1031 Exchange Overview – A Layman's View 2025 Edition

2025 Edition NOTE: This paper is a basic overview of IRC section 1031 tax deferred exchanges. It is not intended to be a guide to such an exchange, as it may omit rules and considerations that could impact upon someone actually conducting a 1031 exchange.

NOTE: This paper will use the terms "old property" for the property being sold and "new property" for the property being purchased. A "property" can consist of more than one piece of real estate.

NOTE: We have participated in many 1031 exchanges and usually have several such transactions every year. However, we are not licensed to provide either legal or tax advice. Licensed professionals such as attorneys or CPA's should be consulted for such advice.

NOTE: We are not Qualified Intermediaries or Accommodators (see item 10.) If you are looking for an intermediary we recommend Whitney Brennan of IPX 1031 Exchange at (916) 806-1468 or Janet Schaum at Old Republic at (412) 389-5606. ***We are Real Estate Resale Professionals and would welcome the opportunity to interview for the job of getting your property sold and/or helping you find the right replacement property.***

1) What is an IRC section 1031 tax deferred exchange? Section 1031 of the internal revenue code (IRC) provides for the deferment of long-term capital gains taxes on the sale of investment real estate when it is exchanged for other

investment real estate of equal or greater value than the real estate being sold. A common misconception is that you will have to find someone to trade properties with you one-to-one.

Most 1031 exchanges involve two entirely separate transactions. In one transaction, you sell your old property and in the other, you purchase your new property. There is normally no reason for the buyer of your old property and the seller of the new property to have any contact with each other.

Some of our exchanges involve property in Georgia being exchanged for property elsewhere in the United States, while others are exchanged for other Georgia property with a better return, more desirable location, newer build, or for other strategic reasons which could include beginning a new depreciation schedule.

2. What is meant by investment real estate? For purposes of this paper, investment real estate is defined as any real estate other than your primary residence or a second home. It is usually a rental property that is either residential – for example a house, townhouse, condo, etc., or commercial for example an office building, warehouse, strip shopping center, etc. However, it could also be vacant land.

3. Why should I participate in an exchange? Most exchangers use 1031 exchanges to defer capital gains taxes, as the capital gains tax can be significant. However, other reasons can include:

- Leveraging dollars that would otherwise be spent on taxes.
- Replacing low- or non-income producing property with income producing property.
- Replacing an older property with a newer one to minimize maintenance costs.
- Replacing a property in one area for property in another area.
- Diversifying a portfolio and minimizing risk often by selling one property and replacing it with several properties.
- Setting up an estate plan that may include dividing assets into multiple properties or into multiple areas. We recently assisted in an exchange including the sale of a property in Central Florida into one purchase in the same area and a second purchase of an investment property here in NW Atlanta. This was to accommodate a legacy for each of their two children.

4. What is meant by deferring taxes? A 1031 exchange enables an owner to defer both the federal and state capital gains taxes on the sale of their old property and roll those taxes over into the new property. Note that the taxes are deferred, not excluded, and could be subject to collection if you subsequently sell the new property without conducting another 1031 exchange or otherwise changing the status of an investment property. Deferred means to suspend or withhold until a certain time.

5. What is the exchange value of my property? Generally speaking, the value would be the sales price less closing costs.

6. Does a 1031 exchange defer Georgia capital gains taxes as well as Federal capital gains taxes? Yes, both Georgia and Federal taxes are deferred. Note that the taxes are not excluded; they are deferred and could be subject to collection if you subsequently sell the new property without conducting another 1031 exchange or otherwise change the status of the investment property into a non-capital-gains-taxable-status in the future.

In Georgia, the state collects 3% of the sales price at closing with possible refunds of the 6% capital gains tax rate if the collected amount is too high. If the non-resident owner is conducting a 1031 exchange, this withholding is waived.

7. What are the time requirements associated with a 1031 exchange? There are two key time frames both measured from the closing date of the old property. Failure to meet either of these two timeframes negates the tax-deferred 1031 exchange.

• Within 45 days, the new property must be identified in writing to the QI (Qualified Intermediary.) You can make changes to your identification any time within the 45-day period; however, on the 46th day, you are locked-in to whatever has been identified as new property.

• Within 180 days, the new property must close. You can identify more than one property; so, if your preferred new property falls out of escrow, you could shift to a replacement new property that was identified during the 45-day-period; however, it would still have to be closed within the 180-day-period. Many exchangers identify more than one new property. There is a rule regarding the tax being due with the tax filings also - if you closed on the first half of a 1031 in November or December you made need to file for a extension.

