

Economic contribution of the like-kind exchange rules to the US economy in 2021

Prepared on behalf of the 1031 Like-kind Exchange Coalition

May 2021

Key findings

Economic activity supported by like-kind exchange rules in 2021

Annual impact relative to size of US economy in 2021

568k Total jobs supported by like-kind exchange rules



46%

260k jobs

Businesses that make use of like-kind exchange rules



21%

122k jobs

Suppliers to businesses that make use of like-kind exchange rules



33%

186k jobs

Related consumer spending

\$27.5b Total labor income supported by like-kind exchange rules



40%

\$11b labor income

Businesses that make use of like-kind exchange rules



27%

\$7.4b labor income

Suppliers to businesses that make use of like-kind exchange rules



33%

\$9.1b labor income

Related consumer spending

\$55.3b Total value added supported by like-kind exchange rules



40%

\$22.4b value added

Businesses that make use of like-kind exchange rules



27%

\$14.8b value added

Suppliers to businesses that make use of like-kind exchange rules



33%

\$18.1b value added

Related consumer spending

Outline

- ▶ Overview of the like-kind exchange rules
- ▶ Tax and economic policy rationale for like-kind exchange rules
- ▶ Modeling approach
- ▶ Estimating the direct economic activity supported by the like-kind exchange rules
- ▶ Estimating spillover economic activity supported by like-kind exchange rules
- ▶ Key results: Economic activity supported by like-kind rules
- ▶ Annual direct investment supported by the like-kind exchange rules, by industry, 2021
- ▶ Employment supported by the like-kind exchange rules, by industry, 2021
- ▶ Taxes paid by, and related to, the use and users of the like-kind exchange rules
- ▶ Sensitivity of economic contribution estimates
- ▶ Caveats and limitations

Overview of like-kind exchange rules

- ▶ Like-kind exchange rules: “the exchange of real property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind which is to be held either for productive use in a trade or business or for investment.”

