



The Voice of the 1031 Industry

**1255 SW Prairie Trail Pkwy
Ankeny, IA 50023
Phone: (515) 244-6515
Fax: (515) 334-1174
www.1031.org**

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Mr. Pete Sepp
Mr. Brandon Arnold, Executive Vice President
Mr. Andrew Lautz, Policy and Government Affairs Manager
National Taxpayers Union

RE: Immediate Expensing of Real Property Improvements

Gentlemen:

We noted with great interest your recent comments in your March 21, 2020 letter to Senate and House leadership, in which you advocated for the immediate expensing of residential and non-residential real property structures. The Federation of Exchange Accommodators (“FEA”) is the national trade association for professionals who facilitate like-kind exchanges under IRC Section 1031.

By way of background, immediate expensing of all classes of depreciable property was a major topic during the course of the passage of the Tax Cuts Jobs Act in 2017, spurring many discussions both amongst the House and Senate tax writing committees and taxpayer groups. The TCJA as enacted allowed for the immediate expensing of personal property only, subject to a phase out period. The major real estate business associations and the FEA opposed immediate expensing of residential and commercial real property for a variety of reasons.

First, the exacerbation of the impact of depreciation recapture in immediate expensing would result in longer holding periods for real estate investors. The attached example of a rental house purchased for \$200,000, and sold with 35% appreciation after 7 years at \$270,000 illustrates this point. In this modest example, the property would need to appreciate by 50% in order for the investor to break even after taxes. If this investor did not reinvest in real estate, but instead reinvested the sales proceeds in a savings account or the stock market, the investor would sustain a net loss.

Second, immediate expensing of commercial and residential buildings has the potential to attract significant speculative capital to real estate for investors who want to take advantage of the immediate tax benefits but who are not interested in improving their properties or holding long term. Investors and speculators with capital could flip properties and trade up every few years. Additionally, immediate expensing could encourage speculative building without concern for tenant demand, resulting in the “ghost buildings” of the 1980s. Eventually, immediate expensing would lock many investors into longer holding periods; transactional activity, and property values along with it, would eventually plummet.

Third, given that COVID-19 has driven so many businesses to work and function remotely, it is quite possible that many businesses may continue to operate remotely in the future, at least for part of their workforce. It is uncertain how many businesses may determine, based upon their pandemic experience, that there may be operational savings and other benefits to a dispersed, remote work force. Thus, the facilities that met pre-pandemic needs may be quite different from those that will meet tomorrow's needs.

In sum, it is our view and the view of many in the commercial real estate industry that immediate expensing is not appropriate for long-life assets like real estate but is appropriate for short-life assets like equipment which can and has provided an economic boost without distorting the economy. Like-kind exchanges under existing IRC Section 1031 provide the same economic incentive to reinvest in investment or business-use real property with the same ability to shelter the gain and defer an immediate tax impact, but without the danger of market distortion.

We are grateful for the opportunity to submit these comments. Should you have any questions, or wish to discuss, please do not hesitate to contact any of us.

Sincerely,

Federation of Exchange Accommodators (FEA)

Suzanne Goldstein Baker, Co-Chair, FEA Government Affairs Committee,
Executive Vice President & General Counsel, Investment Property Exchange Services, Inc.
(312) 223-3003 suzanne.baker@ipx1031.com

David Brown, Co-Chair, FEA Government Affairs Committee
President, Iowa Property Exchange, LLC
(515) 279-1111 dbrown@ipe1031.com

Mary Cunningham, Co-Chair, FEA Government Affairs Committee,
President, Chicago Deferred Exchange Company, LLC
(312) 580-9601 mary.cunningham@cdec1031.com

Impact of Immediate Expensing – Rental Home Investment

An investor purchases a rental home for \$200,000. He puts \$50,000 down in equity and finances the rest of the purchase with a \$150,000 loan. At acquisition, 30% of the purchase price is allocated to land, and 70% to the improvements. Investor fully expenses the improvements, worth \$140,000, leaving a tax basis of \$60,000. He holds the property for 7 years during which time it appreciates by 35%. He sells the property for \$270,000.

Sale transaction if immediate expensing allowed for real estate:

Sale Price:	\$270,000
Closing Costs:	<u>\$ 23,000</u>
Net Sale Price:	\$247,000
Total Taxable Gain:	\$187,000
Gross Profit:	\$ 47,000

Taxes Owed at the time of Sale:

Depreciation Recapture @ 25% on \$140,000	\$35,000
Capital Gains @ 20% on \$47,000	<u>\$ 9,400</u>
Total Federal Tax	\$44,400
CA State Tax @ 10.3%	<u>\$19,261</u>
Combined Federal and State Taxes:	\$63,661

Net After-Tax Loss on Investment **(\$13,661)**

1. Taxes would exceed gross profit, erode Investor's original equity, and create a negative return on investment due to the significant depreciation recapture from immediate expensing. The rental home would have to appreciate by 50% just to break even on total taxes. If Investor chose to reinvest in a savings account or securities, or use the funds to pay down debt, Investor would sustain a net after-tax loss.
2. This would create a significant tax lock-in effect, particularly if the tax benefit from the initial expensing deduction had been spent. If faced with a loss of net worth or the need to liquidate other assets to pay the taxes, investors would be encouraged to hold their properties for substantially longer periods, chilling transactional activity.
3. If Investor reinvested in improved replacement property of equal value, the expense deduction of \$189,000 (70% allocation to improvements) would offset total taxable gain. However, if the sold property had greater appreciation and larger gain, the expense deduction would not fully offset all gain, requiring a greater investment to break even.
4. Tax-driven investors with available capital would be encouraged to flip properties to harvest the tax benefits of immediate expensing.
5. Tax-driven lock-in results in reduced transactional activity, and tax-driven flipping results in a bubble, neither of which is good for the economy.