



MARK DIMERCURIO · 1031 CAPITAL SOLUTIONS

1031 EXCHANGE · EXPLAINER

What Is a 1031 Exchange?

The 1031 exchange, demystified: how to defer — not eliminate — capital gains and depreciation-recapture tax when you sell investment real estate, the deadlines and rules that govern it, and where a DST can fit.

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Why this packet exists

When you sell appreciated investment property, the moment you decide to sell you run into the tax bill — and it's usually larger than people expect, because it isn't one tax. It's the **tax bomb**: federal capital gains *plus* depreciation recapture, *plus* the net investment income tax, *plus* state. A **1031 exchange** (named for Section 1031 of the U.S. tax code) lets you **defer** that tax by reinvesting the proceeds into other "like-kind" investment real estate, within strict IRS timelines.

Deferral is not elimination — but for many investors, it changes what's possible at the point of sale. This packet walks through the mechanics so the fog clears and you can bring informed questions to your own CPA and attorney. Nothing here is a recommendation, and nothing here is an offer.

A little history

Section 1031 has been in the code since **1921**, originally written so farmers could trade one parcel for another without a tax event interrupting the swap. The idea has held up for a century: if you're continuing an investment rather than cashing out, the tax can wait. After the Tax Cuts and Jobs Act, the rule applies only to real estate — but for real estate, it remains a powerful tool.

What "like-kind" actually means

For real estate, "like-kind" is broad: most real property held for investment or business use is like-kind to most other such real property. A rental house can be exchanged for an apartment building, raw land, a commercial building — or a fractional interest in professionally managed real estate. What matters is that both the relinquished and the replacement properties are held for investment, not personal use.

A common misconception is that the two properties have to be similar in type or size. They don't. The standard is about *use*, not resemblance — which is exactly why a single rental can be exchanged into a **mosaic** of different property types.

The tax bomb you're deferring

It helps to see what's actually in the bill, because the size of it is what makes deferral worth understanding:

- **Federal capital gains** on the appreciation — up to roughly 20% on a property held more than a year.
- **Depreciation recapture** — the depreciation you deducted each year lowered your *adjusted basis* (price + improvements – accumulated depreciation), so your gain is larger, and that recaptured slice is taxed at a rate that can reach **25%**.
- **Net investment income tax (NIIT)** — an extra **3.8%** above certain income thresholds.
- **State income tax** — 0% to north of 13%, depending on where you live.

The tax bite on a sale of appreciated rental real estate

Fed cap gains	Deprec. recapture	NIIT	State
■ Federal capital gains — up to 20%	■ Depreciation recapture — 25% on the depreciated portion		
■ Net Investment Income Tax — 3.8%	■ State income tax — varies (e.g., up to ~13.3% in CA)		
Total: roughly 30–40% of your gain			

Illustrative combined rates; your actual tax depends on your basis, income, and state — ask your CPA. Individual results vary.

All figures here are **hypothetical / illustrative — individual results vary**. Only your CPA can compute your actual numbers.

The two deadlines that matter

A 1031 exchange runs on a clock that starts the day your sale closes:

- **45 days** — to formally identify your replacement property (or properties) in writing, signed and delivered to your qualified intermediary.
- **180 days** — to close on the replacement and complete the exchange.

Both are calendar days, and both are strict. You can identify under the **three-property rule** (up to three properties, any value) or the **200% rule** (any number, combined value up to twice your sale price). You also can't take receipt of the sale proceeds — a **qualified intermediary** holds them between the sale and the purchase. Missing a deadline, or touching the money ("constructive receipt"), can disqualify the deferral. This is why planning the exchange *before* you sell matters so much.

The 1031 clock: two strict deadlines



Both are strict calendar days — and a qualified intermediary holds the proceeds the whole time.

Both deadlines are strict calendar days. Plan before you sell. Individual results vary.

One more rule worth knowing: you generally have to replace the **net sale price**, not just your equity — and you can't replace equity with debt. If there was a loan on the old property, it has to be replaced with cash or new financing. (This is one place a DST's built-in leverage option can quietly solve a problem for a seller who can't or doesn't want to qualify for a new loan.)

