Executive Summary

# The Reluctant Landlord

*Why Build-to-Rent Is Becoming the 1031 Exit for Aging Private Real Estate*

## A lot of private real estate wealth has nowhere good to go. The exits it was promised have closed one by one.

Millions of high-net-worth investors hold directly owned real estate they built over decades: small apartment buildings, strip retail, older rentals. The assets appreciated. They also aged. Deferred maintenance stacked up, insurance repriced, and the owners moved past the point where active management fits their lives. For many long-held properties, an outright sale surrenders 25 to 30 percent of gross proceeds to combined federal and state tax, a figure that varies with basis, depreciation recapture, filing status, and state of domicile.

So they hold. Not because holding is the right financial decision, but because every standard exit carries a cost. Selling is expensive. Trading into a comparable building keeps the management problem intact. Delaware Statutory Trusts left a portion of this audience burned. The 721 UPREIT, for all its tax efficiency, remains functionally out of reach for the single-property owner.

This paper presents the case that build-to-rent communities, purpose-built single-family neighborhoods held under professional management, deserve serious consideration as the 1031 exchange replacement for this investor profile. The case rests on three realities:

THE CAPITAL

**Trapped by the tax code**

Roughly 8.3 million small multifamily units built before 2000 sit in private hands, carrying deferred maintenance and embedded gains their owners cannot afford to realize.

THE REPLACEMENT

**New at institutional scale**

Purpose-built BTR now exists as a qualifying replacement property in a form that did not a decade ago: new construction, professional operations, no landlord burden.

THE WINDOW

**Rigid and unforgiving**

45 days to identify, 180 days to close, a Qualified Intermediary in place before the sale. The mechanics reward advisors who start the conversation early.

Executed with proper counsel, a 1031 exchange into a BTR interest can preserve full buying power, exit the day-to-day management burden, and restart depreciation on the excess basis. The gain is deferred, not eliminated, and sponsor, occupancy, and illiquidity risks remain.

### KEY OBSERVATIONS SHAPING THE OPPORTUNITY

- Of approximately 10.4 million privately held small multifamily units (2 to 49 units), an estimated 80 percent were built before 2000, carrying deferred maintenance liability and embedded gains. (American Housing Survey, U.S. Census Bureau)
- For a long-held property, an outright sale can consume 25 to 30 percent of gross proceeds in combined federal and state tax before the investor sees a dollar. The longer the hold, the worse the math.
- DST products addressed the management burden but left a portion of this audience with illiquidity, fee drag, and COVID-era distribution disruptions that tempered demand.
- Under standard 1031 rules, excess basis in a higher-value replacement property starts a fresh 27.5-year depreciation schedule; for new-construction BTR, that incremental shield can be meaningful.

- Renter-by-choice households and downsizing older renters anchor BTR occupancy behaviorally, supporting cash flow underwriting that does not depend on the direction of interest rates.

> **CAVAN RESEARCH INSIGHT**
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> *Absorbing operational risk to defer a tax liability is not an investment strategy. It is a trap. The tax mechanics have been stable since 1984. What changed is the replacement property landscape: build-to-rent at institutional scale did not exist as a viable 1031 vehicle in 2005. It does today.*

## HOW THE CAPITAL ACTUALLY MOVES

Section 1031 permits deferral of gain when proceeds are reinvested in like-kind replacement property within a strict statutory window: identification within 45 days of closing, completion within 180 days, proceeds routed through a Qualified Intermediary. Investors typically access BTR communities through one of three vehicles, depending on timeline, capital depth, and sponsor relationship.

### Direct Fractional Interest

An undivided interest in a specific community, with pro-rata net operating income and direct participation in any eventual sale. The cleanest 1031 qualification; the constraint is aligning the 45-day window with sponsor availability.

### Tenancy-in-Common (TIC)

Multiple exchange investors co-own a single community, each holding an undivided interest. Engineered to accommodate overlapping exchange windows. IRS Revenue Procedure 2002-22 governs qualification; legal vetting is required.

### Fund Structures

Dedicated vehicles offering diversification across communities, structured as programmatic TIC or equivalent qualifying co-ownership. Qualification is not automatic; this path suits investors working with dedicated tax counsel.

## WHY THE CASE HOLDS

**Management Burden, Exited**

Institutional operations are the core model, not a service layered on top of ownership. The investor still bears sponsor, occupancy, and illiquidity risk, but the midnight maintenance call belongs to the operator.

**Fresh Depreciation on New Construction**

No deferred maintenance on day one. Carried basis keeps its original timeline, but excess basis starts a new 27.5-year schedule, an incremental shield existing-stock alternatives cannot replicate.

**Demand That Does Not Track Rates**

Renters-by-choice and downsizing households in their late fifties and sixties anchor occupancy behaviorally. Neither group is renting for lack of alternatives.

**Midwest Operating Cost Stability**

Supply-constrained Midwest markets have generally avoided the catastrophic weather exposure driving coastal insurance repricing. Where the replacement property sits shapes income stability.

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| $290,400 | 8.3M | 25–30% | 27.5 yrs | 45 / 180 |
|---|---|---|---|---|
| tax on $1M of gain, illustrative outright sale | units built before 2000 | of proceeds lost in a taxable exit | fresh schedule on excess basis | days to identify and close |

## CONCLUSION

The wealth that built America's secondary rental housing stock is aging alongside the people who own it. The 1031 exchange has existed since 1921; the replacement property is what changed. For the investor holding a fourplex he cannot figure out how to exit, and for the advisors who serve him, this conversation is worth having before the next maintenance call.

**Request the full white paper at cavancompanies.com**

*Disclosure. Cavan Companies is an active developer and operator of purpose-built BTR communities, including formats discussed in this paper. For informational purposes only. Not investment, legal, or tax advice. Figures are illustrative; individual tax outcomes vary. Consult qualified legal, tax, and financial advisors before any investment decision.*