2023 forecast for 1031 tax-deferred exchanges - by Brendan Greene & 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 45 days of the sale, and acquires “like kind” property within 180 days of the sale.

The housing market has started to shift from a seller’s market to a position more in the middle, and likely, as the year goes on, to a buyer’s market. 2021 and 2022 saw historically low interest rates, which in turn caused historic demand in investment properties and 1031 tax-deferred exchanges despite the high price of such properties for sale. With increased mortgage rates, current investors who have mortgages on their property will be more hesitant to sell if they have to purchase another investment property with a much higher interest rate. This may cause the number of potential investors to decrease, which will decrease demand and result in more investment properties on the market. This will create a more even playing field for buyers, although there will continue to be issues with affordability in part due to the increase in interest rates. As a result of this changing market, particularly for investors, we expect the volume of 1031 exchanges to hold steady or decrease slightly also.

There are a few factors that will aid in the continued sustainment of 1031 exchanges: (i) property owners facing significant capital gains taxes upon sale due to the appreciation in the real estate market over the past five plus years, (ii) the repurposing of real estate due to changes in certain segments of the real estate market, (iii) the sale of investment properties in colder climates and the purchase of investment replacement properties in warmer climates or parts of the country typically known as vacation areas, (iv) the availability of reverse and construction improvement exchanges, and (v) baby boomer retirement and estate planning.

The pandemic has caused many workers to work remotely with a lot of success because of advanced virtual technology, which in turn has caused the commercial office and retail sector to be lagging. As such, many of these office and retail spaces may need to be repurposed.

These properties can be ideal targets for investors looking to do a construction or improvement exchange which are discussed in more detail below. In addition, Section 1031 Like-Kind Exchanges provides incentive for investors who are unable to afford capital improvements to their building to sell properties to investors who have the capital to make such improvements to the properties.

Despite the negative impacts COVID-19 has caused on parts of the real estate industry, in particular the retail and office markets, the increase in property values throughout New England and specifically in Massachusetts over a long period of time 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 becoming acquainted with and 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.

We anticipate the supply of investment replacement properties to increase slightly as mentioned above. However, we still expect to continue to see a sustained demand of “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 somewhat limited supply of investment properties available, investors are not willing to sell their property and be left without anything to purchase. 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 market corrections have begun, especially in certain segments of the real estate industry, there is still plenty of evidence that the real estate market remains strong in the Greater Boston area.

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