



# 1031 EXCHANGES

A SMARTER GUIDE TO KEEPING MORE OF  
YOUR REAL ESTATE PROFITS

# Why Real Estate Taxes Hurt (And How to Delay Them)

When you sell appreciated investment real estate, four different taxes can hit you all at once:

1. **Federal Capital Gains Tax** – up to 20%
2. **Depreciation Recapture** – a flat 25% on all depreciation you've taken
3. **Net Investment Income Tax (NIIT)** – 3.8% surtax on gains if your income is over \$250,000 (married filing jointly)
4. **State Income Tax** – varies by state, up to 13.3% in California

For high-income investors in high-tax states, the combined bill can eat up over 40% of your real estate gain. That's capital lost to taxes that could otherwise be compounding.

But IRS Section 1031 provides a solution: sell, reinvest, and defer.

This is not a loophole. 1031 exchanges have been part of the tax code for over a century, designed to promote reinvestment in the real economy.

## 1031 Exchanges in Plain Terms

The essence of a 1031 exchange is simple:

If you sell an investment property and reinvest the proceeds into another investment or business-use property of equal or greater value — and follow specific rules — you can defer paying taxes on the gain.

### To qualify:

- Both properties must be held for investment or business use.
- You must identify new properties within 45 days of selling.
- You must close on at least one of those within 180 days.
- You must reinvest all equity and replace any debt.
- Funds must be held by a Qualified Intermediary (QI) — not by you.

The IRS treats this as a continuation of your investment — not a liquidation. Therefore, the tax is postponed.

You can exchange into one property or multiple. You can sell one and buy three, or sell three and buy one. Flexibility is built into the structure — as long as you stay within the rules.



IRS

# HOW TO COMPLETE A 1031 EXCHANGE

## *Step-By-Step*



### Step 1: Hire a Qualified Intermediary (QI)

You cannot take possession of the proceeds when you sell — doing so invalidates the exchange. Instead, hire a QI before your sale closes. They'll draft the exchange agreement, receive the sale proceeds, and coordinate the timeline.



### Step 2: Sell Your Relinquished Property

At closing, the title company sends the proceeds directly to your QI. The 1031 timeline begins now.



### Step 3: Identify Replacement Property

Within 45 calendar days, you must submit a written identification letter to your QI naming potential replacement properties.

You can use one of the following rules:

- **Three-Property Rule** – Identify up to three properties of any value.
- **200% Rule** – Identify unlimited properties, but the total value must not exceed 200% of what you sold.
- **95% Rule** – Identify any number of properties but you must close on 95%+ of their total value.



### Step 4: Close on the Replacement Property

You must close within 180 calendar days of the sale of your original property. If you miss the deadline, the entire exchange becomes taxable.



### Step 5: File IRS Form 8824

Your CPA will include this with your tax return to report the exchange and confirm you followed the rules.





# THE REAL POWER OF TAX DEFERRAL:

## *Numbers You Can Use*

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Let's Compare Two Investors:

### **Investor A: Sells and Pays Taxes**

- Sale price: \$1,500,000
- Basis: \$500,000
- Gain: \$1,000,000
- Tax liability (Fed + State + Recapture + NIIT): ~\$380,000
- Reinvests remaining \$1.12M at 7% for 10 years = ~\$2.2M

### **Investor B: Uses 1031 Exchange**

- Reinvests full \$1.5M
- No tax due
- Compounds at 7% for 10 years = ~\$2.95M

Difference: \$750,000 in additional wealth, simply by deferring taxes.

And if Investor B holds the new property until death, their heirs may receive a step-up in basis, wiping out the deferred tax entirely.



# DELAWARE STATUTORY TRUSTS (DSTs): *The Hands-Off Option*

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Many investors love real estate but hate being landlords.  
That's where DSTs come in.

A Delaware Statutory Trust is a legal structure where investors own fractional interests in institutional-grade property — like multifamily apartments, industrial warehouses, or healthcare facilities.

