INDEPENDENT FISCAL OFFICE

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June 30, 2017

The Honorable Bernard O'Neill
Chairman, House Finance Committee
47 East Wing
Harrisburg, PA 17120

The Honorable Stephen Bloom
B8 Main Capitol Building
Harrisburg, PA 17120

Dear Representatives O'Neill and Bloom:

In a letter to the Independent Fiscal Office (IFO), you requested that the office perform a study, including a dynamic analysis, on the economic benefit and tax revenue impact from eliminating Pennsylvania personal income tax on like-kind exchanges. Your letter notes that Pennsylvania is the only state that levies a personal income tax and does not conform to the federal income tax rules that allow deferral of capital gains income generated by like-kind exchanges.

This letter responds to your request. As explained in greater detail below, a lack of detailed state-level tax data effectively limits the scope of the analysis the office is able to undertake. As a result, this analysis relies on federal income tax data that is apportioned to Pennsylvania to examine the potential implications from changing the state income tax treatment of like-kind exchanges. The lack of detailed micro-level data (i.e., taxpayer level) also precludes an analysis of the potential implications for specific industries in Pennsylvania. Federal income tax data suggest that the great majority of like-kind exchanges are attributable to real estate and vehicle transactions, and it is very likely that result also holds for Pennsylvania.

This letter starts with a brief description of like-kind exchanges and the federal income tax treatment of those transactions. Federal like-kind exchange data are then presented for tax years 2002 to 2014 and by industry. The final part of this letter provides a discussion regarding the potential revenue and economic impact from state conformity with federal like-kind exchange tax treatment.

Background

In the ordinary course of business, firms may directly exchange, as opposed to sell, business assets with other firms or use qualified intermediators to facilitate exchanges. For example, a firm might exchange used vehicles for new vehicles. Alternatively, firms could exchange land and buildings in order to expand business operations into new territories. Individuals might also exchange rental properties located in different cities or states. Similar to the sale of assets, an exchange of business property will often generate a capital gain. A firm generates a capital gain if the consideration received from exchange of the asset exceeds the remaining basis, or the amount of depreciable value that remains to be deducted against future federal taxable income. That amount is equal to the original purchase price of the asset less the depreciation deductions already used to reduce taxable income since the original purchase.

If a firm realizes a capital gain upon the sale or exchange of a business asset, then the firm must declare the gain as income on the federal income tax return. An exception to this rule is an exchange of business property that is "like-kind" in nature. Section 1031 of the Internal Revenue Code (IRC) provides that a firm may defer reporting a capital gain for like-kind property that is exchanged and used in the course of business. Business property can receive like-kind treatment if the assets exchanged are of like kind, which includes assets of a like class (i.e., in the same general asset class or the same product class) or like character. The exchange of real estate assets generally qualifies as a like-kind exchange, and the exchanged real estate need not be located in the same state. Like-kind tax treatment is specifically disallowed for the exchange of inventory, stocks, bonds and other securities.

Section 1031 allows firms to defer or delay the recognition of capital gains income and the associated taxes on qualified exchanges. Due to this deferral, the "marginal effective tax rate" on the income produced by holding the business asset is reduced, and the provision provides an investment incentive due to the lower tax cost.[1] The lower effective tax rate, all else equal, makes like-kind exchanges more attractive compared to the counterfactual where tax is immediately due on any capital gain that results from the exchange. For certain capital gains, it is possible that the deferral could be permanent if (1) the asset qualifies for an automatic step-up in basis if a decedent passes the asset to a qualified heir, (2) a firm continually exchanges qualified business property,

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[1] The marginal effective tax rate is the effective tax rate on an incremental investment and reflects all relevant attributes of the tax code such as the statutory tax rate, allowable depreciation deductions and true economic depreciation over time.

rather than sell or hold the asset for the full-term of its depreciable life or (3) land is part of an exchange and is not re-sold.[2,3]

Section 1031 of the IRC was originally enacted in 1921 along with other changes to capital gains tax rules. Due to the dramatic increase in tax rates on capital gains during the first World War, Congress recognized that substantial "lock-in" effects were created that made taxpayers reluctant to realize capital gains and caused them to hold assets longer than they would otherwise. In particular, property exchanges were discouraged because there might be insufficient funds left after remittance of capital gains tax to purchase replacement property of comparable value. The like-kind exchange deferral allows a capital gain to be reinvested immediately in new or different property. The provision was originally targeted towards farmers and other small business owners. However, favorable rulings and regulations since that time have generally expanded the scope of the provision, and it is now used for general exchanges of real estate, machinery, vehicles and artwork.

