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**Re: Why Section 1031 Like-Kind Exchange Should Be Preserved in Tax Reform**

Dear Victoria and Randell:

Thank you for meeting with the representatives of the Investment Program Association (“**IPA**”) on May 2, 2017. At your request, we are writing to follow up on the key points we discussed regarding the importance of Section 1031 to our members, including numerous real estate investment trusts (“**REITs**”).

As you design how tax reform can grow American jobs and the American economy, we urge you to consider the importance of Section 1031 like-kind exchanges. In particular, we would like to remind you of the significance of Section 1031 to the American economy, outline how it is a strong supplement to your pro-growth tax policy agenda, and emphasize the importance of Section 1031 to REITs. We strongly believe that Section 1031 should be preserved in your tax reform efforts.

We are a trade association formed to provide effective national leadership for the direct investment industry through education and public awareness. The IPA supports individual investors access to investment products that are traditionally only available to institutional investors such as lifecycle REITs and business development companies, energy and equipment leasing programs, and real estate private equity offerings. More than two million individual investors take part in these direct investment products, which provides diversified investment portfolios and serves an essential capital formation function for the American economy.

**BACKGROUND: TAX REFORM AND THE BLUEPRINT**

In June 2016, Chairman Brady and the House Republicans published *A Better Way* (the “**Blueprint**”), a tax reform proposal with the goal of delivering jobs, raising wages, and growing the American economy. The Blueprint aims to provide tax neutrality to American businesses by removing “tax-induced distortions” and “letting market forces more efficiently allocate investment.” Accordingly, the Blueprint proposed the full and immediate expensing of investments in assets (excluding land) and significant limitations on interest expense deductions.



The IPA wholeheartedly supports the Blueprint's goal to "make the United States a magnet for investment" and grow the American economy. We offer the below comments in full endorsement of these objectives, but would like to ensure that your pro-growth tax policy agenda does not unintentionally restrict the appropriate management of investment assets or create market distortions.

## **WHY SECTION 1031 SHOULD BE PRESERVED**

The IPA strongly believes that Section 1031 should be preserved in your pro-growth tax policy agenda. Section 1031 encourages investments in America, which creates jobs and grows the economy. In addition, Section 1031 is a critical tool for REITs to sustain and grow their portfolio of investments and serves as a meaningful supplement to the Blueprint.

### **1. Section 1031 Encourages American Investments and Job Growth.**

One study that examined the economic effects of repealing Section 1031 projected a decrease in real estate investment and an increase in holding periods for real estate.<sup>1</sup> This, according to the study, will lead to decreased construction and investment activity, which will subsequently depress the market and employment.<sup>2</sup> A separate study confirmed this projection by concluding the repeal of Section 1031 would, in the long run, lower the GDP, decrease investments, and decrease labor income.<sup>3</sup> Together, these studies show that Section 1031 is already an indispensable catalyst to the American economy. Considering that a taxpayer's investment is usually "traded up" to a better and more expensive property in a typical Section 1031 like-kind exchange,<sup>4</sup> Section 1031 encourages investments in America by allowing taxpayers to properly manage and grow their investments. Without Section 1031, taxpayers may not even be able to reinvest in the same property because of a net "tax drag."

### **2. Section 1031 is a Vital Tool for REITs to Continue and Expand Investments.**

The underlying policy behind Section 1031 is the longstanding premise that it is unfair for a taxpayer to recognize gain when, in economic reality, the taxpayer has maintained a continuity of investment in like-kind property. Consistent with this policy, Section 1031 is a vital tool that allows REITs to continue, expand, and attract investment in real estate.

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<sup>1</sup> See David C. Ling and Milena Petrova, *The Economic Impact of Repealing or Limiting Section 1031 Like-Kind Exchanges in Real Estate* (March 2015), available at <http://www.1031taxreform.com/wp-content/uploads/EY-Report-for-LKE-Coalition-on-macroeconomic-impact-of-repealing-LKE-rules-revised-2015-11-18.pdf> (last visited June 7, 2017).

<sup>2</sup> *Id.* at 54.

<sup>3</sup> See Ernst and Young, *Economic Impact of Repealing Like-Kind Exchange Rules* (March 2015), available at <https://www.finance.senate.gov/imo/media/doc/Federation%20of%20Exchange%20Accommodators-%202.pdf> (last visited June 7, 2017).