**You still get:**

- Monthly or quarterly passive income
- Tax benefits (depreciation, expense pass-through)
- Capital appreciation when the property is sold
- 1031 exchange eligibility

But you have **zero landlord responsibilities.**

**DSTs are often used to:**

- Eliminate management headaches during retirement
- Meet 45-day identification deadlines when time is short
- Diversify across markets and property types
- Replace debt using pre-structured leverage
- Simplify estate planning and heir transfers

You can split your exchange into multiple DSTs, mix with direct real estate, or use a DST as a fallback plan.

# AVOIDING COMMON PITFALLS

While DSTs provide many benefits, investors should also be mindful of the associated risks:

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## Deadlines

- 45-Day Rule: You must identify potential replacement properties within 45 calendar days after selling your relinquished property.
- 180-Day Rule: You must close on at least one of the identified properties within 180 calendar days from the original sale date.

These deadlines are not flexible — even if the 45th day falls on a weekend or holiday.

## Debt Replacement

You must replace any mortgage or debt that was paid off during the sale. For example:

- If you sell a property for \$1 million and had \$400K in debt, you must replace that \$400K through a loan or invest an extra \$400K in cash to avoid boot.

## Boot

“Boot” refers to any cash or non-like-kind benefit received during a 1031 exchange.  
Types of Boot:

- Cash boot – Taking leftover funds from escrow
- Mortgage boot – Not replacing the debt that was paid off
- Non-qualified property – Accidentally including furniture, personal property, or non-like-kind assets

Boot is taxable. But the good news is: if you trigger boot, you only pay taxes on that portion — not the entire gain.



## ESTATE PLANNING

### The Step-Up Rule and Passing Wealth Forward

One of the most powerful aspects of 1031 exchanges is what happens when you die: Your heirs receive a step-up in basis to the fair market value of the property at the time of your death.

#### That means:

- All deferred capital gains vanish.
- Your heirs can sell immediately without owing taxes.
- The full stepped-up basis can be depreciated anew.

#### Example:

You buy a property for \$500K, exchange over the years into \$2.5M of real estate, and pass away.

Your heirs inherit it with a \$2.5M basis. If they sell for \$2.5M, there's no gain and no tax owed.

This makes 1031 exchanges a foundational strategy for multigenerational wealth building.







## WHEN 1031 ISN'T THE RIGHT FIT

A 1031 exchange is a powerful strategy, but it's not right for every investor or every situation.

### **Situations where a 1031 may not be optimal:**

- You need immediate liquidity or cash out
- Your property has minimal or no gain
- You want to reduce risk or take chips off the table
- You're planning to donate the property to charity
- You're already in an Opportunity Zone investment
- You anticipate major changes in your income or estate tax status

Even so, if you're facing six-figure capital gains, it's worth exploring a 1031 — even partially.



# CASE STUDIES

## Case Study #1 | *Retiring Physician*

*Dr. Patel owned a \$1.2M medical office condo in California.*

### **After retiring at 67, he wanted:**

- Passive income
- No management
- To avoid \$400K+ in taxes

### **He exchanged into three DSTs:**

- \$400K in medical office DST
- \$400K in multifamily in Texas
- \$400K in an Amazon-distribution DST

*He now receives regular income and avoided six figures in tax liability.*



**\$66,000**  
Annually  
subject to taxation



**\$400,000+**  
Tax Liability

Tax rates vary based on individual circumstances.



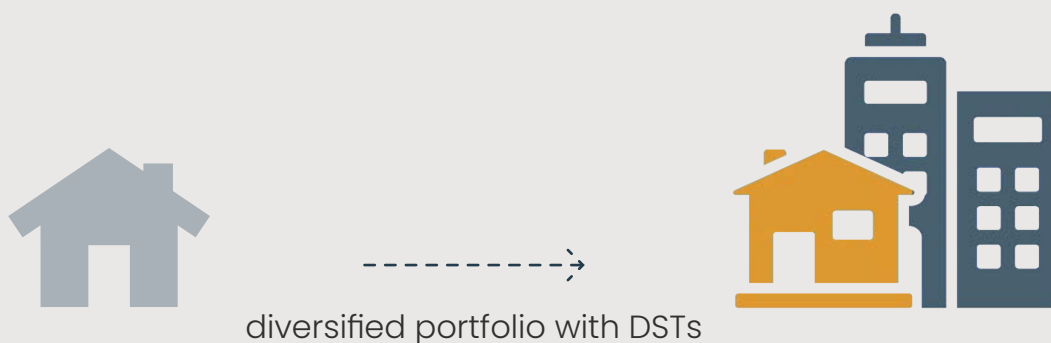
## Case Study #2 | *Landlord Diversifying*