8. What is involved in identifying the new property? To defer all your capital gains taxes, you must buy new property that is equal to or higher in value than the old property. Again, the value would be the sales price less the closing costs. You must also reinvest all the cash proceeds from the sale into the purchase of the new property. The QI maintains the funds from the sale of the property being sold, and then makes those funds available in order to enable the purchase of the new property. You cannot have access to any of the proceeds from the sale of the old property or those funds will be taxed.

You must identify a new property within 45 calendar days after the closing date of the old property. The identification is only valid if the new property has been designated as such in a written document signed by you (and any other party on title) and delivered (hand-delivered, mailed, faxed, scanned and emailed, etc.) to the QI. There are 3 guidelines to use when selecting replacement properties to identify to the QI:
• 3-Property Rule: A maximum of three properties, regardless of what the fair market value is; or • 200% Rule: Any number of properties, as long as the combined fair market value does not exceed 200% of the fair market value of all of the old properties; or
• 95% Rule: Any number of properties without regard to value, provided 95% of the value of the identified properties is acquired at the close of the exchange.

9. What are the current Federal and Georgia capital gains taxes? The current federal capital gains tax rate for single taxpayers with an Adjusted Gross Income (AGI) less than $533,400 and married couples filing jointly with an AGI less than $488,850 is 15% on all component of gain except depreciation recapture. Single taxpayers with an AGI greater than $533,400 or married couples with an AGI greater than $600,050 will be subject to a capital gains tax rate of 20%. For income below $96,700 (married filed Jointly) or $48,350 (single filers) the Capital Gains rate is 0%.

Federal Depreciation Recapture is taxed at 25%. You can find how you have depreciated the property on line 18 of your Schedule E. The Georgia capital gains tax rate is 6% on all components of gain including depreciation recapture. Single taxpayers with an AGI greater than $200,000 and married couples filing jointly with an AGI greater than $250,000 will also be subject to the 3.8% Medicare Tax.

10. What is a Qualified Intermediary (QI)? The IRS mandates that you use a completely independent third party to supervise the exchange. Because this third party must be completely independent, it cannot be your real estate agent, accountant or attorney. The independent third party is usually referred to either as an intermediary or as a qualified intermediary (QI); however, in some areas of the country the third party may be called either a facilitator or an accommodator. This paper will use term "QI."

The QI can be located anywhere in the country; they do not need to be located near you or near either of the properties involved in the exchange. The following steps can help explain the role of the QI. The QI takes title to the old property for a brief instant in the process of having it sold from you to the buyer; i.e., title passes from you through the QI to the buyer. Similarly, the QI takes title to the new property for a brief instant in the process of having it sold from the seller to you. Therefore, the QI has owned both the old and the new properties and can exchange one for the other. Today, the QI no longer has to hold title to both properties. In 1991, the real estate industry successfully lobbied Congress to have the law changed, as escrow companies were charging double escrow or closing fees; i.e. Seller to QI and then QI to you. Today, in lieu of taking title to both properties, the QI is tasked to provide instructions so that both transactions are closed in a manner that conforms to section 1031 of the IRC.

11. How do I locate a QI? We can provide you guidance based on our experience working with 1031 exchanges. QI's are not regulated either by the federal government or by most states; therefore, there may be some less-than-reputable individuals out there. This is an area where you want everything to be done correctly. We would only use as a QI, a company or individual that is experienced, bonded and works with exchanges on a full-time basis; i.e., we would not use an attorney as a QI who only does it on a part-time basis. If it were a relatively simple one-for-one exchange, we would probably use the exchange division of a large escrow or closing company.

12. What is the cost of a QI? For a relatively simple one-for-one exchange of old property to new property, one exchange company that many of our past clients have used charges about $1200 to $1500 plus about $300 for each replacement property. For a one-for-one exchange, a cost of about $1,200 to $1500 is similar to what most QI's charge. Some QI's will charge a lower base fee and retain the

interest earned on the exchanger's funds (held by the QI from the close of the old property to the close of the new property). So, if you are comparing costs, ask about the interest. If the exchange is complicated and and/or involves LLC's, the cost is likely to be in the $3,500 and up range.

13. Why do the proceeds from the sale go to the QI? You cannot have access to any funds from the sale of the old property or those funds will be taxable. The QI places the funds (your money) into a savings account. Note: Some QI's retain the interest on your funds as part of their compensation. If you are shopping for a QI, this may be a cost to consider.

