

POINT & COUNTERPOINT

**To Repeal or Retain Section 1031:
A Tempest in a \$6 Billion Teapot**

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This article is a condensation and summary of the “Lincoln–Douglas Debate on Whether to Repeal Code § 1031” held at the Teaching Tax Committee meeting at the 2015 ABA Section of Taxation Midyear Meeting in Houston, Texas. The debate itself was lively and fun, and raised numerous interesting and provocative points on both sides of the issue. The authors thank Stephen Breystone for filling in at the last minute to participate in the debate. The arguments for and against repeal are presented in article format here, but the authors are not in full agreement with respect to each argument.

To retain, repeal, or reform? These are the questions section 1031 invites. This brief article attempts to lay out the competing arguments in favor of each of the first two questions and then explores the two most prominent reform alternatives. If each of the four authors were to have individually stated their views as to each question, readers would be faced with twelve essays. Instead, they have combined and condensed their argument into four parts: (1) a short history of section 1031; (2) the arguments in favor of repeal; (3) the arguments against repeal; and (4) potential avenues for reform.

Short History of Section 1031

The first “modern” income tax law was adopted by Congress in 1913, and the first antecedent to section 1031 was enacted eight years later, in 1921. The original provision was broader in scope than present-day section 1031, providing that no gain or loss would be recognized on an exchange of property if: (1) the property received did not have a readily realizable market value or (2) the property transferred was held for investment or for productive use in a trade or business and exchanged for property of a like kind or use. The provision allowing non-like-kind exchanges of property was soon eliminated in 1924, and since then the like-kind exchange rules have remained substantially intact, with the legislative tweaks described below, for almost 100 years.

The law itself was substantially unchanged from 1924 to 1984, but during that period a significant body of section 1031 case law developed. Perhaps most importantly, the courts fleshed out the parameters of the section 1031 exchange requirement. They held that multiple-party transactions could satisfy the statutory requirement only if the exchanger was not in actual or constructive receipt of the exchange proceeds. Consequently, most multiple-party exchanges required a facilitator.

In response to the Ninth Circuit’s 1979 holding in *Starker v. United States* that a transaction qualified as an “exchange” even though there was a two-year gap between the transfer of the relinquished property and the receipt of the replacement property,

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Congress enacted section 1031(a)(3) in 1984. That provision allows for deferred exchanges that satisfy the identification and exchange timing requirements. The 1984 legislation also prohibited the application of section 1031 to exchanges of partnership interests. In 1989, Congress added section 1031(f), limiting the benefits of like-kind exchanges between related parties, and section 1031(h), treating U.S. property as being not of like-kind to foreign property.

Administrative regulations and rulings have also actively contributed to the law under section 1031. In 1991, the Service issued extensive regulations that created exchange safe harbors, including the qualified intermediary safe harbor, to help exchangers more easily accomplish transactions that the Service deemed to come within the section 1031 definition of exchange.

The Service also provided substantial guidance on how to structure reverse exchanges, improvement exchanges, leasehold improvement exchanges, and program exchanges with certainty that the Service will not challenge the application of section 1031 to such transactions. The Service also provided

specific guidance about the nature of tenancy-in-common interests and interests in certain statutory trusts that hold real estate. With that guidance, exchangers can be comfortable that a long-held fee interest in real property can be like kind to an interest in a properly structured Delaware statutory trust held by numerous other owners throughout the country. Needless to say, the current application of section 1031 is significantly different from its application in 1921 when its predecessor became part of the law.

Every exchanger must report like-kind exchanges on Form 8824. Published data from recent tax years reveals that individuals file more than 60% of all filed Forms 8824. Corporations account for about 30% of filed returns, but they account for almost 60% of all reported deferred gain. The table below summarizes these numbers.

Arguments in Favor of Repealing Section 1031

An effective tax provision should be equitably distributed, minimize economic distortions, and be easy to administer. Section 1031 arguably fails to meet any

of these classic tax policy criteria. It can be asserted that it disproportionately benefits wealthy taxpayers, causes overinvestment in qualifying property, and has created massive administrative complexity. While section 1031 may have served a valid purpose when first enacted, it arguably has evolved into an entrenched, expensive, undeserved, and unnecessary benefit.