Examples of Like-Kind Exchanges

Two examples illustrate how like-kind exchanges work and how IRC Section 1031 allows firms to delay the remittance of tax on capital gains income.

In the first example, Firm A is a limited liability company and exchanges several used machines for a single new machine owned by Firm B.[4] The old machinery has a fair market value of $100,000 and a current basis of $40,000, which is equal to the original purchase price less depreciation deductions that have been claimed. The machinery is exchanged for other machinery with a fair market value of $90,000 and other goods and services valued at $10,000. The latter items are not like-kind property and are considered "boot." After the exchange, Firm A retains the basis of the original property (but it is increased by the non-like kind property received or cash received as part of the transaction). In this example, the new basis that may be depreciated in the future and used to reduce taxable income would equal $40,000 (remaining basis of original machinery) plus $10,000 (boot) or $50,000.

Under Section 1031, Firm A reports a taxable gain equal to the lesser of the value of (1) the boot received (which may be zero) or (2) the capital gain realized. In this example, Firm A realizes a gain of $60,000 ($100,000 less $40,000) and received boot of $10,000, and would report $10,000

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[2] Step-up in basis is the readjustment of the value of an appreciated asset for tax purposes upon inheritance, determined to be the higher market value of the asset at the time of inheritance.
[3] Land is not depreciated because it is not "used up." The capital gain would generally be deferred until the firm disposed of the property though a sale.
[4] This example is from "Economic Impact of Repealing Like-Kind Exchange Rules," Ernst and Young (March 2015). The study was prepared on behalf of the Section 1031 Like-Kind Exchange Coalition.

on the income tax return.[5] Firm A therefore defers tax on the remaining $50,000 gain, but it also forgoes $50,000 of future depreciation deductions that would have been available if the firm had sold the existing machinery (with $40,000 of basis left) and then purchased the machinery from Firm B for $90,000. Thus, the deferred capital gain equals the foregone amount of future depreciation deductions. The benefit from the immediate deferral of tax on the capital gain exceeds the present value of the reduction in future depreciation deductions. In this manner, the deferral is a timing issue, but as noted, some firms may perpetually delay the payment of tax.

In the second example, a firm may own a vehicle such as a pick-up truck or car.[6] The firm may prefer to obtain a new vehicle every third or fourth year, and the like-kind exchange rules could provide significant tax benefits. The firm may have deducted most of the vehicle cost under IRC Section 179 or utilized 50 percent bonus depreciation, and it is possible that the firm has little or no cost basis left only a few years after the original purchase. A firm that sells a four-year old vehicle with a fair market value of $10,000 would need to report a $10,000 gain if no basis remained. However, if the firm exchanges the used vehicle for a new $40,000 vehicle, then the $10,000 gain can be deferred. In this case, the depreciable basis of the new vehicle is the basis in the old vehicle (zero) plus the net cash paid at purchase, or $30,000. As in the previous example, the capital gain deferred ($10,000) is equal to the reduction in future depreciation deductions that may be claimed on the new vehicle compared to the alternative scenario where the firm sells the vehicle, declares the gain and purchases the new vehicle.