14. I understand that I cannot have access to any funds from the sale of the old property. Could I refinance the old property before I exchange it? This is a gray area. If you were to refinance the old property in the year prior to selling it, you could have a problem with the IRS, as they might argue that your refinancing was done to circumvent the prohibition of receiving funds from the old property. On the other hand, if you could show the funds from the refinancing were used strictly for bona fide investment purposes, you might have a counter argument. You should discuss this with your attorney and QI before making decisions to refinance before conducting a 1031 Exchange.

15. Could I use funds held by the QI for costs associated with the new property like earnest money or having a feasibility study done prior to purchasing it? The QI can only advance funds from your account for items that will be refunded if closing doesn't occur, the most common example being earnest money. The cost for items like a feasibility study, architect fees, etc. would not be refunded if the deal fell through; therefore, the QI cannot advance funds for those purposes. However, if those costs are shown on the settlement statement at closing, they can be paid at that time with funds from your account held by the QI. Your QI can answer specific questions regarding costs you may incur as part of your 1031 Exchange.

16. What is boot? Boot is anything given or received by the exchanger that is not like-kind or does not qualify under 1031 rules. Boot can be in the form of cash, promissory note, or in the form of debt (like a mortgage). Any boot received in connection in the sale of the old property that is not offset by the boot given on

obtaining the new property, is gain that must be recognized (or taxed). Boot-netting Rules:

• Cash paid on buying the new property offsets the cash received on the sale of the old property;

• Cash paid on buying the new property offsets debt relief on the sale of the old property; and • Debt acquired or assumed on the new property offsets the debt relief on the sale of the old property.

• Note: Debt assumed on the purchase of the new property will not offset the cash received on the sale of the old property.

17. Can I do a partial exchange? It is possible, however, any money that you use from the proceeds of your sale will be considered as boot and therefore will be taxed. Discuss fully with your tax advisor and your QI.

18. What kinds of properties qualify for an exchange? Both the old property and the new property must be investment real estate; in most cases they are rental properties. The two properties do not need to be the similar; e.g., you could exchange a house in Georgia for two or more Florida condos and vice versa. Almost any type of real estate qualifies such as a house, condo, store, office, A Delaware Statutory Trust Fund, or even vacant land. Your personal residence or a second home does not qualify. However, you could rent a property for a period of time first, effectively changing its status so that it could qualify as investment property. We have seen Sellers sell an investment property, rent it for a period of time, and then occupy it themselves at a later date changing the status of the property to a primary residence. Many of our clients do this, using equity in their investment property to assist them in purchasing a future residence, perhaps for retirement. We recommend you consult with your tax advisor, attorney and QI when planning this creative use of IRC 1031 Exchange law. Also continue reading this report's #21-23. *Note: A 1031 exchange is an exchange of investment real estate for investment real estate. It does not need to be the same kind of property nor does it have to be one for one. You can exchange commercial property for residential property or vice versa. Or, you can exchange one property for several properties or vice versa. You may wish to look into a Delaware Statutory Trust Properties (DSTP).* They operate somewhat like a REIT with some of the advantages and disadvantages listed here: Advantages of a DSTP:

1) Easy to Identify and fund.
2) Monthly income.

3) Diversification.
4) Very Limited on-going landlord duties.
Disadvantages of a DSTP:
1) They are illiquid and long-term.
2) An individual has limited or no control...
3) There can be no new capital raised – requiring larger reserves.

19. If I own a property that includes my personal residence and a rental unit, would it qualify for an exchange? Yes. Consult with your CPA or tax advisor to determine the percentage value of the property you have attributed to investment. You may exchange that portion of the value.

20. How do I find someone who wants to exchange or trade investment real estate with me? You don't! A common misconception is you need to find someone to trade properties with you. Most 1031 exchanges involve two entirely separate transactions. In one, you sell old property and in the other, you purchase new property. There is no reason for the buyer of your old property and the seller of the new property to have any contact with each other. Often, the properties are located in two different states. A 1031 Exchange is almost never a "trade."

21. Can I exchange the old property into a new residence for myself? No. A 1031 exchange involves investment real estate being exchanged for other investment real estate. However, exchangers sometimes change their minds and occupy property they had intended for rental purposes. In October 2004, new federal regulations were issued as to how long an owner had to have owned a principal residence they had acquired through a 1031 exchange before they could sell it and exclude some or all the capital gain under the Tax Relief Act of 1997.

Many tax experts believe this change to the federal regulations legitimized the process of conducting a 1031 exchange into new property that the exchanger rents for a while, so it qualifies as rental property and then occupies as their principal residence. You should discuss this with your tax advisor, attorney and QI. Also continue reading Question #22 below.