Recent Calls for Repeal

In 2010, the so-called “Volker Report” presented the repeal of section 1031 as an option for reforming the tax treatment of capital gains. Republican Chairman of the House Ways and Means Committee David Camp proposed repealing section 1031 in his comprehensive tax reform discussion draft. Democratic Chairman of the Senate Finance Committee Max Baucus proposed repealing section 1031 in his discussion draft on tax reform of cost recovery and accounting. President Obama’s 2015 Budget proposed limiting section 1031 gain deferral to \$1 million per taxpayer per taxable year, which was estimated to reduce the budget deficit by an estimated \$18.27 billion over the years. News reports, such as an article in *The New York Times* last January about

Form 8824 Data for Tax Year 2011

(All money amounts are in thousands of dollars)

		Individuals	Corporations	Partnerships
Number of Forms 8824		170,268	82,314	22,064
Item	Line No.	Amount	Amount	Amount
FMV of other property given up	12	\$289,416	\$430,345	\$726,115
Adjusted basis of other property given up	13	\$68,974	\$205,219	\$34,677
Gain (or loss) recognized on other property given up	14	\$220,442	\$225,127	\$691,439
Cash received, FMV of other property received, plus net liabilities	15	\$1,787,432	\$1,914,721	\$1,408,502
FMV of like-kind property received	16	\$15,311,387	\$35,229,605	\$15,107,374
Adjusted basis of like-kind property given up	18	\$12,377,383	\$15,110,927	\$9,198,798
Realized gain (or loss)	19	\$4,721,435	\$23,711,560	\$10,132,650
Ordinary income under recapture rules	21	\$52,829	\$2,651,711	\$279,086
Recognized gain	23	\$849,498	\$3,142,592	\$918,758
Deferred gain (or loss)	24	\$3,871,938	\$20,601,736	\$9,213,893
Basis of like-kind property received	25	\$11,439,449	\$17,114,754	\$12,269,709

Source: Internal Revenue Service, Statistics of Income Division.

major American companies “pushing the boundaries” of section 1031, have fueled the appetite for repeal. To be sure, budget estimates may show partisan bias, but the scope of the number utilized by the Obama administration at least provides a sense of the maximum expenditure represented by current law.

Inequitable Distribution of Section 1031 Benefits

Section 1031 is the third largest corporate tax expenditure, estimated to reduce revenues by \$11.7 billion in 2014. Supporters of section 1031 may argue that if it is repealed, taxpayers will simply use other strategies like investment in real estate investment trusts, holding property in partnerships, or cross-renting arrangements. However, these arguments do not support retaining section 1031, although they may support reform of other provisions.

There is little data on the distributional impact of section 1031. However, various studies show that the preferential tax rate for capital gains disproportionately benefits the wealthiest of taxpayers. For instance, the Congressional Budget Office estimates that taxpayers in the top 1% receive 68% of the benefit of low tax rates on capital gains and dividends, while the bottom 80% will receive only 7%. As section 1031 allows tax deferral upon the transfer of investment property that would otherwise frequently produce capital gains for individuals, it is likely that section 1031 benefits the same sort of taxpayer. Section 1031 is unlikely to benefit small investors because the gain deferral would not be enough to offset the costs of the exchange, which generally include hiring an accommodator to facilitate the exchange. Additionally, the transaction cost of hiring an accommodator would be a larger percentage of the tax benefit gain on the exchange of lower-value property. Finally, the data from Form 8824 shows that corporations derive the greatest tax benefit from section 1031,

suggesting that the benefit goes to the largest taxpayers.

Overinvestment in Like-Kind Property Causes Economic Distortion

Section 1031 encourages reinvestment of exchange proceeds in property that is like kind to relinquished property. Thus, section 1031 encourages what might be called “asset-type lock-in effect.” For instance, exchangers lock in to holding real estate, if their initial investment was in real estate. Without section 1031, those same investors might diversify their holdings. By encouraging reinvestment in like-kind property, section 1031 may artificially inflate the value of property that qualifies for section 1031 treatment. Any inflated values affect investor decisions and further distort economic behavior.

Calls for retention of section 1031 come loudest from the real estate and qualified intermediary industries. They predict disaster and economic collapse if the prop of section 1031 is removed. These predictions are undoubtedly biased. The Federation of Exchange Accommodators (FEA), an industry group representing section 1031 exchange accommodators, argued that the Joint Committee on Taxation (JCT) estimates of revenue lost to like-kind exchanges in 2010 were overstated, based on a survey of their customers. JCT’s 2010 estimate of the revenue loss from section 1031 was \$2.1 billion. The actual deferred gain based on Forms 8824 filed in 2010 was \$40 billion, which, if one were to calculate tax savings using a conservative 15% capital gains rate, would translate to \$6 billion of revenue loss. As there was likely some recapture and higher rate capital gain in the mix, the JCT’s estimate rather than overstating, significantly understated the revenue loss.

