T E U T S C H
P A R T N E R S
Real Estate Services

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Tax.reform@mail.house.gov
Comments:
Real Estate Tax Reform Working Group – Section 1031 Exchanges

Ladies & Gentleman:
I am writing regarding potential modifications to or repeal of IRC Section 1031. I am a small real estate developer based in Seattle, Washington. I also sit on the Board of the Washington State Chapter of NAIOP, a commercial real estate organization with several hundred members locally and several thousand nationwide. Like others in my industry, I employ several people, and frequently hire contractors for construction jobs. I am alarmed that Congress is considering the repeal or substantial modification to Section 1031. Commercial and industrial property is attempting to recover from the deepest value recession since the Great Depression. Property values in the commercial / industrial sector have not rebounded as quickly as the general housing market. As a result, political leaders, property owners, realtors and other professionals are continually discussing ways to encourage investment in commercial / industrial property and increase the volume of transactions. Section 1031 exchanges have historically been the vehicle that has insured continued investment in commercial / industrial property. It has allowed investors in this sector to upgrade and expand their facilities, redeploy assets to other geographical areas, capitalize on new labor pools, and the like. At the same time, §1031 requires that the exchange funds received from the sale of domestic real estate be reinvested within 180 days in property within the United States. A repeal or any restriction of Section 1031 as part of tax reform or budget legislation will adversely impact the commercial / industrial property sector.
There are misconceptions about Section 1031 exchanges that threaten the viability of this important investment strategy:

- Exchanges are routinely used by the Middle Class. Section 1031 is not an unfair tax break used only by the wealthy or large corporations. On the contrary, it is one of the few incentives available to and used by taxpayers of all sizes. The majority of exchanges involve properties worth less than $1,000,000. These types of properties are typically those of small investors and small "main street" businesses who are vital to a vibrant economy.

- Exchanges do not divert tax revenue. When a taxpayer reinvests his or her capital in a new commercial / industrial property from an exchange out of a property that has already been depreciated, he or she cannot "restart" depreciation. Capital gain tax may be deferred but additional depreciation is either not available or substantially limited. This foregone depreciation creates tax revenue to the government. This is especially the case if a taxpayer has used cost segregation on components of a property to accelerate what would be long term depreciation on the life of a building as a whole.

- Section 1031 is not a loophole. The Section has been part of the Tax Code since 1921 and has withstood scrutiny for nearly a century. There have been efforts to modify or restrict the Section which have failed in large part due to the fact that policy makers realize the adverse impact those modifications or restrictions would have on the economy.

Section 1031 exchanges have a positive impact on the U.S economy:

- Section 1031 encourages reinvestment in the U.S. Investors who are selling commercial / industrial U.S. property must reinvest in U.S. property and not property in foreign countries. This encourages companies contemplating production changes or expansion to reinvest in bigger, better facilities in the U.S. rather than shuttering U.S. facilities to move to a cheaper foreign labor market.

- Section 1031 enhances borrowing power. If investors cannot use Section 1031 on the sale of commercial / industrial property and use sale proceeds to pay the tax, their assets available for reinvestment are diminished. This impedes their borrowing power which may be essential for enlarging or improving the property into which they are investing. Exchanging preserves the monies available for reinvesting and many investors are able to leverage themselves into the new investment property by borrowing funds to acquire bigger, better properties. This has a positive multiplier effect for the banking industry, the building trades, supplier and other main street businesses.

- Section 1031 lessens the impact of recent losses. The economic downturn that took place from 2008 to the present resulted in property investors losing up to 40% of the value of their properties in many areas of the country. Commercial / Industrial properties still have not rebounded from that downturn. By deferring the payment of capital gain tax and the 3.8% surcharge on sales of commercial / industrial property taxpayers are motivated to use exchanges to preserve the wealth they have left.

- Section 1031 encourages investors to increase their reinvestment. Since Section 1031 requires investors to exchange into an equal or greater investment in equity and debt to get 100% tax deferral they often use loaned funds to leverage their investment. This results in healthy interaction with lenders and further investment in America.

- Section 1031 increases taxable income streams. By preserving reinvestment values in an exchange, taxpayers maintain higher income streams which are typically taxed annually at higher income tax rates than the capital gains tax paid only once.

Thank you for your consideration on this matter.

Sincerely,

John S. Teutsch
Managing Member, Teutsch Partners, LLC