22. We often get this question, though it does not relate to a 1031 Exchange: Can I defer taxes when I sell my primary residence? No, but you can exclude up to $250,000 of gain if you are single or $500,000 if you are married. There are

other rules that may apply to this exclusion. We recommend you consult with your tax advisor and attorney. The Housing and Economic Recovery Act of 2008 places additional limits on the capital gains exclusion for those individuals that have either converted a primary residence into a rental or have made a previous rental property into their primary residence. If the property has been used as a rental after 2009, then the capital gains exclusion is reduced by the following fraction: The Number of days a taxpayer rented property after 1/1/2009 divided by the Number of days a taxpayer owned property. If the sale of the home results in capital gains that exceed the allowed exclusion, then the taxpayer must report the taxable gain and pay the appropriate capital gains taxes.

23. How long do I have to rent a property that I want to use as a future residence? This is a question to discuss with your tax advisor, attorney and QI. Obviously, the longer a property is rented, the easier it is to show there was investment intent. In the past, there were three different opinions:
(1) at least one year and a day;
2) a period of time long enough to enable two tax returns to be submitted showing it to be rental property; and
(3), at least two years.

Recently, there has been a decided movement towards the oneyear and a day criterion.

24. Can I rent new property to a related party? Yes, however, the rent must be fair market rent for the property. In addition, the rental payments must be able to be documented. Otherwise, the IRS may rule that the property is merely a second home, which would not qualify for a 1031 exchange.

If you decide to rent to a related party, you should consider setting up a separate bank account with all rental payments sent there to make it easier to document that fair market rent was actually paid.

25. Can a related party be involved in the 1031 exchange? Section 1031 of the IRC states that you cannot sell to or buy from a related party unless both parties hold the properties for two years after the exchange. A related party includes your parents and grandparents, your siblings, your spouse, your children and grandchildren, and any business organizations where you or your relatives are

members. The IRS has been getting increasingly tough in this area as evidenced by the need now to provide a written statement as to whether a related party was involved in the exchange.

26. Can I exchange into vacant land and build a house? Yes, this is commonly referred to as a construction exchange. Most exchangers want the new property to include the house rather than just the vacant land. Note that this can create timing problems in view of the 180-day requirement to close on the new property. Therefore, a construction exchange usually necessitates considerable advance planning along with the use of a very experienced Realtor and QI. Normally, a limited liability company (LLC) is established that acquires the lot, initiates contracts with the architect/builder and has the house constructed. Financing for these actions is usually provided by the exchanger outside of the exchange; i.e., not from the old property. When the new house has been completed, the lot and house are then deeded to the exchanger as the new property.

27. Are there any other requirements involved in conducting a 1031 exchange? An important rule many don't realize is that the new property must be at least as expensive as the old property (sales price less closing costs). If the new property is less expensive than the old property, the difference in value will be taxable. Sometimes the difference can continue to be withheld and used for improvements to the new property and not be taxed. Discuss this with your QI.

You must take title to the new property exactly as title was held to the old property. If the lender needs your spouse to co-sign a mortgage to the new property and be on title, your spouse must also be on title to the old property. Note: Trusts that do not file a tax return, like a revocable living trust, are usually disregarded for 1031 exchange purposes. Therefore, the owner of a trust is treated as an individual in selling the old property and can subsequently take title to the new property in their own name. This can be very important, as many lenders will not provide mortgages to trusts. If you own the old property in a trust, this is something you should discuss with your QI, attorney, and experienced lender.

28. **Can you do it backwards; i.e., buy the new property first and then sell the old property?** Yes, however, with some very few exceptions, all of the exchanges

made by our clients have been deferred exchanges where the old property is sold prior to purchasing the new property. It is possible to do this in reverse order and purchase the new property first; i.e., prior to selling the old property. This is called a reverse exchange and is more complicated and a bit more expensive than a deferred exchange.

This article is based upon deferred exchanges. Over half of our deferred exchanges involved absentee owners conducting their first 1031 exchange.

29. What advice can you provide on locating a new property? Many of our first-time exchangers look at properties also in Georgia; the state they live in now; in a state they plan to move to someday; have other family such as children living; or finally, a state they believe will have better returns or appreciation. Clients often choose areas they currently live in, areas they visit often, or areas they hope to retire to one day. In our experience, we suggest that you choose an Agent or company that can provide both the sale and property management information. Ideally, the same company you purchase through will manage the property for you after the sale closes.