Defer is not eliminate

A 1031 exchange **defers** capital gains and depreciation-recapture tax — it pushes it down the road, it doesn't erase it. Whether and when that deferred tax ultimately comes due depends entirely on your situation and future decisions, which is a conversation for your own CPA and tax attorney. A step-up in basis at death can, in some circumstances, change the outcome — but that's a planning question for your advisors, not a guarantee from anyone. Anyone who tells you a 1031 "eliminates" your taxes is overselling it.

A worked example

Hypothetical / illustrative — individual results vary. Not a quote, a projection, or a promise. Real numbers depend on your basis, your bracket, your state, and the full shape of your return, which only your CPA can compute.

Picture an investor who bought a Bay Area duplex long ago for roughly **\$220,000**. Today it's worth about **\$1.7 million**, and the rent — while it has grown — never kept pace with the equity, so most of that value sits in the building producing relatively little income.

Line item	Sell outright (hypothetical)	1031 exchange (hypothetical)
Approximate value at sale	~\$1,700,000	~\$1,700,000
Estimated combined tax at sale*	a meaningful slice of the gain \$0 (deferred)	
Equity available to reinvest	what's left after the tax bomb	full ~\$1,700,000

* Illustrative only — a blend of federal capital gains, depreciation recapture (up to 25%), the 3.8% NIIT, and state tax. Your actual rate may be higher or lower.

The point of the illustration is simply this: deferral keeps your **full equity working** rather than sending a slice to the IRS at the moment of sale. Whether that trade-off is right for *you* depends on facts only you and your advisors know.

Where a DST fits

One replacement option is a **Delaware Statutory Trust (DST)** — a structure that lets you own a fractional, passive interest in professionally managed real estate. A DST interest can qualify as like-kind replacement property, which makes it useful for investors who want to defer tax but are tired of active landlording (the move from *active* to *passive*), or who are up against the 180-day clock — a DST can be faster to close than purchasing a replacement property of your own.

DSTs are **securities**, available only to **accredited investors**, and offered solely through a sponsor's Private Placement Memorandum (PPM). **Distributions are not guaranteed.**

The honest trade-offs

A 1031 — and a DST as replacement property — solves real problems, but it does not remove investment risk. Before considering either, weigh:

- **Illiquidity.** DST interests are long-term holds and are not readily sold or traded.
 - **Loss of direct control.** With a DST, the sponsor and trustee manage the property; you don't.
 - **Distributions are not guaranteed.** Income depends on the underlying property and can fall or stop.
 - **Fees.** DST offerings carry fees and costs that reduce returns. Review every offering's fee and risk disclosures.
 - **Risk of loss.** Like any real estate investment, value can fall, including loss of principal.
 - **The deferral has conditions.** Miss a deadline, take constructive receipt of funds, or under-reinvest, and part or all of the gain can become taxable.
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What this packet leaves out

This is an overview, not a complete treatment. It does not cover partial exchanges and "boot," the full debt-replacement rules, reverse and improvement exchanges, related-party rules, the difference between a standard DST and a 721/UPREIT structure, or how a step-up in basis at death may interact with a deferred gain. Those are exactly the topics to raise with your CPA and attorney.

A soft next step

If you'd like to see the order of magnitude for your own situation, the interactive estimator at markdimercurio.com/estimator gives an educational gut-check before you talk to your CPA. And if it would help to talk it through with no pressure, you're welcome to book a complimentary educational call.

Education only. This packet is not tax, legal, or investment advice, and it is not an offer to buy or sell any security. Please consult your own advisors.



The single biggest mistake I see is people setting up the exchange *after* they've already agreed to sell — by then the clock is running and the good options are narrower. If there's one thing to take from this, it's to bring your CPA, your attorney, and a qualified intermediary into the room *before* the sale closes. I'm not here to tell you a 1031 is right for you; I'm here to make sure the fog clears enough that you can decide with your own advisors.

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