In practice, direct exchanges of like-kind property between firms are complicated and unusual. Most exchanges, especially exchanges of real estate, are facilitated by a third party or qualified intermediary.[7] The U.S. Treasury Department used the following example.[8] In a typical three-party exchange, Firm A would like to exchange a rental property for the rental property of Firm B. Firm B does not want Firm A's rental property, but would like a property owned by Firm C. Working through a qualified intermediary, Firm A's property is sold for cash used to buy the property of Firm C. The property acquired from Firm C is then exchanged for Firm B's property. Typically, these transactions would be taxable. Under Section 1031, the intermediary holds the cash (and any non-qualified property) received from selling the rental property of Firm A in a trust account and uses it to acquire the property of Firm C. Firms A and B would not be taxable on their exchange of qualified property, but a capital gain would be taxable up to the amount of any cash or ineligible property received in the exchange. The basis of Firms A and B in their new property would be

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[5] In this example, that amount is treated as a "recaptured" gain under IRC Section 1245 and subject to ordinary federal income tax rates, as opposed to capital gains tax rates.
[6] This example is from "Recent Trends in Like-Kind Exchanges," Gerald Auten, David Joulfaian and Romen Mookerje, Office of Tax Analysis, U.S. Department of Treasury (2014).
[7] For example, see the Federation of Exchange Accommodators at https://www.1031.org/.
[8] See supra note 6.

equal to their original basis plus the amounts of any cash paid for the replacement property and the taxable capital gain from the receipt of cash or ineligible property.

Data on Like-Kind Exchanges

The best source of data on like-kind exchanges is federal income tax Form 8824. On that form, taxpayers must report various information on like-kind exchanges that took place during the tax year, including the fair market value of property received, the adjusted basis of property given up and the deferred gain (or loss) on those transactions. Table 1 (attached) displays a time series of the dollar amount of deferrals reported on Form 8824 for individuals (sole proprietors, certain rental properties and farms), C and S corporations and partnerships for tax years 2002 through 2014 (even years only). The data show that the dollar amount of deferred gains peaked in tax year 2006 at $102.8 billion, then declined dramatically to $33.8 billion in 2009 (not shown). The latest value is $90.9 billion for tax year 2014. Most of the decline during the Great Recession was attributable to real estate transactions, which was manifested in lower deferrals for individuals and partnerships.

Table 2 displays tabulations by sector for corporations and partnerships for tax years 2007 and 2012.[9] For corporations, vehicles and transportation comprised most of the dollar amount of income deferral due to like-kind exchanges, while the real estate sector accounted for a much smaller share. For partnerships, the real estate sector comprised between 51 to 88 percent of the dollar amount of all deferred capital gains under Section 1031.

The tabulations in Table 2 are based on the industry of the corporation or partnership, but not the type of property that was exchanged. A recent U.S. Treasury study examined the types of like-kind exchanges based on specific transactions reported on e-filed tax returns. For partnerships, the data revealed that 76 percent of deferred gains were exchanges of real estate for tax year 2009. For individuals who filed a Schedule C (sole proprietor) or Schedule F (farm), real estate exchanges comprised almost 80 percent of deferred gains in tax year 2011 and 90 percent in tax year 2007. For 2007, nearly half of the amount was deferred gains on residential rental properties and most of the remainder was business real estate and land.

The federal income tax revenue foregone due to deferred gains under Section 1031 is significant. The U.S. Joint Committee on Taxation estimates that the revenue value of income deferral in federal fiscal year 2018 will be $11.7 billion for corporations and $6.2 billion for partnerships, sole proprietors, farmers and individuals with rental properties.[10] Those figures represent the net

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[9] The tabulations exclude S corporations from corporate totals.

[10] See "Estimates of Federal Tax Expenditures for Fiscal Years 2016-2020," Joint Committee on Taxation (January 2017) at https://www.jct.gov/publications.html?func=startdown&id=4971.

cost to the federal government from Section 1031 deferral, and reflect the immediate deferral of capital gains as well as the reduced level of future depreciation deductions that result from those transactions.

