# 1031 Exchange Frequently Asked Questions

## What is a 1031 exchange?

"1031" is a reference to Section 1031 of the IRS Code, which allows owners of business or investment property to exchange their property for like-kind property and defer payment of taxes due on the sale of the relinquished property.

## How does a 1031 exchange work?

Once you have found a buyer for your property and before you close on your sale, you must retain a qualified intermediary (QI), which is a company that specializes in facilitating exchanges. At the time of closing your QI will place the proceeds from the sale into a 1031 exchange escrow account.

From the date you transfer title on the original property to the buyer, you have 45 days to identify your replacement property or properties and 180 days to close on the replacement property(ies). The QI purchases the replacement property you select using the funds in your 1031 escrow account, and transfers the property to you.

## What types of properties can be exchanged?

The IRS defines "like-kind" as any real property held for business or investment purposes. This definition includes raw land, farmland, rental properties and commercial properties. Owners of any of these types of properties can exchange them for a net-leased commercial property offered by AEI.

## What are the rules for identifying replacement property?

Your QI will assist you in completing the property identification paperwork. In completing a 1031 exchange, the IRS allows you to identify replacement property under three different rules:

- ***Three Property Rule:*** You can identify any three properties of any total value.
- ***The 200% Rule:*** You may identify any number of properties as long as the total fair market value of the properties does not exceed 200% of the value of your relinquished property.
- ***The 95% Exception:*** You can identify any number of properties with any total value but you must acquire 95% of what you identify. (This rule is rarely used for most exchangers).

## Are there any costs to do a 1031?

The IRS requires the involvement of a qualified intermediary. The fees of a qualified intermediary are generally $750 to $1,000. You, as a buyer, would be responsible for any legal, tax or other expenses that you incur on your behalf.

## How do I locate a Qualified Intermediary?

There are a number of highly experienced national and regional firms that provide QI services. AEI does not provide these services but can provide a list of experienced QIs upon request.

## Can I complete a 1031 exchange with a portion of my sale proceeds and cash out?

Yes. You can still do an exchange to defer a portion of capital gains that would otherwise be due on the sale of your relinquished property. The portion of proceeds which you do not choose to exchange is referred to as “cash boot” and becomes taxable at federal and state levels.

## How are mortgages and debt handled in a 1031 exchange?

Generally, if you have a mortgage on your property you must take on an equal or greater amount of debt on your replacement property. The amount of sale proceeds used to retire debt on the relinquished property is considered “mortgage boot” and is subject to capital gains taxes. It is possible for you to pay capital gains taxes on the mortgage boot and complete a partial 1031 exchange with the remainder to defer a portion of the capital gains taxes.

## What taxes are involved in the sale of real estate?

It is best to consult your tax professional to calculate your individual taxes due. Generally speaking, your capital gain on the sale of real property is fully taxable at both federal and state levels. Typically, your capital gain is calculated by taking your sale price and subtracting your adjusted basis in the property and selling expenses. The following taxes may apply and may be deferred by doing a 1031 exchange:

1. Long-term Federal Capital Gains – up to 20%
2. State capital gains – typically the rate of state income tax. As high as 13% in some states
3. Depreciation recapture - 25%
4. Medicare tax – 3.8%