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2021 forecast: We expect significant volume of 1031 tax-deferred exchanges to continue this year - by Brendan Greene

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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 “like kind” property within one hundred eighty days of the sale.

The Coronavirus pandemic has caused 2020 to have been a very challenging and chaotic year with much uncertainty in all aspects of our economy. While the uncertainty of the pandemic continues to have an effect on our economy, we experienced a significant volume of 1031 Exchanges in 2020 and we expect that to continue in 2021.

While the pandemic is by no means behind us, we are optimistic that the new vaccines and the active involvement of the Federal Government in expediting vaccinations will help stabilize the economy. It is expected that the Fed, at least through 2021, and most likely beyond, will keep interest rates near zero in order to help stimulate the economy. Low Fed rates will help keep the lending rates near historic lows, which in turn will help keep property values stable, provided rents remain strong.

However, there are still some hurdles in place in connection with city and state moratoriums on tenant evictions which place a disproportionate burden on landlords. Although some uncertainty will remain as we recover from the effects of the pandemic, there is additional concern about new legislation increasing capital gains taxes and the impact on the real estate market overall but we remain hopeful for a strong 2021.

Despite the negative impacts COVID-19 has caused on the real estate industry, in particular the rental market, 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.

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.

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 the pandemic will have an adverse effect on this trend.

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