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1031 exchanges and COVID-19: Pause in market has fueled greater demand for investors - by Brendan Greene and Mark McCue

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Internal Revenue Code (IRC) Section 1031 allows a property owner, who holds property for “the productive use in a trade or business or for investment”, to defer paying capital gains taxes if the property owner sells such property, identifies “like kind” property within forty-five days of the sale, and acquires other “like kind” property within one hundred eighty days of the sale.

While there is much uncertainty as to what impact COVID-19 will have on all areas of our economy, after an initial slowdown in late March and early April, COVID-19 has had little impact on 1031 exchanges so far in 2020. Arguably, the pause in the market during that time has fueled an even greater demand for investors. Also, low interest rates have helped to keep the real estate market strong for investors and developers and should continue to do so for the second half of 2020. The generally strong real estate market in the Greater Boston Area and throughout New England continues to increase 1031 tax-deferred exchanges, and we believe that trend will continue in the second half of 2020. However, the limited supply of investment properties has increased so-called “Reverse Exchanges” and “Construction/Improvement Exchanges”. A Reverse Exchange is when an investor buys the replacement property first, and then sells their relinquished property second. Because of the limited supply of investment properties available, investors don’t want to sell their property and be left without anything to purchase. As such, Reverse Exchanges can be a useful tool to ensure a successful purchase of replacement property before relinquishing their current investment property. A Construction/Improvement Exchange is when an investor either constructs a building on vacant land as part of the replacement property or makes improvements to an existing building. This allows investors much greater flexibility to accomplish an exchange by having the ability to look at a broader spectrum of price ranges for replacement properties, and if properly structured, will have a successful result in deferring capital gains taxes.

The increase in property values throughout New England and specifically in Massachusetts has given investors large equities in their properties subjecting them to higher capital gains taxes on the sale of such properties. Consequently, more investors are using 1031 tax-deferred exchanges in order to defer paying capital gains taxes. Investors enter into exchanges for a number of different reasons. They may want to diversify (sell one large property and buy multiple smaller properties), consolidate (sell multiple smaller properties for one large property) or purchase other investment property that has a better income stream, is easier to manage or has more upside than the property they currently own.

Undoubtedly, COVID-19 will bring about changes in many areas of the real estate industry, but we believe that there continues to be much room for optimism. Interest rates are expected to remain low and Congress is expected to pass a second stimulus package. Many real estate experts still project a steady to strong real estate market in many areas. With rents expected to stabilize and with interest rates remaining relatively low, the purchase of rental properties in Massachusetts and New England continues to be an attractive investment.

Locally, Greater Boston has some of the best financial institutions, universities, hospitals, and tech companies in the world which will continue to drive demand for rental properties. While a price slow-down or corrections are inevitable, especially in certain segments of the real estate industry, like retail, there is still plenty of evidence that the real estate market remains strong in the Greater Boston area. While many urban areas in the U.S. have been losing residents, Boston has continued to add new housing and new residents year after year. Time will tell if COVID-19 will have an adverse effect on this trend.

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