One argument is that even though the government loses revenue when a property owner transfers property and exchanges up into more expensive property, the government effectively

becomes a partner in the reinvested capital and shares in the revenue generated from the reinvestment. This argument requires several assumptions that may not play out with regularity, and, if they do, they may be the result of economic distortion. First, the argument assumes that the property owner’s reinvestment of saved taxes provides a greater economic good than would the government using those funds to provide important services. Second, to exchange up in a transaction, a property owner must have additional capital, obtained through borrowing or already in the property owner’s possession. For the partnership argument to have meaning, one must assume that the property owner would only invest that money if it were able to do so through a like-kind exchange. Most property and business owners will, however, seek to put all available capital to its most productive use. If so, the government will enjoy the benefit of a constructive partnership with the property owner whether the owner uses available capital to invest in like-kind property or uses the capital to invest in different property. The government stands to gain from either type of investment; the government would, however, also prefer that its constructive partner, the property owner, put the capital to its highest and best use. Certainly the best investment is not always in like-kind property. Because section 1031 encourages reinvestment in like-kind property, it causes economic distortions.

Administrative Burden

The common law definition of exchange allows exchangers to engage in multiple-party deferred exchanges, but prohibits exchangers from actually or constructively receiving non-like-kind property as part of the transaction (such property is taxable boot, which can trigger gain recognition). The regulations promulgated in 1991 create safe harbors that help exchangers gain confidence that they are avoiding the

actual or constructive receipt of non-like-kind property. Nonetheless, those safe harbors create an administrative burden for exchangers, impose external costs on the transaction, and appear to provide no nontax benefits to exchangers.

The structure of section 1031 exchanges has been shaped by litigation. The Service has responded to litigation losses by adapting its administration of section 1031. Based on a recent search in CCH IntelliConnect, just since 1994, the Service has litigated 219 cases involving section 1031 and published 20 revenue rulings, seven revenue procedures, and 49 regulations projects related to section 1031. The Service has also issued at least 90 private rulings and several private memoranda since 1994. The section 1.1031(k) regulations governing deferred exchanges alone cover 15 pages. The most recent statistics indicate that over 100,000 like-kind exchanges were reported in 2011 by filing Form 8824. The instructions to Form 8824 estimate 15 hours of paperwork burden per form filed, which amounts to a huge taxpayer burden and does not account for the Service burden of processing those forms. To be sure, some of the administrative burden will not seem salient to taxpayers because taxpayers will turn to intermediaries in order to navigate the complexity.

Debunking Arguments for Retaining Section 1031

Despite section 1031's defects, many voices support it with various arguments. The most often stated reasons for retaining section 1031 appear to be "administrative convenience" and "continuity of investment."

One early justification for tax-free exchanges was that if like-kind exchanges are not currently taxed, then the Service will not be burdened with attempting to value property and enforce compliance. Today, the vast majority of like-kind exchanges, according to a February 2013 FEA report, are accomplished through third-party intermediaries who accept cash for the relinquished property

and pay for the replacement properties with such cash. Thus, the value of the property is known and computing taxation of gain on an exchange would not impose an undue burden. Consequently, value-based arguments in support of section 1031 are outdated.

Aspects of section 1031 exchanges that make valuation a non-issue also create administrative inconvenience. Both taxpayers and the Service suffer considerable inconvenience in structuring and reviewing section 1031 exchanges. Taxpayers must meet detailed requirements to obtain the tax deferral benefits of section 1031, requirements that may be difficult to satisfy when dealing with buyers and sellers who do not care whether the transaction qualifies. The Service has been burdened with analyzing and providing guidance for ever more complex transactions, structured so that the taxpayers can do the transaction they want and still obtain the favorable tax treatment they desire.

The continuity-of-investment rationale provides that as the taxpayer remains invested in like-kind property, taxation is inappropriate. The taxpayer has not liquidated its investment and has no funds to pay the tax. Imposing a tax on the disposition of property discourages the taxpayer from shifting its investment funds to other, more profitable, investments and thus locks capital into a specific asset (asset-specific lock-in effect), so the capital is not used in the most economically efficient manner. As discussed below in the section on reform, the current like-kind parameters arguably do not appropriately incorporate the continuity-of-investment rationale, but the continuity-of-investment norm could be used to craft a policy-justified definition of like-kind property.

Arguments for Retention of Section 1031

In 2014, the U.S. Treasury's Office of Tax Analysis (OTA) recapped the history and policy rationale underlying section 1031, as follows:

One of the arguments for not treating the exchange of like-kind property as a realization event is that the taxpayers were continuing their on-going investment in the same business activity rather than cashing in their investment. In addition, Congress recognized that the dramatic increase in tax rates on capital gains during World War I had created substantial lock-in effects that greatly interfered with normal business transactions. Exchanges of property would be discouraged because there wouldn't be enough money left after paying the capital gains tax to purchase a replacement property of comparable value. Persuaded by these arguments, Congress has allowed capital gains taxes to be deferred in such exchanges since 1921 with only modest changes in the rules.

