National Leadership for the
Direct Investments Industry

IPA
Investment Program Association

July 17, 2017

The Honorable Orrin Hatch
Chairman
Committee on Finance
United States Senate
Washington, D.C. 20510

Dear Chairman Hatch,

On behalf of the Investment Program Association (IPA) and its members, I want to thank you for your leadership in reforming our tax code to promote strong economic growth, and to share the IPA's thoughts on key issues in the tax code affecting the real estate industry.

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 and emphasize the importance of Section 1031 to the real estate economy, including real estate investment trusts (REITs). We strongly believe that Section 1031 should be preserved as Congress considers comprehensive tax reform.

The IPA supports individual investor access to a variety of asset classes with low correlation to the traded markets and historically available only to institutional investors, including: lifecycle REITs, lifecycle business development companies, interval funds, energy and equipment leasing programs, and real estate private equity offerings. These portfolio diversifying investment products have been held in the accounts of more than three million individual investors. They are a critical component of an effectively balanced investment portfolio and serve an essential capital formation function for the U.S. economy. The mission of the IPA is to advocate for portfolio diversifying investments through education and public awareness.

WHY SECTION 1031 SHOULD BE PRESERVED

The IPA strongly believes that Section 1031 should be preserved as Congress considers comprehensive tax reform. Section 1031 encourages investments in America, which creates jobs and grows the economy. In addition, Section 1031 is a critical tool for real estate investors 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 concluded that Section 1031 improves liquidity, increases investment in real estate, and ultimately increases the federal tax revenue because the ultimate taxable gain is, on average, 19% higher because taxpayers continuously reinvest and improve their properties.[1] It also examined the economic effects of repealing Section 1031 and projected a decrease in real estate investment and an increase in holding periods for real estate.[2] This, according to the study, will lead to decreased construction and investment activity, which will subsequently depress the market and employment.[3]

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.[4] Specifically, the study finds that the repeal of Section 1031 will result in an annual $13.1 billion decline in GDP and an annual $1.6 billion decline in federal tax revenue each year.[5]

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,[6] Section 1031 encourages investments in America by allowing taxpayers to grow and manage their investments. Increase investments lead to more American jobs and ultimately more federal tax revenue. Without Section 1031, taxpayers may not even be able to reinvest in the same property because of a net "tax drag." As the studies discussed above show, Section 1031 is already an indispensable catalyst to the American economy and its repeal would cause decrease in GDP, decrease in investments, and decrease in labor income while increasing the cost of capital for business investments.[7]

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.

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

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[1] *See* David C. Ling and Milena Petrova, T*he 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 May 31, 2017).

[2] *Id.* at 5-6.

[3] *Id.* at 54.

[4] *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 May 31, 2017) (hereinafter Ernst and Young Study)

[5] *Id.* at 16-18.

[6] *See* Emily L. Foster, *Advocates Aim to Preserve Like-Kind Exchange in Tax Reform*, Tax Notes Today (May 3, 2017).

[7] Ernst and Young Study, at iii-iv.

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 Congress' goal promoting economic growth.[8]

Conclusion

The IPA fully endorses a simpler and a more rational tax code that can grow American jobs and the American economy. Accordingly, we strongly urge the Committee on Finance to preserve Section 1031 in its tax reform efforts. Section 1031 encourages investments in America and is a vital tool for real estate investors and American businesses to continue, sustain, and grow their investments.

Sincerely,

Anthony Chereso
President & CEO, Investment Program Association

[8] 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.

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