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Why pro-growth tax reform must preserve like-kind exchanges

By Daniel L. Goodwin

With our economic recovery finally accelerating, pro-growth tax reform offers the potential to further prime the U.S. job creation machine. But not all reform proposals effectively safeguard key incentives that fuel domestic investment, new hiring and the enrichment of individual communities. One of the most notable provisions at risk—like-kind exchanges—empowers both businesses and individual property owners to roll over their capital into new investments that spur economic activity across the country.

In advance of debates over which provisions are unwarranted tax loopholes and which are economic growth engines, elected officials on both sides of the aisle should reacquaint themselves with Section 1031's purpose. Like many of my peers in the investment and real estate industries, I was quite concerned when **Sen. Johnny Isakson (R-Ga.)** recently noted that most lawmakers do not fully comprehend the potential economic impact of limiting like-kind exchanges.

Put simply, a like-kind exchange enables a business or investor to defer—*not dodge*—the capital gains tax on a non-personal asset sale, provided that the capital is reinvested in a comparable asset within a prescribed time period. This practice of rolling over and reinvesting proceeds is actually a core catalyst of domestic real estate activity and helps fuel our entire economy.

When conceptualizing the value of like-kind exchanges, think about how the **IRS's home sale exemption** permits homeowners to defer capital gains taxes generated by selling their house. This homeowner tax provision encourages individuals and growing families to apply the proceeds from their home sale to the purchase of a new house. The home sale tax deferral spurs real estate transactions, which like 1031 commercial property exchanges, generate local transfer taxes and provides employment for the following small businesses: appraisers, accountants, contractors, mortgage bankers, real estate brokers as well as both law firms and title companies (just to name a few).

If a home seller had to write a check to pay state and federal capital gain taxes at the time of a sale instead of deferring the taxes, owners may choose not to sell, which would be devastating to the housing market with a consequential loss of employment opportunities for many small businesses.

Similarly, if commercial property owners were forced to pay capital gain taxes at the time of sale, a number of people would not sell, resulting in a loss of local transfer taxes and the loss of income for small businesses. Make no mistake about it; most tax free exchanges occur because commercial property owners want to move up to a larger property and reinvest their capital just like homeowners, not because they need to sell. People who elect tax free exchanges are voluntary sellers who, in many cases, will not sell if the 1031 program is eliminated.

In attempting to advance reform that will simplify our federal code and help reduce the deficit, it is understandable that leaders in Washington want to evaluate all existing tax policies. However, Congress must remain deliberate and measured throughout this process to ensure we do not eliminate economic catalysts within our existing code.

Like-kind exchanges contribute to the growth of our economy by stimulating transactional activity and promoting investments across the country. A United States manufacturer, for example, cannot obtain a 1031 deferral benefit by moving a plant overseas; it must reinvest domestically, promoting local business growth. This reinvestment also provides revenue for local governments in the form of transfer taxes, increased property taxes, new construction and improvements to existing structures—all of which build communities, job growth, and quality of life.

To illustrate what a negative chain reaction could look like; consider what happens if a capital gains tax deters a small business from selling its long-held manufacturing building in favor of a modern structure. The business does not stimulate the local economy through the use of other small businesses; it does not contribute new local fees and transfer taxes; and it is prohibited from taking necessary steps to grow its own enterprise. Similarly, a farm family that wants to expand to a larger farm to provide work for the farmer's children often needs to defer the capital gains tax to make the transaction economically viable. Without the 1031 program it is doubtful that many farmers could afford to upsize; with the resulting loss to the economy of many benefits such as the purchase of larger farm equipment, as well as, all the other real estate related expenses mentioned above. If countless property owners across the country are facing a similar disincentive to sell, the health of our economy could be affected.

Remember that under Section 1031 capital gains taxes are deferred—not eliminated. The Federal Government ultimately receives all of its taxes, while stimulating local economies and growing small businesses. Additionally, following a tax free exchange, real estate depreciation which generates tax deductions is limited; thereby actually generating more net federal tax revenue.

To be clear, I agree that our federal tax code is in need of an overhaul. The new Congress has a tremendous opportunity to modernize and streamline an outdated system, but it should not come at the expense of eliminating tax provisions that fuel significant growth.

As new legislation is drafted, lawmakers should draw on information shared by **the Real Estate Roundtable**, **NAREIT**, [the Federation of Exchange Accommodators](#) and **National Association of Realtors** to better understand how like-kind exchanges increase the size and number of real estate transactions, which stimulate the economy.

Individuals, trade organizations, small businesses, and research studies confirm the obvious benefits of keeping Section 1031 as a pro-growth and pro-taxpayer economic catalyst.

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