The like-kind exchange rules today found in section 1031 have been around for almost a century, and appear to provide the beneficial objectives that Congress intended when it first adopted these rules in 1921.

Congress sought to encourage reinvestment in existing businesses, and to counter the "asset-specific lock-in effect," by specifically permitting tax-free exchanges of qualifying property. Congress wanted to promote economic growth, advancements in technology, job growth, and growth in government tax revenues, and Congress correctly foresaw that these worthy goals would be stymied if upgrading business and investment assets were treated as a taxable event.

If these time-tested provisions are now repealed, aging capital equipment will be retained instead of upgraded; real estate utilization will become increasingly inefficient; and the biggest loser would be the federal Treasury, which is the single biggest financial beneficiary of the reinvestment transactions explicitly promoted by section 1031.

Continuity-of-Investment

Section 1031 is not the only provision to limit the taxability of exchanges. A presumption of taxability for exchanges may be enshrined in section 1001, but this presumption is less robust than it may initially appear. Consider, for example, the various nonrecognition provisions that apply to the organization and reorganization of corporations and partnerships. Taxpayers also have the ability to defer gain on the happening of casualty or condemnation events through a qualifying replacement of the damaged property. Further, the Treasury has the ability to contest taxpayer losses when the substance of a transaction suggests that no beneficial change has occurred, and the codified wash sale rules provide specific limits on the ability to deduct losses on nonsubstantive sales of securities. The list of exceptions goes on and on.

The common thread in all these exceptions is that the taxpayer has not really changed its position but instead has economically continued its position. This continuity-of-investment rationale has been embraced by all three branches of government where like-kind exchanges are concerned. As the Second Circuit noted in *Jordan Marsh v. Commissioner* in 1959: “Congress was primarily concerned with the inequity, in the case of an exchange, of forcing a taxpayer to recognize a paper gain which was still tied up in a continuing investment of the same sort.”

The continuity-of-investment norm is efficient and supports a comparative equity analysis for retention of like-kind exchanges. It is a standard observation that a tax system should prioritize taxing inelastic transactions—transactions that taxpayers engage in primarily because of nontax goals or constraints. The argument is that taxing such transactions will have minimal effect on taxpayer behavior. On the other hand, taxing elastic transactions will trigger changes in taxpayer behavior: they will reduce or cease engaging in the transaction or

incur planning costs to minimize or avoid the tax.

While the logic of this line of reasoning is fairly uncontroversial, it would be costly and difficult (if not impossible) to discern and measure elasticities with precision. In addition, taxing solely through reference to elasticities would almost certainly raise distributional fairness issues since a tax on some of the most inelastic transactions—for example, basic food and housing purchases—would be highly regressive. A reasonable second best alternative for the tax system is to develop administrable proxies for elasticity and to select those proxies that raise fewer distributional concerns.

The continuity-of-investment principle is arguably one such workable proxy for elasticity. After all, if a taxpayer is not substantively changing its investment and is instead merely continuing the same investment, such a transaction is far more likely to be tax elastic. That is, the taxpayer could elect not to engage in the transaction or could pay more (though less than the tax that would be owed) to construct an economically similar but nontaxed transaction. Proponents of the like-kind exchange rules argue that the current rules are already consistent with the continuity-of-investment principle.

The like-kind exchange rules also do not operate in isolation. In particular, if taxpayers hold property until death the tax basis in the property is stepped-up to fair market value, permanently eliminating the deferred gain. This opportunity amplifies the incentive taxpayers would have, if the like-kind exception were repealed, to change their transactional behavior rather than accept the tax.

Distributional and Comparative Equity

Efficiency is, of course, only one important tax policy criterion. Distributional and comparative equity considerations are also critical to tax design. The current like-kind exchange

rules do not raise significant concerns with respect to equity. Like-kind exchanges are accessible to and widely utilized by individuals, including small investors holding a single rental property. To be sure, wealthier corporations and individuals also have access to the benefits of the like-kind exchange rules, but it is also worth considering that like-kind transactions for wealthier individuals and corporations may be more tax elastic because these taxpayers may have greater access to alternative planning techniques.