30. How does the average person afford to buy more expensive investment real estate? They use the equity they have in the old property as a down payment on the more expensive new property. For example, if you own old property worth $350,000 with a mortgage balance, you have $200,000 of equity in the property ($350,000 less $150,000.) Using a 25% down payment, the $200,000 should enable you to buy a new property or combination properties valued at up to $800,000. The rent that you expect to receive from the new property would be used to help you qualify for a mortgage on the new property.

31. I own one-half of a property with my brother owning the other half with title being in both of our names. He wants to cash his half out, while I want to conduct a 1031 exchange with my half. Is this possible? As a general rule, yes; however, this is something you need to discuss with your QI, attorney, and tax advisor. You would also need to take title to your new property exactly as you held title to your half-interest in the old property. 32. Could I buy Real Estate Investment Trust (REIT) shares as my new property? No. The IRS has ruled that REIT shares do not qualify as real estate in an exchange. A REIT is like a mutual fund that owns real estate; it is a security, not real estate. There is an exception

for a special type of REIT called an UPREIT or Umbrella Partnership REIT but there are restrictions; e.g., you can't exchange out of an UPREIT to buy actual real estate. You might look into a Delaware Statutory Trust Fund (Question 18.)

33. How do I report a 1031 exchange to the IRS? IRS Form 8824 is a 2-page form that must be submitted in the year that you sold your old property. You will be required to state on the form whether your 1031 dealings were with a related party. You will be required to include the name/address of the QI.

34. Recent rules. Three relatively recent rules apply to principal residences. The tax relief act of 1997 enabled a homeowner to sell their principal residence and exclude up to $500,000 of gain (married) or up to $250,000 (single) providing they had occupied the home for an aggregate 24 out of the prior 60 months. So, an owner only needed to own the property for three years, one year as a rental, to qualify for the exchange and then two years as a principal residence to qualify for the tax relief act of 1997. In October 2004, there was a change to the 1997 law. An owner who acquired their principal residence by way of a 1031 exchange must now own the property for at least five years before they sell it in order to be eligible for the exclusion. The owner still needs to rent it for enough years, so that it qualifies for the Exchange, and then have it be their principal residence for at least two years. The exchanger also has to pay depreciation recapture on depreciation claimed (after May 6, 1997) while the property was a rental; i.e., depreciation recapture while the property was a rental will not be excluded.

The Housing and Economic Act of 2008 reduces the capital gains that can be excluded when a homeowner sells a principal residence that they acquired via a 1031 exchange, as the amount of the tax exclusion will be adjusted by the non-resident use of the property. This law became effective 1/1/09.

The amount of time of non-resident use after 1/1/09 is the numerator or top of a fraction with the bottom or denominator of the fraction being the total time since property acquisition. That fraction times total gain (exclusive of depreciation recapture after May 6, 1997) is the gain that will be taxed to the homeowner. If you live in a property that was a rental you definitely need to discuss this with your CPA and your QI. As of 1/12018 Personal property assets that can no longer be exchanged include intangibles, such as broadband spectrums, fast-food restaurant franchise licenses and patents; aircraft, vehicles, machinery and

equipment, railcars, boats, livestock, artwork and collectibles. Transition rules permit a personal property exchange to be completed in 2018 if either the relinquished property was sold or the replacement property was acquired by the taxpayer during 2017*. Note that there is no mention in the transition rule of acquisition by an EAT; the rule is specific to the taxpayer*.

35. What are the other ways to conduct an exchange? There are four ways to conduct an exchange. The first is to conduct a deferred or delayed exchange as discussed in this paper. The other three are as follows:
• The Reverse Exchange: This occurs when the new property is acquired prior to the sale of the old property.
• The Simultaneous Exchange: This occurs when the old property and the new property both close at the same time.
• The Improvement Exchange: This occurs when you wish to use proceeds from the exchange to make capital improvements to the new property.

36. Some final thoughts. A 1031 exchange is not the right investment tool for everyone. Over the years, we have assisted many owners in making a decision not to conduct an exchange. Often, all that is required is an estimation of the selling basis, buying basis, and accumulated depreciation. Contact us locally (678-232-0927 or 678-477-4897) or via e-mail (mike.stott@mac.com). Due to the added complexity from recent tax law changes, we recommend that you speak with a Certified Public Accountant (CPA) or tax attorney prior to deciding on a course of action. Due to the rising value of real estate on Georgia, you will likely be pushed into the higher tax brackets if you have owned the investment property for a significant period of time and the resulting tax bill could be costly if you don't conduct a 1031 exchange.