March 6, 2013

Center on Budget and Policy Priorities
820 First St. NE, Suite 510
Washington, DC 20002
Attn: Chuck Marr
Chye-Ching Huang
Joel Friedman
Jared Bernstein

Re: FEA Response to Center on Budget and Policy Priorities
“Tax Expenditure Reform: An Essential Ingredient of Needed Deficit Reduction”

Dear Ms. Huang and Mssrs. Marr, Friedman and Bernstein:

The Federation of Exchange Accommodators (“FEA”) is the industry association for exchange facilitators, also known as Qualified Intermediaries (“QI”). FEA member companies facilitate tax-deferred exchanges of investment and business use properties under IRC §1031 for taxpayers of all sizes, from individuals of modest means to high net worth taxpayers and from small businesses to large entities. Members range from small privately held businesses to large publicly traded companies and banks.

The Center on Budget and Policy Priorities (CBPP) recently issued an opinion piece entitled “Tax Expenditure Reform: An Essential Ingredient of Needed Deficit Reduction.” The FEA is troubled with the generalizations and inaccuracies offered by the CBPP in the section titled “Like-Kind Exchanges,” relating to tax-deferred exchanges under §1031 of the Internal Revenue Code.

The CBPP’s opinion is based largely on one article from the New York Times and an obscure treatise. The opinions contained in those source documents are not facts, nor should they be the basis for suggesting sweeping changes to the tax code. The FEA wishes to correct the misconceptions upon which the CBPP’s opinion is premised:

• **§1031 is not an unfair tax break for the wealthy.** 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.

• **§1031 does not provide subsidies for rental truck fleets and investment property and does not divert billions of dollars of tax revenue.** Rather, §1031 provides taxpayers with an opportunity to preserve cash flow, grow their businesses and improve their investments. Tax is deferred, not eliminated; gain will be recognized and taxed when the taxpayer sells and effectively “cashes out” of the asset. In the interim, 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. Moreover, businesses are able to maintain a continuity of investment by upgrading machinery, equipment and other business-use assets without tax on gain reducing cash flow available for growth of the business. In short, §1031 permits an efficient use of productive capital.

• **§1031 exchanges of assets are different from swapping shares of 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.

• **Qualified Intermediaries are not Brokers.** The CBPP describes a system that does not reflect the reality of the marketplace. Unlike a broker, the QI does not help clients to market their relinquished properties and locate their replacement properties. Rather, Qualified Intermediaries (QIs) perform an essential function, as outlined in the Treasury Regulations. The QI guides the taxpayer through the exchange, preparing the necessary documents and holding the exchange funds to prevent improper receipt by the taxpayer. In an often overlooked role, the QI serves as an unofficial gatekeeper for the IRS, promoting compliance with the technical requirements for proper exchange treatment, without which, tax revenue would decrease through improperly claimed §1031 treatment and increased auditing costs.

• **§1031 has not escaped rigorous Congressional scrutiny.** The CBPP suggests that the only explanation for the continued existence of tax-deferred exchanges must be a lack of “rigorous scrutiny” by Congress. Quite the opposite is true. Even the treatise cited by the CBPP acknowledges that the House versions of the Revenue Act of 1987 and the Omnibus Budget Reconciliation Act of 1989 both contained provisions that would have “severely restricted the use of like kind exchanges.” In fact, certain restrictions on exchanges between related parties were enacted in 1989. The absence of change does not equate to a lack of review. The truth is that §1031 has been reviewed on many occasions, both by Congress and Treasury. Changes have been made, but significantly, the importance of tax-deferred exchanges has been affirmed.

**Economic Benefit of Tax-Deferred Exchanges**

The non-recognition of gain on an exchange 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 property, change geographic location, 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 promotes investment in the U.S.** Owners of domestic real estate are encouraged by the benefits of tax deferral to reinvest in U.S. real estate, rather than place their money in other or foreign investments. Foreign owned automobile manufacturers, for example, cannot receive tax deferral benefits by shuttering a US plant, and moving the facility to Asia. §1031 provides a strong incentive to multinational companies to maintain and increase investments in the US.
• **§1031 stimulates the US economy.** The tax deferral benefits of §1031 serve to stimulate the manufacturing economy, encouraging U.S. 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.

• **Elimination of §1031 would have a chilling effect.** §1031 exchanges play a significant role in the velocity of the economy. Many business transactions simply would not take place without §1031, including sales and purchases of real estate, machinery, equipment and leased assets. Without the tax incentive, many transactions will be delayed or abandoned, and real estate values will be further eroded. Fewer transactions also 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, after-market alteration, customization and installation industries. At the end of the economic chain, 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. The bottom line is that without the current treatment under §1031, cash-strapped owners of business-use and investment assets, including farmers, could be forced to downsize their businesses, farms and ranches 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.

**Conclusion**

The CBPP opinion piece concludes: “The like-kind exchange provision is a strong candidate for reforms to rein in its excesses or repeal it.” The real world has proven just the opposite. Tax-deferred exchanges are a vital stimulant to our economy. Taxing the gain on assets held for investment and business use would not be a tax on wealth; rather it would result in a tax on operating cash flow. §1031 not only encourages reinvestment over profit taking, it provides a strong incentive to keep that investment at home, in the United States.

Should you have any questions, or wish to discuss, please do not hesitate to contact me.

Sincerely,

David Brown  
President  
Federation of Exchange Accommodators  
(515) 279-1111  
dbrown@ipe1031.com