Comparative equity—that likes should be treated alike—is often used as an argument for repeal, but that critique assumes that the proper comparison is between taxpayers who engage in like-kind exchanges and those who engage in taxable exchanges. If the proper comparison is instead between taxpayers who continue their investment through like-kind exchanges and those who continue their investment by simply holding the same property, then comparative equity supports retention. As a policy norm, comparative equity is problematic precisely because so much depends on which taxpayers and which transactions are being compared. Its importance remains, however, because comparative equity often resonates with intuitive perceptions of fairness. If more serious repeal proposals were advanced in the legislature, it is likely that outright repeal would strike many individuals as unfair, particularly when the continuity-of-investment norm is at its strongest.

Reinvestment Is the Wrong Time to Tax

U.S. income tax law broadly accepts that the “right” time to tax appreciation or gain in an ongoing business or investment activity is when the taxpayer is “cashing out” its investment, and not when the activity is merely being “restructured” for reasons of economic efficiency. Section 1031 provides nonrecognition when a taxpayer is merely replacing older, worn-out equipment with new equipment, or is

moving its business operations from an existing facility to a new, more efficient facility. The laudable policy underlying section 1031 is to encourage a more efficient use of existing resources and, correspondingly, not to discourage economically valuable upgrade transactions by imposing a tax event.

The Treasury OTA's explanation quoted above specifically notes that taxing restructuring transactions would create a "substantial lock-in effect that greatly interfered with normal business transactions." The lock-in effect is a real phenomenon: where there is discretion or any modicum of tax elasticity, taxpayers simply do not voluntarily inflict major tax costs upon themselves. As one simple but illustrative example, large U.S. corporations retain offshore literally trillions of dollars of foreign income in controlled foreign corporations, and do not repatriate these funds back to the United States because they have a choice and choose not to trigger a current tax event. That is the predictable human behavior that underlies the "lock-in" effect and that section 1031 is designed to ameliorate.

The crucial point is that taxpayers respond to taxes in very smart, aggressive, and sophisticated ways. There are many alternative ways to structure business transactions so as to maintain tax liquidity (meaning nonrecognition of immediate gain) even if section 1031 were repealed. For example, a taxpayer can rent the property that it owns currently to the party that should be the next owner, and can rent the property that it would otherwise like to acquire as replacement property from that property's current owner. These "work around" structures would very likely be far less efficient arrangements than exchanging the relinquished property for the replacement property, but cross-renting would almost certainly be preferable to paying tax at a rate of 40% or more on what would otherwise be a rational reinvestment transaction.

Perhaps the most important observation by Treasury is that "[e]xchanges of property would be discouraged because there wouldn't be enough money left after paying the capital gains tax to purchase or replace a property of comparable value." That is why section 1031 arguably represents excellent fiscal policy. Taxpayers redeploy the economic value from the relinquished property and reinvest it in new property of comparable or greater value. If taxpayers choose to extract money in the course of an exchange, these cash proceeds are taxed first, up to the full amount of the built-in gain. This can be contrasted with installment sale rules under section 453, where gain is recognized proportionately, or with the rules governing entity distributions, such as section 301 or section 731, where tax basis is recovered first and built-in capital gains are taken into account thereafter. The point is that section 1031 is not a tax give-away: it is arguably tailored so that gain recognition is avoided only if funds are fully reinvested in the applicable business or investment activity.

The "Lock-In Effect:" Myth or Math?

The following example illustrates the asset-specific lock-in effect. Taxpayer A owns an airplane used for transportation purposes in A's trade or business. Assume the current airplane ("Old Jet") was originally purchased for \$12 million, has been depreciated down to zero for federal income tax purposes, and is still worth \$10 million.

Assume A sells Old Jet for \$10 million in a taxable transaction and the gain is taxed at a 40% rate. A would owe \$4 million of tax and would then have \$6 million of after-tax proceeds left for personal purposes or to reinvest. A may be reluctant to sell a \$10 million asset if the sale leaves him with just \$6 million to reinvest after paying taxes.

Of course, if A intends to retire, imposing tax at this time is appropriate,

and that is how section 1031 works. But assume instead that A seeks to upgrade his business by replacing Old Jet with a new airplane ("New Jet") costing \$20 million. This would be a bad time to impose tax on A—bad for A, but also bad for the economy and especially bad for the Treasury (as explained below). Fortunately, section 1031 allows A to exchange Old Jet for New Jet and improve the efficiency of his business without incurring a current tax.

Under section 1031, A can invest an additional \$10 million (either self-funded or borrowed) and add this to the \$10 million realized on the sale of Old Jet, in order to purchase New Jet for \$20 million. By contrast, if the sale of Old Jet were fully taxed, A would need to raise an additional \$14 million—\$4 million to pay the tax plus an additional \$10 million to purchase New Jet, an increase of \$4 million. The tax would discourage A from engaging in the transaction, thus "locking-in" his investment in Old Jet. Because section 1031 helps alleviate this type of asset-specific lock-in effect, it helps to eliminate economic distortions.

