmare for the IRS in managing this election process. The Professional Exchange community contains thousands of highly trained and dedicated tax professional who provide the resources to educate and guide taxpayers through complicated tax decisions on 1031 Exchanges. My personal experience over the past 23 years is that the rank and file accountants and lawyers lack the expertise to successfully guide taxpayer through this process. Section 1031 exchange professional intermediary community provides the best example of a private public partnership with the government and the private sector to successfully manage the application of a tax Code provision that results in a tremendous stimulus to economic growth.

Thank you for your consideration on this matter.

Sincerely,

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President
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