Economic Impact of Repealing IRC Section 1031
Synopsis of Ernst & Young Study

Background:

Section 1031 of the Internal Revenue Code permits deferral of capital gains and recapture tax on business or investment property that is exchanged for like-kind business or investment property rather than sold for cash. Like-kind exchanges are relied on extensively by small businesses and taxpayers in multiple industries, including real estate, transportation, equipment / vehicle rental and leasing, and construction.

These rules are based on the tax policy that it is unfair to tax a "paper" gain when there is continuity of investment in like-kind property; i.e. there has been no "cashing out" by the taxpayer. Section 1031 encourages transactional activity by making it more cost effective to relocate to larger or more appropriate sites and to exchange assets for those that better meet business needs.

Ernst & Young conducted an analysis of the macroeconomic impact on the U.S. economy of recent tax reform proposals to repeal §1031 like-kind exchanges and documented these findings in a March, 2015 report (revised November, 2015), titled *Economic Impact of Repealing Like-Kind Exchange Rules*.

Major Findings:

- Repeal of §1031 would subject businesses to a higher tax burden on their transactions, resulting in longer holding periods (the "lock-in" effect), greater reliance on debt financing and less-productive deployment of capital in the economy.
- The cost of capital would be increased, discouraging investment, entrepreneurship and risk-taking, and slowing the velocity of investment.
- Repealing like-kind exchange rules would slow economic growth, shrink investment, and ultimately reduce gross domestic product (GDP), even if the revenue savings were used to lower tax rates.
- This negative economic impact would be most concentrated in those industries that rely heavily on like-kind exchanges, such as: real estate, construction, truck transportation, equipment / vehicle rental and leasing.
- The effect of §1031 repeal on economic activity supported by the **ten most impacted industries** would be a **decline in annual GDP of $27.5 billion**. (Table 1 below).
- **The total impact on overall U.S. GDP would be a drop of $8.1 billion each year** (Table 2 below).

Repeal of Section 1031 Does Not Meet the Goals of Tax Reform:

The stated goals of tax reform are economic growth, fairness, efficiency, revenue neutrality, competitiveness, and investment, leading to job creation and a stronger economy. The study concludes that repeal of §1031 would be at cross-purposes with these goals. It would adversely impact the U.S. economy by discouraging investment, causing a reduction in GDP, a contraction in the economy, and would unfairly burden certain industries and taxpayers. Moreover, lower GDP results in lowered tax revenue, thus, repeal of §1031 would not be revenue neutral.

Important Comparison:

➢ Estimated tax revenue to Treasury over 10 years (repeal score for years 2014-2023 by Joint Committee on Taxation)	$40.9 billion
➢ Estimated **reduction** of overall U.S. GDP over 10 years (EY Study)	**($61 - $131 billion)**

Table 1. Long-run effect of repeal on GDP each year of the 10 sub-industries with large proportions of like-kind exchange property as a % of capital stock ($billions)

Industry	Like-kind exchange property as % of sub-industry capital stock	Annual Direct GDP impact	Annual Indirect GDP impact	Annual Induced GDP impact	Annual Total GDP impact
Non-residential real estate	27%	-$6.0	-$1.4	-$1.3	-$8.7
Specialty construction trade contractors	16%	-$2.3	-$2.6	-$2.8	-$7.7
Truck transportation	34%	-$1.5	-$1.5	-$1.7	-$4.7
Heavy and civil engineering construction	19%	-$0.9	-$1.1	-$1.1	-$3.1
Air transportation	14%	-$0.5	-$0.4	-$0.3	-$1.2
Residential real estate	3%	-$0.4	-$0.1	-$0.1	-$0.6
Oil and gas extraction	7%	-$0.4	-$0.1	-$0.2	-$0.6
Commercial and industrial machinery and equipment rental and leasing	14%	-$0.3	-$0.1	-$0.1	-$0.5
Automotive equipment rental and leasing	14%	-$0.2	-$0.1	-$0.1	-$0.3
Pipeline transportation of natural gas	26%	-$0.1	$0.0	-$0.1	-$0.2
Total, 10 selected industries		**-$12.5**	**-$7.3**	**-$7.7**	**-$27.5**

Note: The 10 sub-industries selected for this analysis include sub-industries with like-kind exchange property of at least 3.0% of sub-industry capital stock, and with at least a 0.5% share of economy-wide capital stock. These industries are listed, with their NAICS codes, in Appendix D. Long-run impacts are scaled to the 2013 US economy. Figures may not sum due to rounding. Source: EY analysis.

Table 2. Long-run effect of repeal on GDP each year under revenue-neutral reduction in the corporate income tax rate and alternative policy scenarios

Scenario	Annual GDP change ($billions)	Annual GDP change (%)
Increased revenue used to reduce corporate income tax rate	-$8.1	-0.04%
Increased revenue used to increase government spending	-$13.1	-0.07%
Increased revenue used to reduce business sector taxes	-$6.1	-0.03%

Note: Long-run dollar figures are scaled to the 2013 US economy. Source: EY analysis.