2024 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.

The housing market continues to be a difficult one for both buyers and sellers. Real estate and, in particular, residential home prices remain at historic highs and inventory is low. Interest rates have dropped slightly but are still high, and experts predict that they will likely remain high but should come down a little more during the year. This combination of high real estate prices, high interest rates and low inventory dissuades prospective buyers and leaves sellers in a position of power in most scenarios. Additionally, we have entered into an election year, which causes further uncertainty in both the economy and the housing market. This kind of uncertainty typically makes investors more cautious, and investors may wait to see the results of the election before deciding whether to sell their properties.

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. 2023 brought higher mortgage rates, and investors who had mortgages on their property were more reluctant to sell if they had to purchase another investment property with a much higher interest rate. This caused 2023 and most likely will cause 2024 to have a decreased demand and potentially result in more investment properties on the market. This may create a more even playing field for buyers, although there will continue to be issues with affordability in part due to high 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.

Although there was a decrease in volume of 1031 exchanges in 2023 and likely in 2024, 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, (ii) 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, (iii) the availability of reverse and construction improvement exchanges, and (iv) baby boomer retirement and estate planning.

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 allows an investor to buy a replacement property first, and then sell their relinquished property second. Because of the somewhat limited supply of investment properties available, investors are not always willing to sell their property without knowing that they can purchase a replacement property.

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