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Dear Member of Congress:

I write in opposition to repealing section 1031 "like-kind exchanges" as part of any tax reform. Like-kind exchanges compliment the goals of tax reform by allowing taxpayers important investment flexibility that encourages stronger economic growth. Instead of facing repeal, section 1031 should be preserved and expanded.

Section 1031 of the tax code allows taxpayers to defer paying taxes on certain types of assets when they use those earnings to invest in another, similar asset. This can be done again and again, provided the transaction involves a similar type of property.

This provision has existed in the tax code for more than 100 years and is used on assets such as real estate, machinery for farming and mining, and equipment such as trucks and cars. Because an investor doesn't have to pay tax until they cash out, section 1031 eliminates a potential barrier to investment, which in turn promotes the more efficient allocation of capital resources.

Like-kind exchanges should serve as a model for the taxation of all investments and should be retained in any overhaul of the tax code as a complementary provision to full business expensing. The provision has no place being categorized as a "pay-for" to buy lower rates and repeal would move the code toward higher taxes on investment, which in turn hurts economic growth and reduces income.

Like-Kind Exchanges Compliment the Goals of Pro-Growth Tax Reform: The tax code should encourage the efficient allocation of resources by taxing at the point of consumption. Under this system, investment would be treated neutrally (and efficiently) so that decisions would be made based on economic benefit. When measured against this goal, section 1031 is a necessary and complimentary part of a pro-growth tax system.

The House GOP "Better Way" tax reform blueprint takes many steps in moving the code toward this goal. For instance, the blueprint replaces the convoluted system of depreciation with immediate, full business expensing of all tangible assets (such as equipment) and intangible assets (such as intellectual property), but not land. This allows business owners to make decisions based on the merits of the transaction, not because of government induced tax barriers. In turn, this means a more efficient allocation of resources.

A move toward full expensing of assets will streamline business activity by allowing the efficient purchase of new assets and Section 1031 should be considered complimentary to this goal. 1031 allows less productive assets to be replaced with more productive assets, and therefore eliminates any lock-in effect that would otherwise discourage business activity. This is especially important for land assets that are excluded by the blueprint, which in many cases represents a significant portion of many properties. Because of the exclusion of land, repeal of like-kind exchanges – even with full expensing – may have the effect of impeding otherwise productive transactions.

Repealing Section 1031 is Economically Destructive: One key part of pro-growth tax reform is repealing preferential, distortive business credits and deductions – or "loopholes" as the left refers to them – in exchange for lowering marginal rates on corporations and small businesses as part of a net tax cut. The rationale is that it broadens the base of taxpayers, allows lower rates across the board than would otherwise be possible, and ensures the most efficient allocation of capital possible through the neutral treatment of businesses.

While this principle should be part of any tax plan, like-kind exchanges have no place in this conversation. 1031 grants important flexibility for a taxpayer to make the most economically efficient investment decisions in a way that benefits – not hinder economic growth and efficiency. If Section 1031 were to be repealed it would create a lock in effect that would discourage certain types of otherwise productive transactions. Conversely, this would result in less productive deployment of capital in the economy which would hurt economic growth and capital while raising little revenue.

Because of this lock-in effect, repeal could cost the U.S. economy as much as $13.1 billion in lost GDP year after year, according to a study conducted by Ernst and Young. This GDP loss would also result in investment falling by $7 billion every year and would reduce income by an estimated $1.4 billion.

Like-Kind Exchanges should be a Model for All Capital Gains: Ideally, all income derived as a "capital gain" should be exempt from taxation. This tax hits income that has already been subjected to income taxes and has been reinvested to help create jobs, grow wages, and increase economic growth. Naturally, this double taxation impedes the ability to invest and foster stronger economic growth.

Capital gains taxes should be reduced – or better yet, repealed – and preserving and expanding section 1031 should be part of this effort.

Under like-kind exchange rules, you only have a gain when you decide to cash out. The gain is the difference between the final sale amount and the original purchase, and is embedded over the years in the business. In effect, it becomes due when the business activity effectively ends.

There's no reason this cannot work for other capital gains. If you buy a stock for $100 and sell it for $150, you should be able to plow that $150 into new stock purchases without having to pay tax along the way.

This would also have the added effects of promoting tax simplicity and economic efficiency. Investors would no longer have to report each and every stock and mutual fund transaction on their taxes every year, simplifying tax filing for millions of Americans. It also would make all capital markets--for everything--more efficient.

Every time the government takes money out of the pool of capital investment, capital grows more slowly and we're all poorer than we otherwise would be. The key to wealth creation is to leave capital--untouched by government--free to grow for as long as possible.

Some have proposed repealing or limiting section 1031 as a way to make incremental progress towards taxing all capital gains as ordinary income. Instead of moving in this direction, we should be expanding the scope of like-kind exchanges as part of ending double taxation, promoting tax simplicity, and encouraging investment.

The bottom line is that section 1031 like-kind exchanges should not face repeal – regardless of whether it is considered as a standalone proposal or as part of comprehensive tax reform. Doing so would be economically destructive and would move the tax code closer toward higher taxes on investment and capital formation. Instead of repeal, section 1031 should be preserved and expanded as part of pro-growth code.

Onward,

Grover G. Norquist
President, Americans for Tax Reform