*Maria owned two duplexes worth \$1.1M in Sacramento. She was tired of tenant headaches but didn't want all her eggs in one basket.*

### **She exchanged into:**

- \$250K in a national grocery DST
- \$250K in industrial real estate
- \$600K in a net-lease multifamily DST

She diversified across three states and three sectors — fully passive and tax-deferred.







## Case Study #3 | *Planning for Heirs*

*David inherited two small commercial buildings. He wanted to simplify things and avoid management issues for his kids.*

He sold both and invested the proceeds (\$1M) into four DSTs. One offered a 721 UPREIT option, meaning his heirs could later roll into REIT shares and sell gradually.



# STATE TAX COMPARISON:

## *CA vs TX vs FL*

Here's how tax exposure compares depending on where you live:

Tax Type	California	Texas	Florida
State Capital Gains Up To	13.3%	0%	0%
Federal Capital Gains Up To	20%	20%	20%
Depreciation Recapture	25%	25%	25%
Net Investment Income Tax	3.8%	3.8%	3.8%
<b>Total Exposure</b>	<b>~42%</b>	<b>~28.8%</b>	<b>~28.8%</b>

If you're in a high-tax state like California or New York, the benefits of deferral are significantly larger.

Even in no-income-tax states, the compounding power of deferring federal and recapture taxes is a huge advantage.





# Understanding 721 UPREITs

A 721 exchange (a different section of the tax code) lets investors contribute DST shares into a REIT's operating partnership in exchange for Operating Partnership (OP) units.

## **This allows for:**

- Continued tax deferral
- Potential long-term liquidity
- Ease of estate transfer

## **Pros:**

- Gain remains deferred
- OP units can be converted to REIT shares over time
- OP units are generally more liquid
- Heirs receive step-up in basis

## **Cons:**

- Once you UPREIT, you cannot do another 1031
- You're now a REIT shareholder with no control
- Liquidity comes with exposure to public REIT performance (depending on structure)

UPREITs are especially useful in estate planning or retirement scenarios where investors may want income or liquidation flexibility without selling real estate outright.



# HOW BOOT HAPPENS

## *And How to Avoid It*

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As mentioned earlier, **boot = taxes**. So it's critical to structure your exchange properly to avoid it.

### **Boot Examples:**

- Selling for \$2M and buying for only \$1.7M — the \$300K difference is cash boot.
- Paying off \$800K in mortgage and not replacing it — that \$800K becomes mortgage boot.
- Taking a portion of the proceeds out for personal use — taxed immediately.

### **How to Avoid Boot:**

- Buy equal or greater value property
- Replace all debt with either a new loan or extra cash
- Use a DST to “plug the gap” with exact value match
- Don't accept cash or benefits from the sale

Many exchanges that start off as “partial” exchanges can easily be structured into full deferrals with the right mix of DSTs and debt replacement strategies.





## DST FEES AND RESERVES: *What to Watch For*

DSTs are passive investments — but you still need to understand the fee stack and structure.

### **Typical Fees Include:**

- Acquisition Fee: 1%–2% of property value (paid to sponsor)
- Asset Management Fee: 0.25%–1.0% annually
- Disposition Fee: Upon property sale
- Loan Costs: Interest-only loans may be pre-structured into the deal

### **Cash Reserves**

Most DSTs hold back 3–5% for:

- CapEx
- Vacancy periods
- Tenant improvements
- Unexpected expenses

This helps protect the property — but also means not all cash flow is distributed. Always read the PPM (Private Placement Memorandum) and request a fee breakdown and reserve strategy from the sponsor or your advisor.

