As Mortgage Rates Drop, Expect 1031 Exchange Deals to Pop

A solid understanding of the fundamentals of Section 1031 exchanges is more important than ever as sellers look to redeploy their gains.

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For most of 2024, relatively high property values combined with rising interest rates priced buyers out of the market for new commercial and residential real estate acquisitions.

This slowdown has not only impacted investors and homeowners, but it's also affected the entire real estate industry — from lenders to appraisers, brokers, law firms, title insurance companies and beyond.

Because Section 1031 exchange activity moves in lockstep with the real estate investment cycle, activity for qualified intermediaries has slowed as well.

Section 1031 exchanges traditionally have been used by investors to preserve equity that has appreciated in certain qualified real property investments. As a refresher, a Section 1031 exchange allows for the deferral of capital gains tax on the sale of qualified, like-kind property.

It also allows for the deferral of depreciation recapture and deferral of state taxes (where applicable). An exchanging taxpayer will not recognize the capital gain until the replacement property is sold without the use of another exchange. To qualify for exchange treatment, property must be held for investment or used in a trade or business.

Exchange Trends

In previous downturns, new exchange activity slowed for different reasons. During the global financial crisis (mid-2007 to early 2009) and its aftermath, exchanges were used less frequently for preserving equity, mainly due to offsetting losses from other transactions or a general erosion of equity altogether.

Later, many taxpayers used exchanges as a strategy for deferring potential tax liability from short sales and foreclosures.

By the end of 2010, the volume of exchange transactions began to increase significantly, and, for a decade, exchanges were quite popular as property values continued to rise and mortgage rates remained low.

However, as economic disruptions caused by the COVID-19 pandemic rattled the job market and drove inflation to levels not seen in nearly 50 years, the Federal Reserve responded by raising the federal funds rate 11 times in 17 months, effectively ending the long run of high transaction volume so many of us enjoyed.

Interestingly, regardless of the recent Fed funds rate decreases, mortgage rates have been holding firm over the past few months.

The fact that property values have remained somewhat steady in many sectors means that many investors are still sitting on gains they would like to put to work by exchanging into new properties.

As mortgage rates eventually fall, we expect eager buyers once again will have access to loan funds they can afford and that make sense for their investment strategies.

These elements, when combined with the prospects of purchasing distressed real estate opportunities, are certainly a strong undercurrent in the market. These conditions suggest a return to higher transaction volume than we have seen in the past 12 to 18 months.

As sellers look to redeploy their gains, now might be the perfect time to explore the many exchange options available to investors.

Exchange Strategy Alternatives

Most taxpayers are familiar with the most common exchange transaction, the forward-delayed exchange. In these exchanges, a taxpayer sells his or her relinquished property to a third-party purchaser, uses a qualified intermediary (QI) to hold their exchange proceeds and eventually acquires a replacement property from a different third-party seller.

Many taxpayers are not aware of other exchange structures that have been used for years by savvy real estate investors and developers.

These other strategies include reverse exchanges, whereby the replacement property is acquired prior to the sale of the relinquished property.

In these transactions, the taxpayer must rely not only on the assistance of a QI, but must also engage an accommodating titleholder (AT) to take title to the targeted replacement property.

The AT, which is often a limited liability company that is owned by an affiliate of the QI, will hold the replacement property on behalf of the taxpayer until the taxpayer has sold the relinquished property.

Additionally, taxpayers may use a construction exchange to build an ideal replacement property or use leasehold exchanges when they wish to build the replacement property on land they already own.

Again, an AT must be used to hold title to the property during the period when improvements are being completed.

These exchanges may also be used in the reverse format, whereby a taxpayer uses the AT to start the construction process on the replacement property prior to the sale of the relinquished property.

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Choose Your QI Wisely

In the past, many assumed their QI was bound by state or federal regulations. Shockingly, for many years QIs were not held to any such regulation, and many taxpayers learned this lesson the hard way.

Numerous QIs filed for bankruptcy from 2007-2009 for a variety of reasons. In certain situations, the QI absconded with client funds.

In other instances, the QI commingled client funds and held them in less liquid investment vehicles to obtain more attractive interest rate returns for the QI's own benefit.

When these investments became truly illiquid, the QI often engaged in Ponzi scheme-type activity whereby the exchange proceeds from new exchanges facilitated by the QI were used to fund other exchanges that were being completed.

When transactional real estate came to a halt and there were no new exchange proceeds to cover replacement property closings, the QI was exposed for these non-transparent practices, and most filed for bankruptcy.

Despite these abuses, QIs remain largely unregulated by federal and state laws. It is important for taxpayers and their advisors to be vigilant when selecting a QI.

In addition to 1031 exchange strategies, other real estate-focused tax strategies, such as opportunity zone funds and cost segregation studies, may also experience an increase in activity this year.

With an expected uptick in overall multifamily transaction volume, there is much to be cautiously optimistic about in the commercial real estate world for 2025 and beyond. ●

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