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Review of 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, although seeming to be loosening, it is still relatively low. Mortgage interest rates have leveled off or dropped slightly especially in the past few weeks, but remain relatively high in comparison to the past 10 years. Most experts predict that they will likely remain high but should come down a little more during the year. Despite this combination of high real estate prices, high interest rates and low but growing inventory, the first six months of the year have seen a surprisingly robust volume of 1031 transactions. The most recent United States inflation results came in a lot weaker than expected in June. This leads some expert investors to believe that interest rates might be coming down as soon as September.

Present polls show (but we all know how fast things change) that Trump is more than likely to become the next President. At the beginning of this year, there was more uncertainty about who may win the Presidency, which often times leads investors to be more cautious, and the thought is that investors may wait to see the results of the election before deciding whether to sell their properties. That does not seem to be the case for the first half of 2024. 1031 exchanges rebounded from slow market conditions in 2023 mostly caused by such low inventory.

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 to have a decrease in demand which was a part of the reason that resulted in more investment properties on the market in the first half of 2024. This has created a more even playing field for buyers and increased activity.

Although there are varied opinions on the investment real estate market for the second half of 2024, there are some common themes that will aid in the continued sustainment of 1031 exchanges:

(i) moderate price growth – after many years of rapid price growth, the expectation is one of more moderate but continuing growth,

(ii) the repurposing of real estate due to changes in certain segments of the real estate market (i.e. downtown city office space,

(iii) regional differences - 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.

With the increase of inventory and continued price growth, investors may find it easier to identify suitable replacement properties within the strict timelines of a 1031 exchange. This should lead to a rise in exchange activity as investors take advantage of the improved market conditions. We anticipate the supply of investment replacement properties to continue to increase slightly as mentioned above. However, some trends for the remainder of 2024 are:

(i) more demand for “Reverse Exchanges” and “Construction/Improvement Exchanges” 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;

(ii) challenges with traditional financing rates which may result in more seller financing; and

(iii) heavily managed properties exchanged for passive investments like triple net leases (NNN) and/or investments in Delaware Statutory Trust (DST).

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