Section 1031 Creates Constructive Partnership

Two contrasting examples present the argument that the government may actually gain revenue if the transaction described above is structured as a section 1031 exchange.

Example 1. Assume the exchange of Old Jet for New Jet qualifies for section 1031 nonrecognition. A has acquired New Jet without paying a current (immediate) tax of \$4 million, but the Service will soon be paid this additional \$4 million amount in full! That is because, under section 1031, A will have only \$10 million of depreciable tax basis in New Jet, even though the purchase price is \$20 million. (Section 1031 mandates carry-over tax basis, adjusted upward by the additional cash invested by A.) The missing tax basis translates into an additional \$4 million of taxes over

the next six years (the depreciation period of New Jet if it is classified as five-year property under MACRS).

Example 2. Assume A structured the transaction instead as a \$10 million taxable sale of Old Jet and paid \$4 million in taxes. He would now have to come up with \$14 million (instead of \$10 million) in order both to pay taxes and to buy New Jet for \$20 million. However, A would then have an extra \$10 million of tax basis in New Jet, and would claim these depreciation deductions over the next six years. (In fact, if Congress continues to extend bonus depreciation and greatly enhanced section 179 deductions in 2015, A would write off much or all of this additional \$10 million of tax basis in the very first year.) That \$10 million of additional depreciation would result in a projected \$4 million reduction in A's taxes over the next six years.

These examples show that section 1031 is essentially a timing provision that affects when tax is imposed. In Example 2, A pays \$4 million up front to Treasury, but then this same amount is “returned” to him over the next six years thanks to the extra \$10 million in depreciation deductions. Economically, A has effectively lent \$4 million to Treasury tax-free, which is then rapidly repaid to A in the form of tax deductions. The government's borrowing costs are low, so an interest-free six-year loan has limited value. Assuming five-year property under MACRS depreciation and using the mid-term AFR rate for January 2015 of 1.75%, the value of this \$4 million loan is about \$125,000. If 50% bonus depreciation is again adopted in 2015 (as it was in 2014), the value of the loan is about \$62,000. On a \$10 million sale-and-acquisition transaction, \$62,000 is a 0.6% effective tax rate.

Conversely, if section 1031 is available, Treasury loses this immediate \$62,000 economic benefit, but A may be more likely to engage in an upgrade transaction—the “unlocking” effect. This will confer an economic benefit to A. But it is also an economic benefit to

the economy: A will probably employ additional employees, the vendor of New Jet will benefit, as will the vendor's employees, as will everyone who sells goods and services to the vendor, or to A, etc., etc. This multiplier effect is the economic inverse of the asset-specific lock-in effect.

The Partnership Approach to U.S. Income Taxation

Tax law could be considered a partnership agreement between A and Treasury. The taxpayer puts up the capital, and the government puts up infrastructure, roads, education, and laws. The government can modify this arrangement unilaterally. The same partnership arrangement is made with all taxpayers.

A gets the federal government (and usually one or more state governments) as partners in his business, whether he wants that or not. A puts up all the money, and takes all the risks. If the partnership venture is successful, the governments take 40% or more of the taxable income. But Treasury enjoys additional benefits, because Treasury has the same partnership with everyone else involved, directly or indirectly, in A's business. Treasury will collect income taxes from A's employees, from the vendor of New Jet, from that vendor's employees, from A's other vendors, from the vendors to the New Jet vendor, etc., etc. Treasury will also collect employment taxes and unemployment taxes, federal excise taxes imposed on aviation fuel, on telephone usage, and other transactions.

Thus, section 1031 promotes business investment; business investment has a multiplier effect on the economy, including government revenues. Lawmakers clearly recognize that capital investment by taxpayers is a good thing, and in recent years have provided huge incentives to reward investment, including bonus depreciation and greatly increased deduction limits under section 179.

In 2009, the federal government adopted a “Cash for Clunkers” program, which was designed to encourage car owners to turn in old “clunkers” and purchase new vehicles. The Cash for Clunkers Program was comparable, both in policy and in practice, to section 1031. Thanks to section 1031, every commercial airline fleet regularly upgrades, modernizes, and expands its fleet of airplanes, thereby enhancing the comfort and safety of the passengers. Likewise, every car rental company regularly upgrades and expands its fleet, taking older cars out of rental use and substituting new, low-mileage cars with the latest technologies for safety and gasoline efficiency. What the Cash for Clunkers Program did for a brief period of time, section 1031 does quietly but with enormous efficiency, year in and year out, for the benefit of everyone concerned.