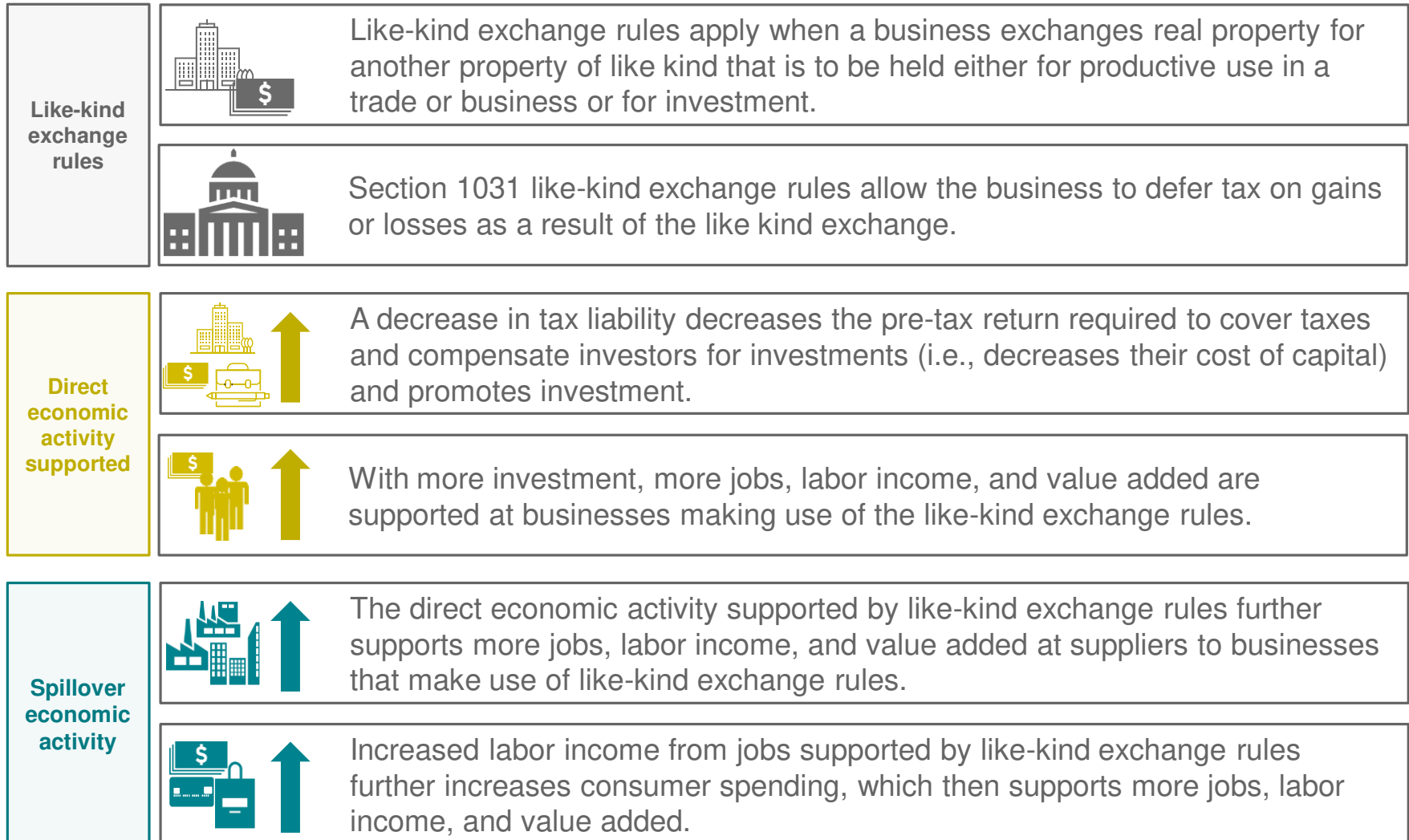
Internal Revenue Code Section 1031

- ▶ A taxpayer exchanging like-kind property is not required to recognize a taxable gain or loss at the time of the exchange; tax is deferred.
- ▶ Businesses: Expand opportunities to relocate to better locations, increase the ability to exchange older and sometimes inefficient assets for more efficient properties, and otherwise better align business assets with current and future business needs.
- ▶ Overall economy: Reduce the tax impediments to the transfer of property, which helps improve the overall allocation of capital by making it easier to assign assets to their most productive uses.

Tax and economic policy rationale for like-kind exchange rules

- ▶ Rationales for deferring tax on gains and losses realized in like-kind exchanges
 - ▶ Encourages investment and transactional activity. Imposing tax on continuing investment discourages and slows the velocity of investment, resulting in market illiquidity and increased cost of capital.
 - ▶ Better matching of investments with business needs. Tax deferral permits a business to expand opportunities to relocate, consolidate or acquire better, more efficient assets that meet current and prospective needs.
 - ▶ Improved allocation of capital. Reducing impediments to the transfer of property improves the overall allocation of capital and encourages the highest and best use of real property.
 - ▶ Preservation of cash-flow. A like-kind exchange preserves cash flow and avoids liquidation of other assets or increased reliance on debt financing due to tax considerations.

Modeling approach



Estimating the direct economic activity supported by the like-kind exchange rules

- ▶ Like-kind exchange rules encourage investment by reducing the tax cost of investment.
- ▶ Taxes raise a business' cost of capital because the business has to earn enough to cover taxes and still pay a competitive return to investors.
- ▶ This analysis estimates the cost of capital* with and without the like-kind exchange rules.
- ▶ An estimate of the responsiveness of investment to the cost of capital (the “investment elasticity”) from economic research is then applied to estimate the investment supported by the like-kind exchange rules.
- ▶ The change in investment is then translated into jobs, labor income, and value added based on the composition of like-kind exchange activity.
- ▶ The baseline amount of investment, jobs, labor income, and value added for businesses that make use of like-kind exchange rules is estimated primarily from capital stock data from the US Bureau of Economic Analysis (BEA) and analysis from Ling and Petrova (2020) that uses real estate data from CoStar.

* This framework is commonly used by the Congressional Budget Office, Congressional Research Service, Joint Committee on Taxation, and US Treasury Department and accounts for the major features of the federal income tax system (e.g., tax depreciation, tax rates, investor-level taxes).

Estimating spillover economic activity supported by like-kind exchange rules

- ▶ An input-output model of the US economy (IMPLAN Model) is then used to estimate the supplier purchases and consumer spending related to the economic activity directly supported by the like-kind exchange rules:
 - ▶ Supplier purchases supported by like-kind exchange rules. Like-kind exchange rules support purchases of goods and services from other businesses, which support jobs, labor income, and value added at these supplier businesses. Moreover, demand for these goods and services leads to additional rounds of economic activity as suppliers to the businesses purchase operating inputs from their own suppliers, and so on.
 - ▶ Consumer spending supported by like-kind exchange rules. This refers to the consumer spending supported by workers at the businesses that make use of like-kind exchanges and their suppliers. When these workers spend their earnings at US businesses (e.g., grocery stores, retailers, movie theaters), they support economic activity in those sectors. The earnings that these workers spend on food at a restaurant, for example, supports jobs at the restaurant and at farms, transportation companies, and other businesses that are involved in the restaurant's supply chain.

