



Section 1031 Impact on US Economy

Internal Revenue Code Section 1031

Since 1921, Federal tax law under IRC section 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 (QI). 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. 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.

Tax Reform Implications

Tax reform aimed at reducing the deficit has renewed efforts to simplify the tax code and eliminate loopholes. **IRC section 1031 is neither a loophole, nor a tax savings vehicle, but rather a powerful economic engine based on sound tax policy.** The non-recognition exchange policy is premised on the understanding that the taxpayer continues with the same qualifying investment, with no intervening receipt of cash, and is left in the same tax position as if the relinquished asset was never sold. This valuable section should be retained in its current form because it accurately reflects the economic reality of investment continuity in which no profit is taken, thus there is no premise to tax.

- **Section 1031 is not an unfair tax break for the wealthy or large corporations.** 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.
- **Section 1031 permits 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. Tax-deferred exchanges provide an important stimulus to a multitude of economic sectors, having local, national and global effect.
- **1031 Exchanges contribute significantly to the velocity of the economy and promote investment in the US.** Owners of domestic real estate are encouraged by the tax benefits to reinvest in US real estate, rather than place their money in other or foreign investments. 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.
- **1031 Exchanges stimulate the economy,** encouraging real estate transactions, 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.



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- » **Section 1031 stimulates the agricultural sector.** Farmers and ranchers use 1031 Exchanges to combine acreage or acquire higher grade land or otherwise improve the quality of the operation. 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.
- » **Section 1031 is used to promote conservation and environmental policies.** Grants of conservation easements can be structured as tax-deferred exchanges, facilitating government and privately funded programs designed to improve water quality, reduce soil erosion, maintain wetlands and sustain critical wildlife habitat. These exchanges also enable landowners to acquire replacement farm or ranchland in less environmentally sensitive locations.
- » **Section 1031 is not an “abusive tax avoidance scheme.” It provides only a temporary deferral; taxes are not eliminated.** Tax will be paid either 1) upon sale of the replacement asset, or 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.
- » **Gain deferred is directly offset by a reduction in future depreciation deductions available for assets acquired through an exchange, making section 1031 revenue neutral over the life of the asset.** 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. 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.
- » **Elimination of section 1031 would have a chilling effect on real estate, manufacturing and other business transactions.** Without the tax incentive, 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 eroded.
- » **Elimination of 1031 Like-Kind Exchanges would create an overall decline in real estate values, causing the banking system to return to the unstable condition of the 2009 recession and with it, a lack of available credit, further stifling economic activity.** A drop in real estate values creates a reduction in equity value that, in turn, cascades into devaluation of collateral for loans which causes a technical default under a commercial loan agreement. Most commercial real estate loans have 3 to 7 year terms. If the property value has dropped when the loan is due for renewal, the debt/equity (i.e. “loan to value”) ratio will be upside down, and the owner (borrower) will be required to add more capital (i.e. the approved loan amount will be reduced requiring a partial pay down). Under the best of circumstances, this results in an inability for the owner to increase his portfolio through investment in other real estate, because he must use that capital for the existing real estate. Under the worst of circumstances, when the owner lacks the capital now required to maintain the existing real estate loan, that loan will be pushed into foreclosure, causing a further reduction in value, not only for that parcel, but for other properties in that neighborhood. Banks have rebuilt their commercial real estate loan portfolios since the recession and the banking system is finally strong and able to make new loans. These loan portfolios are based upon the assumption that capital remains static.



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- »» **Fewer transactions translate into fewer jobs** not only in the 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 industries. Fewer transactions ultimately result in fewer jobs in the tourism and recreation industries, as well as at restaurants and other local small businesses that generate revenue from the after tax dollars of employed workers.

- »» **Elimination of section 1031 would tax cash flow, not wealth.** 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. **The taxpayer doing a 1031 Exchange is not taking any profit from this transaction; it is being plowed back into the business.** 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. 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.

- »» **Section 1031 permits high volume 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. 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. This would result in a direct reduction of cash flow available for purchase of new equipment. Owners and lessors of equipment and fleets utilize 1031 Exchange safe harbor guidelines to appropriately manage non-recognition of gain when assets are replaced, preserving cash flow, and preventing a forced downsizing of the business.

- »» **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.

- »» **Elimination of section 1031 would result in a substantial increase in depreciation deductions and reduced income tax revenue.**



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Tax Simplification / “Rollover”

Proposals have been made in the past to “simplify” section 1031 by shifting to a “rollover” structure, eliminating the need for a Qualified Intermediary (QI). This would result in more complexity for taxpayers, eliminate the value provided by the QI, and reduce the compliance rate for 1031 Exchange transactions. QIs actually simplify the process because they create and provide necessary form documentation for a 1031 Exchange, serve as a resource to taxpayers and their advisors, and act as unofficial gate-keepers for the IRS. **The FEA opposes transition to a “rollover” as unneeded, less user-friendly and more costly to taxpayers; problematic from an enforcement standpoint, creating uncertainty in the process; and having the potential to foster unintentional abuse, resulting in a revenue negative situation for the IRS.** The QI safe harbor provides a substantial free benefit to the government because QIs promote compliance with the technical requirements for proper exchange treatment, without which, tax revenue would decrease through improperly claimed section 1031 treatment and increased auditing costs.

Summary

Section 1031 provides significant benefits to taxpayers of all sizes with a “trickle down, 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, redeploying underutilized or idle assets, and discouraging fearful contraction and cash hoarding. 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.**