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2022 Mid-Year Review and Forecast for 1031 tax-deferred exchanges in second half of 2022 - 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. All real estate held for “investment” purposes may be considered “like kind” to any other real estate held for investment or business purposes. For example, a condominium can be sold and an apartment building, retail shopping center, or single-family home can be purchased (or vice versa) so long as the property being sold and the property being purchased is held for investment purposes.

The continuing roll out of the Coronavirus vaccines in 2021 and the first half of 2022 has helped stabilize the economy. While the uncertainty of the pandemic continues to have some effect on the economy, there have been other factors in the more recent months that have become as big or bigger concerns. Rapidly rising inflation, higher interest rates, the war in Ukraine, and continued chain supply issues have risen to the forefront. These issues have started to increase real estate properties “days on the market” which in turn have increased the inventory. The uptick in inventory has started to slow the rate of appreciation.

Despite all the uncertainty in the real estate market, we feel that there will continue to be a fairly high volume of 1031 Exchanges for the second half of 2022 because investors have seen substantial increases in the value of investment properties over the last several years and still want to avoid significant capital gains taxes.

Some small concerns remain about 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 $500,000.00. This seems unlikely to move forward. However, investors should keep an eye open to proposals to increase 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.

Although the inventory of investment properties is trending to increase, it is generally still low inventory. As such, the past two years there has been a large increase in 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.

Despite the uncertainties in the real estate market caused by inflation, increasing interest rates, and other issues, 1031 Exchanges continue to be a very valuable tool for real estate investors. The ability to defer capital gains taxes and depreciation recapture by reinvesting into replacement property avoids having to pay significant and likely increasing capital gains taxes.

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