

Congressman David Young
515 Cannon House Office Building
Washington, DC 20515

Also via email

Dear Congressman Young,

You and I met about 1 ½ years ago in Des Moines and talked about the importance to my business (ExchangeRight Real Estate www.exchangeright.com) of keeping Section 1031 Exchanges in the Tax Code. (Recall I used to work for your father). At the time, it was in the Democrats budget to potentially eliminate or curtail Section 1031.

It is now apparent from discussions I have had with several groups and advisors that House Ways and Means Committee Chairman Brady's Tax Reform Blueprint would completely eliminate Section 1031 and also disallow all business interest expense and these tradeoffs would allow the immediate expensing for all business investments in equipment, buildings, etc. While I generally applaud work on tax reform – I have major concerns with this part of the proposal.

From my analysis of these provisions, the largest corporations with lesser need to finance their businesses with debt capital will be huge winners. Apple for example has almost no interest expense and a 10% drop in tax rate would save them \$3 Billion in first year based on their last financial statements – this is without assuming any benefit to them of immediate expensing. Small family businesses, farmers, real estate investors and new businesses that need debt capital grow their businesses and provide good jobs will be hurt significantly.

ExchangeRight gathers real estate assets for investors doing 1031 exchanges. We manage about \$600 million of real estate for investors. Our average investor is doing a Section 1031 exchange of less than \$400,000. These are hard-working farmers, doctors, lawyers, dentists, and small business owners who have invested much of their savings in real estate and wish to preserve that value by re-investing on a tax-deferred basis. The 1031 exchange concept has been available to investors in the Tax Code since 1921 – nearly a century. It has remained a part of tax law through various major tax reforms. The reason it has survived is because it is very good tax policy as it encourages re-investment which drives economic growth and is built on the principle of not taxing gains until they are realized by the taxpayer.

My partners' and my businesses employ approximately 50 people and our Iowa headquarters is in Ankeny. Most of these positions would be eliminated if Section 1031 was eliminated from the tax code. I know people in the Qualified Intermediary business who service investors doing 1031 exchanges. All of those businesses here in Iowa and across the nation will immediately go out of business if Section 1031 is repealed.

The elimination of business interest expense deduction would be devastating to many low farmers and small businesses as well. The benefits of lower business tax rates and “immediate” expensing proposed in Brady’s Tax Plan will not be nearly enough for many to offset this lost deduction. We modeled our own business based on 2015 numbers and our effective **Federal only** tax rate would have been **44%** under the new plan (assuming 25% tax on our business taxable income). This is because ExchangeRight uses borrowed capital to acquire real estate assets and then turns around and resells them to investors doing 1031 Exchanges. Financing (and thus interest expense) is a very important part of our business model and cost structure. Farmers (like my semi-retired 87-year old father) rely on operating financing and need to be able to take tax deductions for that interest cost. Businesses like car dealers rely on interest expense deductions to carry the inventory they need to run their businesses.

Brady’s team has informed real estate industry professionals that immediate expensing of real estate investments with loss of interest expense deduction will offset the lost economic value of having Section 1031 exchanges. There are many holes in this concept:

1. Land is left out in this concept – land owners like farmers, real estate developers, etc. would no longer have incentive to reinvest in new land – this will slow growth and development.
2. Every real estate transaction includes a component of land – thus the IRS would immediately look to challenge the portion of each and every new real estate investment and classify more as land – thus limiting the immediate “expensing”
3. Farmers, investors, and all who have owned real estate for a long term will be hurt badly. They have low basis to “roll” into a new investment and get an “immediate expense” for. If they sell they will just have gains, and thus economic activity is likely to be materially slowed as a result. Whether they sell or hold; they are giving up the interest expense deduction from holding real estate. Thus they get no benefit from the immediate expensing; they lose the chance to do future 1031 exchange and lose their interest expense deduction.
4. Current 1031 provisions allow taxpayers to sell an asset in one tax year and reinvest within 180 days and this often crosses over tax years. The current Blue Print “immediate expensing” would have to be completed within the same tax year. This will mean that real estate buyers will be inclined to delay new purchases until late in the year and sellers will not want to sell late in the year because they will not have time to reinvest. This would create a very imbalanced real estate market.