# INVESTOR CHECKLIST FOR DSTS AND DIRECT PROPERTY

Use this checklist when evaluating potential DST or replacement property options:

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- ✓ Sponsor has exited similar deals successfully
- ✓ Property type matches your investment profile (e.g., income vs. appreciation)
- ✓ Asset is stabilized (or improvements clearly explained)
- ✓ Debt is fixed-rate and non-recourse
- ✓ Fees are transparent and not excessive
- ✓ Hold period aligns with your liquidity needs
- ✓ Backup DST options exist in case of failed escrow
- ✓ Your CPA has reviewed tax implications
- ✓ A QI has been engaged in advance
- ✓ Exit strategy is clearly stated (sale vs. UPREIT)





# IRS AUDIT RISK *and Best Practices*

The IRS recognizes and supports properly structured 1031 exchanges — but that doesn't mean they won't scrutinize a deal if red flags are present.

## **Top Audit Triggers:**

- Holding the relinquished property for too short a time (under 12 months)
- Flipping property under the guise of investment
- Related-party transactions that don't follow special rules
- Failing to file IRS Form 8824

## **Best Practices:**

- Hold property for 1–2 years before exchanging
- Keep rental agreements, depreciation schedules, and lease records
- Use a reputable QI with documented compliance protocols
- Work with a tax advisor to model scenarios in advance
- Don't co-mingle personal funds or benefits with exchange proceeds

When in doubt, keep clear documentation of investment intent.

## FREQUENTLY ASKED QUESTIONS

### **Can I 1031 into multiple properties or DSTs?**

Yes. That's common. Just make sure to follow the identification rules (three-property rule, 200% rule, etc.).

### **Can I do a partial exchange?**

Yes, but you'll owe taxes on the portion you don't reinvest (boot).

### **Can I live in my replacement property later?**

Technically yes — but only after holding it as an investment for a qualified period (typically 2 years minimum, with documented rental intent).

### **What happens if I miss the 45- or 180-day deadlines?**

You lose the tax deferral. DSTs are often used as a fallback when time is tight.

### **Can I use a 1031 exchange for inherited property?**

No need. Inherited property gets a step-up in basis, which resets the capital gains tax to zero.

## GLOSSARY (TERMS YOU'LL ACTUALLY USE)

**1031 Exchange** – A tax strategy that allows real estate investors to defer capital gains taxes by reinvesting proceeds into like-kind property.

**Boot** – Any non-like-kind benefit received in an exchange, such as cash or debt relief. Boot is taxable.

**Depreciation Recapture** – Tax owed on previously taken depreciation deductions, generally taxed at 25%.

**DST (Delaware Statutory Trust)** – A passive real estate ownership structure approved by the IRS for 1031 exchanges, where investors hold beneficial interests in a trust that owns property.

**Fair Market Value (FMV)** – The price a property would sell for on the open market.

**Holding Period** – The amount of time you must own a property before exchanging to establish investment intent.

**Like-Kind Property** – Real estate held for investment or business purposes. All real estate is generally considered like-kind to other real estate under 1031.

**Net Investment Income Tax (NIIT)** – A 3.8% federal tax applied to certain investment income, including gains from real estate sales above thresholds.

**Qualified Intermediary (QI)** – A third party who holds funds between the sale and purchase in a 1031 exchange, required for the transaction to be valid.

**Step-Up in Basis** – A rule allowing heirs to inherit property at its current market value, eliminating prior capital gains.

**UPREIT (721 Exchange)** – A strategy to contribute real estate (or DSTs) into a Real Estate Investment Trust in exchange for Operating Partnership units, continuing tax deferral.



# PERCH

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For educational purposes only. Real estate investments, including those involving 1031 exchanges, involve risks such as market fluctuations, vacancies, and potential illiquidity. Investors should perform their own due diligence before making any investment decisions.

DST investments involve risk, including loss of principal, are illiquid, and generally suitable only for accredited investors.

The scenario presented is hypothetical and for illustrative purposes only. Assumptions used may not reflect actual market conditions, investment results, or investor outcomes. Individual results will vary.

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