Key results: Economic activity supported by like-kind rules

Economic activity supported by the like-kind investment at businesses that make use of the like-kind exchange rules

	Businesses that make use of the like-kind exchange rules	Suppliers and related consumer spending	Total
Employment	260,000	308,000	568,000
Labor Income	\$11 billion	\$16.5 billion	\$27.5 billion
Value Added	\$22.4 billion	\$32.9 billion	\$55.3 billion

Note: All estimates are for economic activity in the United States and are relative to the US economy in 2021. Labor income is a component of value added. Figures are rounded.

Source: EY analysis.

Employment supported by the like-kind exchange rules, by industry, 2021

NAICS description	Companies that make use of the like-kind exchange rules	Suppliers and related consumer spending	Total
Leisure and hospitality	84,000	36,000	120,000
Trade, transportation, and utilities	73,100	52,700	125,800
Financial activities	28,700	44,000	72,700
Education and health services	25,200	38,000	63,200
Professional and business services	24,400	65,000	89,400
Manufacturing	10,100	17,400	27,500
Other Services	8,600	34,900	43,500
Construction	3,900	4,900	8,800
Information	1,200	5,600	6,800
Natural resources and mining	900	9,700	10,600
Total	260,000	308,000	568,000

Note: All estimates are for economic activity in the United States and are relative to the US economy in 2021. Figures are rounded.

Source: EY analysis.

Taxes paid by, and related to, businesses that make use of like-kind exchange rules, 2021

	Businesses that make use of like-kind exchange rules			Related suppliers	Related consumer spending	Total
	Business taxes	Employee taxes	Total direct			
Dollars in millions						
Federal taxes	\$660	\$1,330	\$1,990	\$1,330	\$1,645	\$4,965
Individual income taxes	\$120	\$890	\$1,010	\$680	\$840	\$2,530
Payroll taxes	\$370	\$370	\$740	\$490	\$610	\$1,840
Corporate income taxes	\$140	\$0	\$140	\$90	\$110	\$340
Excise taxes	\$25	\$35	\$60	\$40	\$50	\$150
Customs duties and fees	\$5	\$35	\$40	\$30	\$35	\$105
State and local taxes	\$440	\$695	\$1,135	\$745	\$925	\$2,805
Property taxes	\$180	\$150	\$330	\$220	\$270	\$820
Sales taxes	\$110	\$150	\$260	\$170	\$210	\$640
Individual income taxes	\$0	\$300	\$300	\$200	\$250	\$750
Excise, license, and other taxes	\$110	\$95	\$205	\$130	\$160	\$495
Corporate income taxes	\$40	\$0	\$40	\$25	\$35	\$100
Total taxes	\$1,100	\$2,025	\$3,125	\$2,075	\$2,570	\$7,770

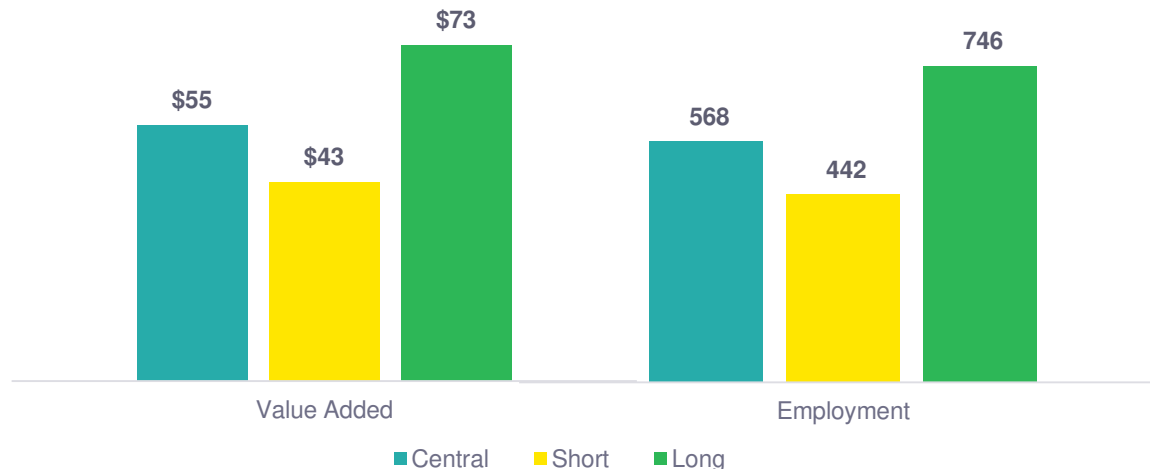
Note: All estimates are relative to the US economy in 2021. Figures are rounded.

Source: EY analysis.

Sensitivity of economic contribution estimates

- ▶ The holding period of the real property exchanged for a like-kind real property, considering depreciation schedules, can have a significant impact on the economic activity supported by the like-kind exchange.
- ▶ While a “central” holding period of approximately 8.5 years was used, a result from an EY survey of businesses that make use of the like-kind exchange rules, actual holding periods can vary.
- ▶ The figure below presents estimates using a shorter holding period (“short”) of approximately 7 years and a longer holding period (“long”) of approximately 12 years.

