TAX FAIRNESS OREGON

1031 Exchanges: A Great Boon for Real Estate Investors but the Tax Break Does Nothing for the State

Oregon should disconnect from the federal 1031 Exchange program. It costs the General Fund $85 million per biennium while giving a capital gain tax break to real estate investors.

Oregon taxes all income at the same rate, except for when we don't. If investors sell their business, investment stock or commercial bonds, they pay income taxes on that gain, no matter what their next investment is. But because we are connected to a unique federal tax break, investors in real estate[1] can exchange one property for another and avoid paying any capital gains tax at the time of the sale. The 1031 Exchange tax break is named for the part of the Federal income tax code where it is found.

While a wealth creator for investors, letting tax be deferred for years is unfair to all other taxpayers, who must pay Oregon income taxes on their income as it is earned, as well as specifically to other types of investors. Meanwhile, it provides no benefit to the State. And some taxpayers coyly move their property investments to low-tax states when they near their period of real estate ownership.

Under the heading **There Are Low-Tax States and High-Tax States,** a business which facilitates these exchanges, called an intermediary writes: *…let's consider a property (Property A) that is owned in a state with income tax (State A). Property A is relinquished in a 1031 exchange. There is a capital gain from the sale of Property A, and it is subject to income tax in State A, but that tax is deferred, and Property A is replaced by a property in another state. When the replacement property is eventually sold, the income tax on the capital gain is paid in the state where the sale took place. State A never receives the tax revenue from the relinquishment of Property A.*[2]

Oregon does have a procedure known as "clawback," which tracks the chain of exchanges following a 1031 exchange that relinquishes a property in Oregon with the goal of eventually recapturing the tax revenue from the exchange that originated there. To track this, the State requires that an annual statement be filed on the progress of that exchange. When the property is

[1] What qualifies for a 1031 "Like-Kind" exchange? Real property and personal property can both qualify as exchange properties; but real property can never be like-kind to personal property in personal property exchanges. The rules pertaining to what qualifies as like-kind are more restrictive than the rules pertaining to real property. As an example, cars are not like-kind to trucks. Certain kinds of property are specifically excluded: inventory or stock in trade; stocks, bonds or notes; other securities or debt; partnership interests, certificated of trust.

[2] Excerpts from the website of a firm that facilitates 1031 changes for a fee, Another site clearly makes the case: "*There is no doubt that section 1031 is a useful tool for investors. We've helped hundreds of investors defer substantial capital gain taxes through a 1031 exchange and grow wealth by reinvesting tax-deferred money into a more profitable investment property.*

sold in another state, the tax comes due on the capital gain from the relinquishment that took place in Oregon. As a result, the investor has to pay capital gains taxes in the state where the sale took place *and* in Oregon on the earlier exchange. Thus, the investor's tax bill increases significantly. California, Massachusetts, and Montana have instituted similar mechanisms. However this only gets the tax revenue years later, on the original amount of the gains in Oregon. And it is very difficult to track, and could be lost entirely upon the owner's death or via fraud.

Disconnecting would not make us a total outlier. Pennsylvania simply does not acknowledge the 1031 exchange. Capital gains from property sales in Pennsylvania are subject to the regular Pennsylvania corporate or personal income tax rates depending upon the ownership structure.

What we propose is that we follow Pennsylvania's example. Let's disconnect entirely from Federal IRC section 1031.