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2021 mid-year review and forecast for 103 tax-deferred exchanges in second half of 2021 - 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 45 days of the sale, and acquires “like kind” property within 180 days of the sale.

The roll out of the Coronavirus vaccines back in January has helped stabilize the real estate market and the economy in the first half of 2021. While the uncertainty of the pandemic continues to have an effect on our economy, we experienced a significant volume of 1031 exchanges in the first half of 2021, and we expect that to continue in the second half.

While the pandemic is by no means behind us and we are currently experiencing a significant uptick in positive cases, it appears that the Massachusetts economy, which helps drive the real estate market, should be less affected by the pandemic than other parts of the country because of the large number of individuals in Massachusetts who have been vaccinated. Additionally, it is expected that the Fed, at least through 2021, will keep interest rates low 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. The tough part of purchasing investment property in Massachusetts is that there has been very low inventory, which has caused bidding wars and has actually driven up prices in the first half of the year. A lot of people have been working from home and have figured out that they can work remotely and have decided to purchase residential investment property in vacation areas that can have some utility use. It is important to remember that an investor can only use a vacation home for the greater of two weeks or 10% of the time it is rented in one year.

Although some uncertainty will remain and investors will continue along the bumpy road of recovering from the effects of the pandemic, there are additional major concerns about new legislation President Biden has proposed concerning tax treatment for 1031 exchanges and long-term capital gains tax rates. Biden’s initial proposal is to end tax-deferral treatment on 1031 exchanges for gains in excess of \$500,000. In addition, Biden is seeking to raise the long-term

capital gains tax rate to 39.6% for households making more than \$1 million, which is up from a 20% federal tax rate. Combined with a 3.8% Medicare surtax and a 5% Massachusetts state capital gains tax, certain Massachusetts investors could face up to a 48.4% long-term capital gains rate. Furthermore, according to the Treasury Department's announcement, the capital gains rates would be retroactive to the date of announcement. This plan is not etched in stone, however, and will need to be approved by Congress. However, investors should be prepared for some increase in capital gains tax rates. If the capital gains tax rates do increase, and the 1031 rules remain intact, then investors will more likely try to take advantage of doing a 1031 Exchange to defer such taxes.

The continued limited low inventory and 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.

Our exchange company, Greater Boston Exchange Company, LLC (a subsidiary of McCue, Lee & Greene, LLP) is owned and operated by myself and attorney Mark McCue. Combined we have over 50 years of experience in real estate law and tax issues. We act as both Qualified Intermediaries for exchanges and as consultants to investors, borrowers, attorneys and accountants to facilitate successful exchanges.

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