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2023 forecast for 1031 tax-deferred exchanges - 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 “like kind” property within one hundred eighty days of the sale.

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. The strong seller’s market has started to shift, although real estate prices have continued to rise slightly due to high demand. The difference now is the pace of the market, which has slowed down and put buyers at more of an advantage than they have been in the post-pandemic years. While mortgage rates continue to be high, comparatively to recent years, the Federal Reserve has so far been successful in reducing inflation which could stabilize or potentially reduce interest rates. Higher mortgage rates result in fewer buyers entering the market, and 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.

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.

We anticipate the supply of investment replacement properties to increase slightly. 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. Both scenarios are set up as a “parking transaction”. In a “parking transaction”, the taxpayer (exchanger) does not initially take title to the replacement property. Instead, the replacement property is “parked” with an Exchange Accommodation Titleholder (EAT), which is typically the Qualified Intermediary (QI), and the exchanger and the EAT enter into a written Qualified Exchange Accommodation Agreement (QEAA). The EAT holds title to the replacement property until such time as the exchanger arranges for the sale of the relinquished property to the buyer. The EAT is typically a single member limited liability company (LLC) where the QI is the sole member.

When the replacement property is purchased and “parked” with the EAT, the exchanger has 45 days from the date of purchase to identify the relinquished property or properties, and 180 days from the date of purchase by the EAT to sell the relinquished property. Now that lenders have become more familiar and comfortable with reverse and improvement exchanges, exchangers have more tools to navigate in a complicated market.

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 of sellers having multiple offers on a sale of real estate has 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.

Our exchange company, Greater Boston Exchange Company, LLC (a subsidiary of McCue, Lee & Greene, LLP) is owned and operated by attorneys Brendan Greene and Mark McCue with combined experiences of over 50 years 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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