5. Long term holders of real estate investments will have a significant increase in effective tax rates. Example:

Long-Term Apartment Owner

Year of Purchase	1985
Cost	\$200,000
Depreciation taken	<u>\$200,000</u>
Remaining Basis	\$0
Fair Market Value	\$500,000
Debt (refinanced 2015)	\$350,000
Annual Cash Flow (before debt)	\$40,000
Interest Expense	\$15,750
Net Cash Flow	\$24,250

	<u>Current</u>	<u>Proposed</u>	
Ordinary Tax (assume IA resident)	50%	37%	<--No interest deduction at 37%
Owner Taxes	<u>\$12,125</u>	<u>\$14,800</u>	
Owner Net After-Tax Cash Flow	\$12,125	\$9,450	
<i>Reduction in after-tax cash flow</i>		-28%	

***Net Cash Flow to owner is decreased by nearly 1/3 with no benefit from immediate expensing.**

6. If tax reform trades away Section 1031 and business interest expense for “immediate expensing” of real estate assets (and other assets); then this area will become the first place a future Democrat controlled Congress will attack to raise revenues. Once power is flipped – Democrats will push to go back to a more normal (and frankly logical) depreciation approach; however, Section 1031 and business interest expense will already be gone and will not likely come back into law – EVER.
7. Elimination of interest expense deductions will cause younger farmers and business owners to either not be able to start business, require them to remain renters and/or drive them out of business. Borrowed capital is the life blood of new businesses and young farmers. Having young farmers remain renters leaves the land wealth of Iowa in the hands of investors instead of in hands of people who live and work on the land. The same will be true of other businesses that have to make difficult capital deployment choices and for many this will mean never getting started. Below are examples of why the loss of interest expense is potentially so damaging to capital intensive businesses (especially land or inventory intensive businesses that will not benefit from immediate expensing). ***There will be years where effective tax rates on farmers will be more than 100% without the ability to deduct interest expense.*** This could additionally put farmers in already difficult year of not having the cash to pay their tax bills. Examples:

Farming Examples

Renter	Poor Year	Good Year	Excellent Year
Operating Income (loss)	-\$50,000	\$200,000	\$400,000
Interest Expense for Operating Costs	\$100,000	\$100,000	\$100,000
Machinery Expensed	\$0	\$0	\$300,000
Net Cash Income	-\$150,000	\$100,000	\$0
Taxable Income (Proposal)	\$50,000	\$300,000	\$200,000
Tax Due @ 33% (25% Fed plus IA)	\$16,500	\$99,000	\$66,000
Effective Tax Rate on Net Cash Income	Over 100%	99%	Over 100%

Land Owner	Poor Year	Good Year	Excellent Year
Operating Income (loss) above	-\$50,000	\$200,000	\$400,000
Add back rent expense	\$150,000	\$150,000	\$150,000
Operating Income for Land Owner	\$100,000	\$350,000	\$550,000
Interest Expense for Operating Costs	\$100,000	\$100,000	\$100,000
Interest Expense on Land Cost	90,000	90,000	90,000
Machinery Expensed	\$0	\$0	\$300,000
Net Cash Income	-\$90,000	\$160,000	\$60,000
Taxable Income (Proposal)	\$100,000	\$350,000	\$250,000
Tax Due @ 33% (25% Fed plus IA)	\$33,000	\$115,500	\$82,500
Effective Tax Rate on Net Cash Income	Over 100%	72%	Over 100%

The largest corporations with lower leverage ratios and wealthiest Americans in the country will of course benefit greatly from Brady's plan with reduced tax rates and immediate expensing. Those same corporations will also pay the best professionals to find ways to economically still get their "interest expense" deductions. They will do this through offshore companies, preference share issuances, JV entities, partnership entities and a myriad of other structures yet to be designed. This is not a guess on my part. I KNOW this will happen because I spent over 20 years of my career as someone who did that exact kind of tax-planning; utilizing the tax laws to get the best possible outcome for my large employers and large corporate clients. Big corporations will find ways to work around the interest expense deduction issue.

President-elect Trump's plan does not have a concept of immediate expensing for buildings (only equipment) and it seems unclear as whether loss of interest expense deductions in his plan would include interest associated with real estate investments. What is clear is that the House will drive the ultimate process and it is highly unlikely that Trump will stand in way if the reform plan includes major themes he wants like lower corporate and personal tax brackets.

My other major concern is the danger of the economic experiment with the US economy. Section 1031 has helped fuel re-investment in the U.S., and business interest expense deductions encourages people to create jobs and take on new business ventures. What if the theory model behind Brady's plan is wrong and instead of driving growth, it immediately put a strain on real estate values, results in thousands or hundreds of thousands of immediate or near-immediate job losses and drives a recession. Large corporations will benefit under his plan and likely come out very well – but it is small businesses and investors who really drive the growth in the economy – and I believe this experiment will put many of them at risk.

I would be more than happy to discuss any of this in person. I respect your service to the people of Iowa very much. I hope once you get fully informed on this issue that you will see as I do that immediate expensing (at least for real estate), coupled with loss of business interest expense deductions, and the death of the 95-year-old Section 1031 should not be a part the tax reform bill.

Kind Regards,

A handwritten signature in blue ink, appearing to read "David Fisher", with a stylized flourish at the end.

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