Impact of Section 1031 Conformity on Pennsylvania

For the purpose of this analysis, the IFO requested and received data from the Pennsylvania Department of Revenue on like-kind exchanges reported on PA Schedules D-I and D-III. Due to various technical issues, the IFO determined that it was not possible to use those data for the purpose of a microeconomic analysis from conforming state tax treatment with federal treatment of like-kind exchanges. Therefore, this analysis extrapolates federal data from the latest tax year (2014) to tax year 2018 to attempt to quantify the potential impact on Pennsylvania revenues and the general economy.

The latest year of federal tax data (2014) reveals total Section 1031 income deferrals of $90.9 billion. The analysis assumes that corporate and individual deferrals grow at 4 percent per annum, while partnership deferrals grow by 6 percent per annum, yielding $109.5 billion in gross deferrals for tax year 2018. That amount only reflects the deferral of income, and does not reflect the fact that firms that benefit from deferral also have fewer depreciation deductions to claim over the life of the asset, or until it is sold, compared to the counterfactual case where the gain is reported immediately.

The analysis assumes that four percent of total federal deferrals would be reported on the Pennsylvania income tax return as occurring within Pennsylvania.[11] The analysis then uses the data from Table 2 to determine the types of property that would use like-kind exchange treatment and assumes a similar mix of property for Pennsylvania. Finally, the analysis computes the additional depreciation deductions that would have been claimed if the property had not qualified for like-kind treatment and income deferral (i.e., the counterfactual scenario). Those foregone deductions must be deducted from the reported income deferral to derive the total net effect from the Section 1031 exchanges.[12] That computation is only done for individuals, partnerships and S corporations in Table 1, because the state corporate net income tax conforms to federal tax treatment. Based on these assumptions and the 3.07 percent personal income tax rate, the analysis estimates that the static revenue impact from state conformity with federal income tax rules could reduce state income tax revenues by $40 to $60 million per annum once the proposal was fully phased-in. That outcome requires several years to occur because, over time, the initial income

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[11] The four percent share is consistent with the ratio of Pennsylvania population or personal income to U.S. totals.
[12] Other factors could also reduce the potential revenue loss from conformity. See "The Economic Impact of Repealing or Limiting Section 1031 Like-Kind Exchanges in Real Estate," David Ling and Milena Petrova (March 2015).

deferral would be partially offset by lower depreciation deductions that could be claimed in the future. This static revenue estimate does not reflect any potential impact on the future size or growth rate of the Pennsylvania economy.

Potential Economic Impact of Section 1031

An important factor that affects the investment incentive from the like-kind exchange rules is the extent to which the provision reduces holding periods and the marginal effective tax rate on business investments. Advocates claim that repeal of IRC Section 1031 would increase holding periods, reduce the velocity of investment (i.e., the rate at which firms convert assets to better match current needs) and raise marginal effective tax rates. A recent study by Ernst and Young finds that repeal of Section 1031 could increase the marginal effective tax rate on business investments by (1) 5 to 9 percentage points for corporate equipment with a 5 to 10-year tax life and a holding period of 5 years and (2) 2 to 4 percentage points for a building acquired by a partnership with a holding period of 10 to 20 years.[13]

The Ernst and Young analysis finds the greatest impact from Section 1031 on the transportation, construction and real estate/equipment rental sectors. The analysis estimates a reduction in U.S. long-run gross domestic product (GDP) of 0.07 percent if Section 1031 were repealed and the higher tax revenues were used to increase government spending. If the revenues were used to reduce the corporate income tax rate, the study finds a 0.04 percent reduction in U.S. long-run GDP. These results use dynamic modeling that allow for macroeconomic "feedback" effects. That is, the policy change is allowed to impact the size and future growth rate of the U.S. economy. The study did not estimate the federal tax revenue loss due to utilization of IRC Section 1031.

Summary

The income deferral under IRC Section 1031 is a long-standing provision that has expanded over time. Currently, the provision is generally used for exchanges of real estate and vehicles. State policymakers will need to weigh the positives and negatives from conforming the state personal income tax with the federal tax code. On the positive side, conformity provides simplification and would eliminate a separate computation that must be made by Pennsylvania taxpayers. The literature also suggests that conformity would reduce holding periods and would provide an incentive to engage in a higher volume of qualified like-kind exchanges. The lower tax cost may facilitate new transactions and exchanges that firms would not otherwise undertake under the current tax rules. In general, these new transactions have potential to enhance economic growth

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[13] See supra note 4.

because firms enter into the transactions voluntarily, presumably to enhance output, efficiency and profits.

