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FOR THE SAKE OF ARGUMENT

How Like-Kind Exchanges Make The IRS Rich

When Businesses Prosper, So Does The U.S. Government

BY JOSEPH B. DARBY III

SPECIAL TO BANKER & TRADESMAN

On Jan. 30 in Houston, Texas, I participated in what the ABA Tax Section styled a "Lincoln-Douglas Debate" on the future of Internal Revenue Code Section 1031 – the extremely popular provision that permits tax-free exchanges of real estate as well as other business and investment property.

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To commemorate the occasion, I donned a stovepipe hat and then advocated, with Lincolnesque passion, a position that I think would have won over Honest Abe himself: I argued that like-kind exchanges are good for everyone, but especially good for the IRS and the U.S. Treasury.

How could that be? Because the U.S. Treasury, through the tax code, is a partner in every business (and every household) in America, and so when businesses reinvest and grow, everyone benefits – especially the IRS.

The Partnership With Uncle Sam

Start with that legendarily impenetrable work, the Internal Revenue Code. It is called the tax law, but it is really a partnership agreement between every citizen and the U.S. government. This partnership is famously one-sided: The Treasury is quick to share on the upside – 40 percent or more of profits flow, as taxes, into the coffers – and is notoriously stingy on the downside. The U.S. government can change the terms, unilaterally, at any time. Most importantly, this partnership is not optional: It is the proverbial offer you can't refuse.

But that means the U.S. government has a vested stake in every business, and it profits handsomely – through tax revenues – when those businesses prosper.

Code Section 1031 Encourages Smart Reinvestment

Under 1031, taxpayers can sell existing property held for investment or business use, and then purchase property of "like kind" to be held for the same purposes. For historic reasons, the transaction must be structured as an "exchange," but as a practical matter it is economically equivalent to a "rollover" provision, thanks to modern regulations.

If 1031 were eliminated, there would clearly be a "lock-in" effect, meaning that taxpayers would hold onto old property rather than self-inflict a taxable gain. There are arguments about whether the lock-in effect would be severely crippling, or merely somewhat adverse.

Much overlooked, however, is the marvelous fact that 1031 encourages businesses to replace obsolete equipment with new equipment. Rental car companies regularly upgrade their car fleets and airlines regularly upgrade their aircraft. That happens because of 1031. Moreover, taxpayers in 1031 transactions often upgrade both in quality and value – directly benefitting the IRS.

The Math Of Reinvestment

Assume an airplane is fully depreciated and has zero tax basis, and a current fair market value of $10 million. If that airplane is sold, it will generate $10 million of gain and $4 million of tax (assume a 40 percent rate). If that airplane is instead exchanged under 1031 for a new aircraft, the government collects no tax. Therefore government is out $4 million of tax, right? Wrong.

If the exchange is taxable and the taxpayer goes forward (a big *if* because of the lock-in effect), the government would temporarily receive $4 million. But the taxpayer would have $10 million of additional tax basis in the new airplane, and would depreciate that amount over the next five years, causing the government to return the $4 million to the taxpayer (through $10 million of extra depreciation). All the U.S. government really gets is a $4 million interest-free loan that it rapidly repays over five years. Assuming normal depreciation, the value of this "interest free" loan is about $125,000. If 50 percent bonus depreciation is available, the value of the loan is about $62,000. Chump change.

Now assume, as regularly happens under 1031, that the taxpayer upgrades the $10 million airplane for a $20 million airplane. The U.S. government is now *way* ahead. It is a 40 percent partner in a partnership that has just doubled its capital investment, and therefore has likely doubled its income generation power, all at zero cost to the Treasury.

Next, remember that Uncle Sam has the same partnership with everyone else – with the airplane manufacturer, the manufacturer's employees, etc. This is the "multiplier effect," and it multiplies Treasury revenues. In short, Code Section 1031 helps spur the economy and enrich the U.S. government.

We have crumbling bridges across America today, as we try to eke out a few more years of usage. In private industry, 1031 provides a strong incentive to upgrade old equipment with new, gleaming, state-of-the-art equipment.

Rather than abolish Section 1031, Uncle Sam should emulate it. ■

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