Total economic contribution; dollars in billions, employment in thousands



Note: All estimates are for economic activity in the United States and are relative to the US economy in 2021. Labor income is a component of value added. Figures are rounded.
Source: EY analysis.

Caveats and limitations

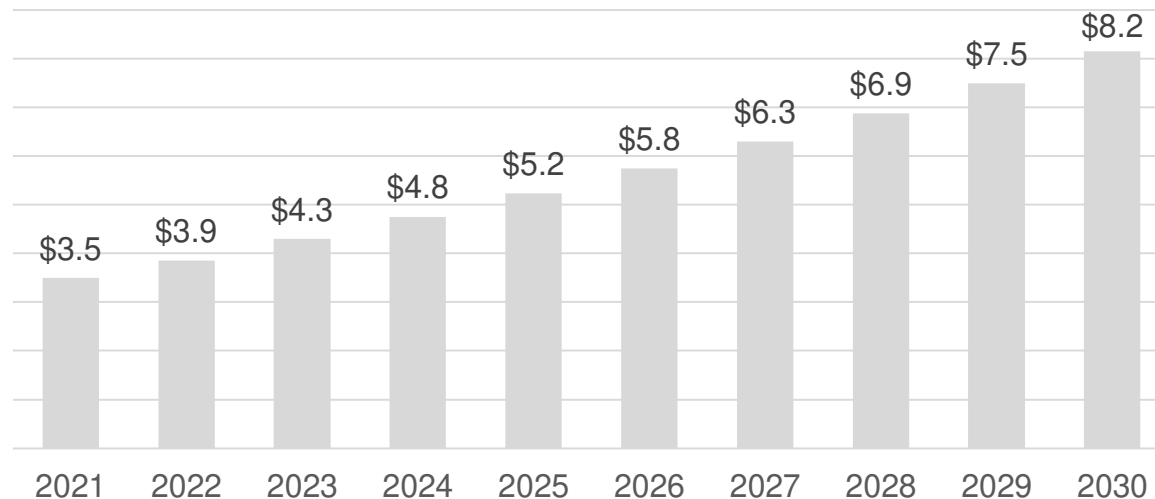
Any modeling effort is only an approximate depiction of the economic forces it seeks to represent, and the economic model developed for this analysis is no exception. Several limitations and caveats are noteworthy:

- ▶ **Results show a static snapshot of economic activity.** The input-output modeling approach used in this analysis shows the 2021 economic activity of businesses that make use of the like-kind exchange rules based on their relationships with other industries and households in the US economy. The results do not reflect the impacts of an expansion or contraction of economic activity.
- ▶ **Amount of like-kind exchange activity in 2021 uncertain.** This analysis of the economic activity supported by the like-kind exchanges rules relies on the most recent data available. This analysis uses 2019 as a proxy for the 2021 US economy. This proxy is used because economic forecasters generally expect the pre-COVID level of US GDP to be reached as early as the end of 2021. However, the COVID-19 pandemic may result in the repurposing of significant amounts of real estate and, thus, this report may understate the amount of like-kind exchanges over the next several years.
- ▶ **Estimates are limited by available public information.** The analysis primarily relies on information reported by the US BEA and Ling and Petrova (2020), which relies on data obtained from CoStar. The analysis did not attempt to verify or validate this information using sources other than those described in the report.
- ▶ **Analysis only examines the amount of investment that is supported by the like-kind exchange rules.** In addition to the potential economic activity that is supported by the investment activities themselves, there would be expected benefits related to the more efficient allocation of capital, which are not quantified in this analysis but would be in addition to the impacts presented. Moreover, the like-kind exchange rules affect the amount of revenue raised by the federal government. This change in revenue results in a change in the federal deficit, government spending or transfers, other taxes, or a combination thereof. These changes in turn, impact the US economy. These impacts on the US economy are not within the scope of this analysis.

Appendix: Foregone depreciation from the use of like-kind exchange rules

- ▶ While businesses that make use of the like-kind exchange rules are able to defer capital gains taxes, they forgo depreciation deductions that would otherwise be claimed on replacement property under a fully taxable transaction
- ▶ The foregone depreciation offsets some of the revenue cost of tax deferral
- ▶ The federal revenue associated with the foregone depreciation is estimated to average \$6 billion annually (over the 10-year budget window)
- ▶ By comparison, the tax expenditure for the like-kind exchange rules, which is net of foregone depreciation, averages roughly \$9 billion annually (over the 10-year budget window)

Estimate of federal revenue associated with forgone depreciation offsetting the benefit of tax deferral under the like-kind exchange rules (dollars in billions)



Source: EY analysis.