Provisions like bonus depreciation and section 179 do not necessarily promote upgrading of equipment or prudent redeployment of capital. These provisions reward, without qualification, all new purchases. The underlying message is “Go spend money.” But section 1031 is expressly designed to reward the upgrading and reinvestment in an existing business. The underlying message of section 1031 is “Go spend money wisely.” Section 1031 directly encourages replacing and upgrading business assets, and promotes economic growth far more effectively than bonus depreciation and section 179, and does so for the benefit of all, including Treasury.

Potential Avenues for Section 1031 Reform

As an alternative to outright repeal or outright retention, Congress could also consider amending section 1031. Two mutually-compatible amendments in particular are often suggested for enhancing the equity and efficiency of section 1031. First, Congress could narrow the definition of like-kind property to better support the

continuity-of-investment norm. Second, Congress could change section 1031 to a rollover provision to reduce complexity and promote equity. The first suggestion would make section 1031 exchanges somewhat less common, while the second provision would make them considerably more common.

Amend the Definition of Like-Kind Property

When section 1031 was first enacted, Congress arguably did not anticipate that it would eventually apply to the exchange of raw land in Iowa for a condo in Miami, a warehouse in Memphis for an oil and gas interest in Williston, or a water right in Arizona for an undivided interest in a commercial building in Brooklyn. This broad definition of like-kind property arguably now does more than merely facilitate the continued investment in similar property.

The equity justification for section 1031's continuity-of-investment argument best applies, however, if it helps property owners do tax free what a property owner could do tax free without disposing of property. For example, a person can construct improvements on raw land tax free. Consequently, the continuity-of-investment argument would appear to support the tax-free exchange of raw land for a building. Absent section 1031, however, a person cannot, in a tax-free transaction, convert fee ownership in raw land into an undivided interest in that land, a mineral interest in the land, water rights related to the land, or air rights. Consequently, the continuity-of-investment norm arguably does not justify the broad interpretation of like-kind property that currently allows tax-free exchanges of such properties under section 1031.

The efficiency argument presented above also supports a narrower definition of like-kind property. Under that argument, section 1031 should apply to tax elastic exchanges; *i.e.*, those a property owner would not engage in if a tax were imposed. Determining whether an exchange is tax elastic or inelastic

would require significant analysis. Take, for instance, the example of an owner of an old airplane who wishes to replace it with a new, faster, larger airplane. Tax resulting from the disposition of the old airplane would be just one factor that the owner would consider when deciding whether to upgrade to the new airplane. Other factors would include the owner's need for additional speed and the economic or psychological benefit to be gained from a larger, more luxurious airplane. If those nontax factors outweigh the tax, then the transaction becomes tax inelastic. In such situations, tax would not create asset-specific lock-in effect, and section 1031 merely creates a windfall. Similarly, the decision to upgrade rental car fleets and commercial airplanes is likely driven primarily by market factors and regulation rather than any tax imposed on the disposition of assets. Perhaps section 1031 provides opportunities to pass savings on to customers in such situations, but it seems unlikely to be a key factor in an upgrade decision. Thus, even though taxing gains does have asset-specific lock-in effect, the scope and extent of that effect should help define the parameters of section 1031. Undoubtedly, many property owners would do exchanges without the benefit of section 1031, and if asset-specific lock-in effect is the justification for section 1031, it arguably should be used only when it ultimately tips a taxpayer's decision to exchange or not to exchange. Congress could better fine-tune the definition of like-kind property to reach the appropriate calibration of section 1031's scope in this area.

One possible modification would be to narrow the definition of like-kind property for section 1031 by adopting the section 1033 standard of "similar or related in service or use." According to a May 2011 report by the FEA, its members reported that 75% of the section 1031 exchanges they facilitated would meet the stricter section 1033 standard of similar or related in service or use. According to

that report, a significant majority of all exchanges would qualify for section 1031 nonrecognition under the narrower definition of like-kind property, but some would not qualify, thereby helping to narrow federal budget shortfalls. Among other benefits, using the familiar section 1033 standard would likely reduce administrative burden relative to adopting an entirely new standard, because of the long history of applying the section 1033 standard.

