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APRIL 2025

How 1031 Exchanges Help Investors Defer Capital Gains Taxes

Most people who have had experience with the real estate business have at least heard of 1031 Exchanges, but not everyone is familiar with exactly what they are and how they work. Structuring a real estate transaction as a 1031 Exchange can result in substantial tax savings and for that reason we felt it was worthwhile to give a brief overview.

To begin, one must understand that when selling an investment property, the seller may have a tax consequence referred to as a Capital Gains Tax. For simplicity, consider an investment property to be any property other than your personal residence. When an investment property increases in value, the increase is considered a capital gain. Capital gains are “realized” and become subject to tax when you sell the investment. The taxes can be owed on both Federal and State tax returns, and the tax rate depends on how long you owned the investment. Long term capital gains are gains on investments owned for more than 1 year and are usually taxed at a lower rate than short term capital gains (gains on investments owned for 1 year or less).

The 1031 Exchange name comes from Internal Revenue Code Section 1031 which enables you to defer the payment of capital gains tax by re-investing the proceeds from the sale of an investment property into another property referred to as the replacement property. Instead of paying tax on the gain or profit realized from the sale of the investment property, that amount of gain is carried over to the replacement property by means of a reduction (for taxation purposes) of the replacement property’s acquisition price. If and when the replacement property is sold, the gain in value will then be calculated as the difference between the sale price of the replacement property and the original purchase price less the original capital gain which was deferred. 1031 Exchange deferrals can be continued through as many exchanges as you wish. However, when you ultimately sell a replacement property without reinvesting in a new property, there will be capital gains tax liability.

As an example, let’s suppose you purchased a rental house in 2021 for \$300,000. Then in 2023, you sold that house for \$400,000, and

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since you didn't want to pay the capital gains tax on the \$100,000 of value increase, you replaced your original investment with a replacement investment of vacant land which you purchased for \$500,000. If structured as a 1031 Exchange, you would defer or postpone the tax owed on the \$100,000 gain by reducing (for tax purposes) the acquisition price of the replacement land by the same amount of your gain (\$100,000). Even though you actually paid \$500,000 for the land, your new basis in that land is now \$500,000 less \$100,000, or \$400,000. To complete the scenario, assume that in 2025 you sell the land for \$700,000 and you don't replace it with another investment property. Therefore, you'll most likely have a capital gains tax to pay on the increase in value of the land. However, even though you paid \$500,000 for it and sold it for \$700,000, because you deferred paying tax on the \$100,000 you made from selling the original rental house, you now have reduced your basis in the land from \$500,000 (less the \$100,000 gain) to \$400,000. Therefore, instead of a \$200,000 gain, the IRS requires you to recognize a \$300,000 gain on which to pay the capital gains tax. As you can see, in 2023 you deferred your capital gains tax by reinvesting, but upon sale of the land in 2025 the gain was recognized, and the tax became due.

There are numerous and strict requirements which must be followed in order to realize the investment benefits and avoid expensive penalties. Some, but not all, are as follows:

- (1) The seller doing a 1031 Exchange cannot receive the funds for the sale. Therefore, the exchange process must involve a "Qualified Intermediary" also known as "QI" who is a trained professional hired by the seller and who actually executes the exchange. The QI holds all proceeds from the sale until reinvesting them into the replacement

property. The QI must be selected prior to closing on the property being sold.

- (2) The properties involved ("Relinquished Property" and "Replacement Property") must be "like kind". This is liberally interpreted and with real estate, usually any investment property will qualify so long as its not considered your personal residence.
- (3) Potential replacement properties must be identified in writing within 45 calendar days of the closing of the property being sold. Closing on the replacement property must occur within 180 calendar days after selling.
- (4) To realize the full benefits of the exchange, the replacement property must be of equal or greater value than the property being sold.

This is not intended to be a complete summary of the 1031 Exchange, but rather a limited and hopefully easy-to-understand explanation of how the process works. The full scope of the intricacies and risks involved can only be determined by consultation with a professional tax advisor who should have full knowledge of your tax situation and the specific laws of the state in which you reside.

COMMUNITY CALENDAR

Paonia/Hotchkiss

•Arbol Farmers Market—Paonia Town Park Every Tuesday 5-7:30pm May 13th-October 14th 2025

•Hotchkiss Sheep Camp Stock Dog Trials— May 9-11 2025 One block from downtown on 2nd St. next to fire station

•Folk N' Roots Rendezvous—May 23-25 2025 at Big B's. Three days of free live music & family friendly activities!

Cedaredge

•Plant & Dig Garden Club—meets every 3rd Friday from 2-4pm. Call Joan for more info: (970)901-9360

•Pop Up Farmers Market—Weds from 4-7pm in downtown just west of Rick's at 145

•Grand Mesa Arts & Events Center has a variety of wonderful classes coming up: www.gmaec.org/calendar



Real Estate Acronyms

Real Estate agents often sprinkle their language with abbreviations and acronyms that can be confusing for prospective buyers and sellers. Here are some of the most common:

CMA – A Comparative Market Analysis is a report that estimates a property’s value based on comparable properties that have sold and/or are actively for sale in the area.

CC & R – Covenants, Conditions and Restrictions which are a set of rules and regulations usually determined and enforced by a homeowner’s association.

HOA – A Homeowner’s Association

FMV – Fair Market Value is the estimated price that a property will sell for.

FSBO – For Sale By Owner, often pronounced “Fisbo”, is a designation for a property being sold by the owner rather than through a real estate broker.

IRR – Internal Rate of Return is a way to measure return on investment usually for commercial properties.

MLS – Multiple Listing Service is a database of properties for sale in a particular area.

NAR – The National Association of Realtors is a lobbying organization that offers certifications and special designations for real estate agents. It also provides self-regulation by means of a Code of Ethics.

NOI – Net Operating Income which is a way to measure return on investment that compares revenue against operating expenses.

MEC – Mutual Execution of Contract is the date by which all parties have signed a contract.

LOC – Line of Credit is a short-term financing option for property owners.

LTV – Loan to Value is the ratio or percentage of the loan amount compared to the property value.

POA – Power of Attorney is the authority given by a property owner to another person to execute real estate documents on their behalf.

REO – Real Estate Owned is a term often used to designate a property owned by a bank or mortgage company.

SFR – Single Family Residence is a free-standing property that houses one family only.

ILC – Improvement Location Certificate is a diagram prepared by a surveyor of the configuration of a property showing the location of all structures (all improvements). It is not a boundary survey.



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POSTAGE



TO:

Please call me if you know someone who would like to receive this newsletter!

Delta County Real Estate

Year to date (YTD) statistics as of March 31st 2025

Sold Listings— 84 (2024) vs. 72 (2025), a decrease of 14.3%

Median Sales Price— \$352,500 (2024) vs. \$380,000 (2025), an increase of 7.8%

Days on Market Until Sale— 143 (2024) vs. 125 (2025), a decrease of 12.6%

New Listings— 126 (2024) vs. 141 (2025), an increase of 11.9%

Average Sales Price— \$393,425 (2024) vs. \$434,905 (2025), an increase of 10.5%

YTD Average Sales Price by Area

Delta Area - \$384,842

Surface Creek - \$414,169

North Fork - \$545,167