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The dynamic and evolving 1031 marketplace has changed significantly in the last year

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Similar to the real estate market, the 1031 marketplace has changed significantly over the course of the last year. In my role on the board of directors of the Federation of Exchange Accommodators (FEA), the national trade association for 1031 Qualified Intermediaries, I am able to see the trends in the 1031 market on a national and regional level. In addition, through my position as chair of the Small Business Resource Committee of the FEA, a committee comprised of many smaller Qualified Intermediaries (QIs) throughout New England and the country, I see a macro view of what other QIs face on a daily basis.

The 1031 Qualified Intermediary industry has undergone a number of changes recently. Due to the slowdown of the real estate market, falling interest rates, and a decrease in the overall number of 1031 exchanges, several small and even a few of the largest QIs are going out of business or laying off a significant number of employees. Other QIs are being sold to banks, while some of the elder statesmen and women are retiring and otherwise leaving the 1031 industry. These 1031 veterans often leave behind less experienced employees, causing the 1031 industry to lose a large amount of technical knowledge and experience. On the positive side, the QIs remaining tend to be stronger, more experienced, and better able to withstand the natural ups and downs of real estate and business cycles.

These changes mean that investors must continue to conduct due diligence on the QI they choose.

As we have written previously, in conducting due diligence on your QI, you should confirm who owns the QI, what kind of experience they possess, whether the owners and employees are Certified Exchange Specialists (CES), where the exchange funds are deposited, and what types of investments are used for the exchange funds.

In addition to the above changes, several states have begun to change the tax treatment of 1031 exchanges for state income tax purposes. In the eternal search for additional revenues, some states, such as Massachusetts and California, have enacted or are considering so-called claw-back provisions; whereby exchangers who purchase replacement property in states other than the state where the relinquished property was located will owe taxes back to the original state either immediately or at some point in the future.

Other states, such as New Hampshire, have enacted statutory changes, regulatory changes, or otherwise have adopted positions which negatively affect the use of single-member LLCs in certain forward, reverse, and improvement exchanges. California has hired a number of new auditors whose focus will be 1031 exchanges, in particular reverse exchanges and exchanges involving partnerships.

On the Federal level, no significant changes appear imminent. Congress recently proposed the elimination of exchanges involving collectibles through, interestingly enough, the Farm Bill.

However, in the end, that provision was removed and collectibles, such as artwork, are still eligible for 1031 exchange treatment. The successful removal of this provision can be largely attributed to the FEA and its board of directors, who constantly monitor legislative and regulatory activity in Washington, DC and at the various state levels.

The decrease in the number of exchanges has been attributed to several factors. The overall slowdown of the real estate market is a prime factor. Investors are buying and selling fewer properties, especially residential investment property. Commercial and some industrial property are still active. Another factor, possibly the reason for fewer sales, is the inability of buyers to obtain adequate and appropriate financing. As the credit markets recover, this pressure should lessen.

Concern over capital gains rates has been cited as a reason to forego an exchange and pay the tax. Many investors expect capital gains rates to rise under any new Administration and therefore, the reasoning goes, they would rather pay the taxes now. For some investors, perhaps this line of thought makes sense. For most, though, they seem to forget that some of the gain will actually be taxed at 25% or higher, plus the various state taxes that may apply.

In addition, many baby boomer investors are acutely concerned with estate planning issues. Often times, these investors own fully depreciated properties, or properties that have been held for a long period of time and would realize a significant amount of tax upon sale. For these investors, 1031 exchanges make sense because of the ability to effectuate multiple 1031 exchanges, avoid current capital gains taxes, and, upon death, their heirs receive a stepped up basis (fair market value) and years of appreciation is never taxed.

Investors and their advisors should continue to seek competent advice from experienced QIs, CPAs, and attorneys anytime they are considering a 1031 exchange. But, in the end, 1031 exchanges remain an extremely powerful tool to real estate investors.

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