Convert Section 1031 to a Rollover Provision

Congress could alternatively consider converting section 1031 to a rollover provision. The current definition of section 1031 prohibits an exchanger from actually or constructively receiving exchange proceeds and appears to prohibit the receipt of replacement property prior to the transfer of relinquished property. Exchangers hire accommodators to ensure that they do not actually or constructively receive exchange proceeds and to defer the acquisition of replacement property when needed. One concern is that the use of accommodators adds cost and complexity to section 1031 exchanges, and that Congress could fix those aspects of section 1031 by converting it to a rollover provision. For example, section 1031 could be modified to allow exchangers to apply section 1031 to any disposition and acquisition of like-kind property that occurred within a certain period of time of each other—perhaps 180 days. This type of rollover provision would reduce or eliminate the need for qualified intermediaries and other accommodators in the exchange transaction and should make section 1031 available to a broader cross-section of property owners. In fact, tax systems in other developed economies allow rollovers.

Any time intermediaries are used, costs are added. The issue is whether the costs of intermediation are worth the benefits the intermediaries provide. One argument is that accommodators help to police section 1031 exchanges

by ensuring that exchangers properly identify exchange properties within the required time period, that they acquire like-kind property, and that they complete exchanges within the required time period. Even if most accommodators help ensure that exchanges comply with the law, surely some are “accommodating accommodators” that will assist exchangers with transactions that do not satisfy the requirements. For example, such a bad apple could help an exchanger back date documents to create the appearance that the client satisfied the identification requirement. A bad apple could also knowingly facilitate the transfer of property such as a mortgage or a contract, which is not like kind to other real property, to an exchanger as part of an intended real property section 1031 exchange. In extreme cases, accommodators have mismanaged or embezzled exchange proceeds, causing inefficiencies and delaying disbursement of exchange proceeds. Even if there are only a few

bad apples, they could have an outsized impact and cause the proverbial spoiling of the whole barrel.

Fortunately, defalcations appear to be the exception to the general practice of good accommodator behavior. Without regular audits of accommodators, however, taxpayers cannot assess whether they should incur the costs of intermediation. The FEA may not be suited or designed to regulate its membership in such a way that encourages accommodators to help ensure that exchangers comply with the section 1031 requirements. If not, then there appears to be limited justification for the complex, accommodator-facilitated method we currently have. One of us (Jay) is, however, convinced through his work in this field that the current system of intermediation helps the vast majority of taxpayers and provides economies of scale that make it substantially certain that the benefits of intermediation outweigh the costs.

A rollover system would most likely result in lost revenue because more

transactions would qualify for section 1031 nonrecognition, but Congress could make up for that lost revenue by narrowing the definition of like-kind property and by limiting section 1031 nonrecognition to small transactions. Thus, although a “simpler” rollover version of section 1031 would have appeal on its face, it could require major modifications to an area of the Code that already functions reasonably well and that arguably is among the least of many pressing tax problems. U.S. tax law, by universal agreement, is overly complex and confusing. At the very least, great care would need to be taken to ensure that a rollover provision eased complexity rather than simply shifting it to other areas. It should also not provide fodder to unscrupulous tax preparers, to whom a rollover may prove a tempting target for new sources of fast refund claims or even identity theft. If that care is taken, any new costs that result from a rollover provision could potentially be offset by the savings that result from reducing intermediation costs. ■

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networks that can help provide you with opportunities to take on pro bono assignments. Whether it be volunteering to help prepare wills for the terminally ill, learning how to serve as a guardian ad litem to help protect the interests of children or seniors, or defending the rights of low-income tenants in disputes with their landlords, there are myriad opportunities to give back in every community. Another priority that the American Bar Association has identified is providing representation for juveniles caught up in immigration proceedings. And if civil rights or criminal justice is your passion, there are always opportunities to help out, including in habeas proceedings for indigent defendants, preparing amicus briefs, or advocating or educating others on these important issues.

The comments to Rule 6.1 make clear that the breadth of pro bono opportunities are intended to ensure that all lawyers can give back to the legal system through pro bono work. For example, the goal of providing at least 50 hours of services to persons of limited means can be accomplished through direct representation, legislative lobbying, administrative rulemaking, and training and mentoring others who will represent persons of limited means. So even government lawyers, whose work restrictions may limit their ability to provide direct representation in certain areas, can still participate in pro bono activities.

If you are interested in learning more about tax related pro bono opportunities, please take a look at the Tax Section’s website (http://www.americanbar.org/groups/taxation/tax_pro_bono.html) or contact the Tax Section’s Pro Bono Counsel, Derek Wagner, who can be reached at the Tax Section’s office in Washington, D.C. For nontax related pro bono opportunities, contact your local bar association or the ABA Standing Committee on Pro Bono & Public Service.

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Tax Law Improvement

Rule 6.1 also encourages lawyers to participate in activities for improving the law, the legal system, or the legal profession. By becoming more active in the work of the Tax Section, you can fulfill this goal. For example, the Tax Section is regularly called upon to provide comments on proposed regulations or other guidance, and we

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