However, the potential impact on the overall state economy is unclear. For 2016, the total size of the Pennsylvania economy was $652 billion. If Pennsylvania comprises four percent of total U.S. deferred gains, then the deferred income gains that currently do not conform to federal tax treatment may total roughly $2.5 billion (excludes C corporations). It is unclear how much state conformity with federal tax rules would increase that amount, or how many transactions are prevented by the disallowance of income deferral at the state level. Regarding the current amount of income deferral reported for federal tax purposes, the disallowance of those deferrals under state tax law yields higher business taxes and lower after-tax business income. Conformity with federal tax rules would increase after-tax business income that could be spent or invested.

On the negative side, the analysis estimates that General Fund revenues, once conformity was fully phased-in, could decline by $40 to $60 million per annum. Due to the balanced budget requirement, the revenue reduction implies an offsetting increase in other revenue sources, or a reduction in spending of a similar magnitude. An analysis would need to compare the economic impact of higher business income to the alternative use of those funds as tax revenues, such as government spending on education or infrastructure. The $40 to $60 million estimate is a static revenue estimate because it is not possible to model the impact from federal conformity due to lack of detailed state-level data and the relatively small size of the proposed policy compared to the overall state economy.

Per the policy of the office, this letter will be posted to the IFO website three days after transmittal. If you have any further questions regarding this analysis, please do not hesitate to contact my office.

Sincerely,

Matthew J. Knittel

Matthew J. Knittel
Director, Independent Fiscal Office

Enclosures

Table 1: Deferral of Federal Like-Kind Exchange Gains

millions of dollars

	2002	2004	2006	2008	2010	2012	2014
Individuals	$13,656	$28,734	$25,992	$11,386	$2,723	$7,834	$16,086
All Corporations	$11,275	$19,049	$41,244	$28,650	$31,026	$38,124	$41,031
Partnerships	$15,133	$25,902	$35,526	$16,024	$6,126	$15,680	$33,809
Total	$40,064	$73,685	$102,762	$56,060	$39,876	$61,639	$90,926

Note: Individuals includes sole proprietors, farm returns and certain rental properties. Corporations includes both C and S corporations. Value for corporations for 2014 is an estimate.

Source: Internal Revenue Service, Statistics of Income Division, data from Form 8824.

See https://www.irs.gov/uac/soi-tax-stats-business-tax-statistics.

Table 2: Deferral of Federal Like-Kind Exchange Gains by Sector

millions of dollars

	Tax Year 2007		Tax Year 2012	
C Corporations	Amount	Share	Amount	Share
Oil and Gas	$1,598	6.2%	$4,228	12.6%
Vehicles and Transport	$13,374	51.8%	$23,302	69.5%
Banks and Finance	$3,659	14.2%	$2,593	7.7%
Real Estate	$3,197	12.4%	$553	1.6%
All Other Sectors	$3,973	15.4%	$2,852	8.5%
Total	**$25,801**	**100.0%**	**$33,528**	**100.0%**

	Tax Year 2007		Tax Year 2012	
Partnerships	Amount	Share	Amount	Share
Oil and Gas	$306	0.9%	$549	3.5%
Vehicles and Transport	$856	2.4%	$5,290	33.7%
Banks and Finance	$512	1.4%	$110	0.7%
Real Estate	$31,394	88.2%	$8,059	51.4%
All Other Sectors	$2,512	7.1%	$1,672	10.7%
Total	**$35,580**	**100.0%**	**$15,680**	**100.0%**

Note: S corporations are not included in the above tabulations.
Source: "Recent Trends in Like-Kind Exchanges," Auten, Joulfaian and Mookerje, U.S. Department of the Treasury, Office of Tax Analysis (2014).