<sup>4</sup> See Emily L. Foster, *Advocates Aim to Preserve Like-Kind Exchange in Tax Reform*, Tax Notes Today (May 3, 2017).



Consider, for example, a common umbrella partnership REIT structure (“**UPREIT**”) in which the REIT acquires real estate from an original owner in exchange for partnership interests in its operating partnership. Without Section 1031, the REIT would be limited in its ability to effectively manage such real estate in its portfolio. First, the subsequent sale of real estate acquired in an UPREIT transaction triggers Section 704(c) built-in gain to the original owner of the real estate, and in some cases an obligation by the REIT under a tax protection agreement to make the original owner whole on a grossed-up basis. In many cases, Section 1031 allows the REIT to sell the property at issue and acquire a replacement property in a Section 1031 like-kind exchange and, thereby, defer the built-in gain trigger and related indemnity obligation. Without Section 1031, REITs may experience a “lock in” effect for UPREIT assets in their portfolio. Second, if a REIT generally sells real estate property over certain levels in any given year, it runs a risk that it could be considered a “dealer” and trigger the prohibited transaction rules under Section 857(b)(6) (becoming subject to 100% tax on any gains from the sale). Section 1031 allows the REIT to properly manage such adverse tax considerations, thus allowing the REIT to make sound and tax-neutral business decisions. This result—tax policy fostering more investments and allowing businesses to make tax-neutral decisions—is consistent with the Blueprint’s goal discussed above.<sup>5</sup>

### **3. Section 1031 Supplements the Blueprint.**

Section 1031 supplements the constraints under the Blueprint’s proposal that excludes land from immediate and full expensing. For example, consider a taxpayer who owns a building and the underlying land, needs to sell them for business reasons, but desires to acquire new land for development. The taxpayer will recognize gain when it sells its building and land, but will not receive an offsetting deduction from its new land acquisition because land is specifically excluded from immediate expensing under the Blueprint. This example shows a significant tax discrepancy and a reinvestment decision that is heavily tax dependent. Section 1031 supplements the Blueprint by allowing the taxpayer to reinvest irrespective of the type of replacement real estate it chooses to acquire.

Consider another example of a communications REIT that wants to expand its fiber optic networks held via an “indefeasible right to use” (“**IRU**”) or an energy company that wants to build out its gas gathering systems in the energy space. For expansion, communications companies often exchange IRUs with each other in a direct swap (IRU for IRU) without cash. Energy companies also exchange easements or land leases in a similar manner. In either case, the companies would have no offsetting expense deductions against the gain realized in the direct swap. Not only does this discourage the proper development and expansion of infrastructure, it also restricts the communications or energy company’s ability to expand to underserved regions—both undesirable results from a tax policy perspective. Again, Section 1031 supplements the Blueprint and allows such companies to expand independent of tax considerations.

### **4. Repeal of Section 1031 Will Artificially Bunch Transactions at Year-End.**

Under the Blueprint and without Section 1031, taxpayers will be incentivized to complete their transactions at year-end, which creates an artificial “bunching” of transactions. For instance, if a

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<sup>5</sup> Moreover, Section 1031 is consistent with the same tax policy that provides deferral for taxpayers through a corporation via Section 351 or a partnership via Section 721.



taxpayer has net gains in a particular year, it will want to offset that business income through an end-of-the-year investment that is fully and immediately deductible under the Blueprint. Considering most taxpayers are calendar year taxpayers, there will be an artificial “bunching” of transactions at year-end caused by taxpayers who seek to minimize their tax. This would create unprecedented transactional administrative burden and artificially distort the market for investments and capital—not a desirable outcome from a tax policy perspective and contrary to the Blueprint’s goal of tax-neutrality. Section 1031 would remove this unnecessary impact.

### **CONCLUSION**

The IPA fully endorses the Blueprint’s objectives to grow the American economy and to “make the United States a magnet for investment.” Accordingly, we strongly urge the Committee on Ways and Means to preserve Section 1031 in its tax policy agenda. Section 1031 encourages investments in America and is a vital tool for REITs and American businesses to continue, sustain, and grow their investments. Moreover, it serves as a useful supplement to the Blueprint by addressing issues that may arise from immediate expensing.

We thank you for your consideration of our above comments.

Respectfully submitted,



Anthony Chereso  
President & CEO, Investment Program Association

