



## Cascade Exchange Services, Inc. Frequently Asked Questions

### What is a 1031 exchange?

In a typical real estate transaction, the property owner is taxed on any gain realized from the sale of property. However, under Internal Revenue Code, Section 1031(a).1, the tax on the gain is deferred until some future date.

Section 1031 provides that "no gain or loss is recognized if property held for productive use in a trade or business or for investment purposes is exchanged solely for property of a like-kind to be held either for productive use in a trade or business or for investment." A tax-deferred exchange is a method by which a property owner trades one or more relinquished properties for one or more replacement properties of "like-kind", while deferring the payment of federal income taxes and some state taxes on the transaction.

The theory behind Section 1031 is that when a property owner has reinvested the sale proceeds into another property, the economic gain has not been realized in a way that generates funds to pay any tax (no taxable event). In other words, the taxpayer's investment is still the same, only the form has changed (e.g. vacant land exchanged for apartment building). Therefore, it would be unfair to force the taxpayer to pay tax on a "paper" gain.

The like-kind exchange under Section 1031 is tax-deferred, not tax-free. When the replacement property is ultimately sold (not as part of another exchange), the original deferred gain, plus any additional gain realized since the purchase of the replacement property, is subject to tax.

### What are the Exchange Rules?

Rules for Every Tax-Deferred Exchange:

1. Exchange Like for Like: Remember that property sold and purchased must be investment property, used for trade or business purposes, or used for the generation of income. Like-kind property refers to the intended use of the real property, not the type of real property, as investors often believe. Like-kind property exchanges may for example include any of the following: bare land for a rental house, duplex for a fourplex, retail center for an apartment complex or an office building.
2. Exchange Even or Up in both Net Equity and Net Value: If not, a recognized (taxable) gain will occur.
3. Identify acceptable property or properties within 45 days of sale date: All replacement property must be identified in writing! There are three rules that limit the number of properties that can be identified, and the taxpayer must meet the requirements of one of these rules. There is no extension to the identification period!
  - o Three Property Rule – you may select no more than three properties; there is no price limit. You may substitute one selection for another during the 45 day period.
  - o 200 Percent Rule – you may select any number of properties; however, the total price of the properties must not exceed twice the price for which you sold the relinquished property.



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- 95 Percent Rule – any replacement property identified before the end of the 45-day identification period and received before the end of the exchange period qualifies, but only if the exchanger receives identified replacement property constituting at least 95 percent of the aggregate fair market value of all identified replacement properties.
- 4. Acquire replacement property within 180 days of sale date or before filing your tax return for the year of the sale .
- 5. Use a qualified intermediary (QI): This intermediary is employed by an exchange agreement to hold and disburse funds for the benefit of the exchangor.
  - The exchangor cannot have actual or constructive receipt of exchange funds. Exchangor cannot receive funds, borrow against funds, or direct their use. Sale proceeds will remain in an Exchange Value Account (EVA) during the exchange, where they are outside of the exchangor's control.
  - The “QI” cannot be an agent or nominee of the exchangor.
  - Funds are used to acquire replacement property and pay for closing costs associated with the purchase.

Role of the QI:

- Exchangor signs Exchange Agreement
- Exchangor assigns relinquished property to the QI
- QI transfers property to buyer
- QI holds sale proceeds in EVA
- QI acquires replacement property for exchangor, but does not find property, negotiate contract...

**Can I exchange a property if I do not own 100% of the relinquished property?**

Many taxpayers may hold a fractional interest in a property, but would like to exchange their interest. A tenant in common interest may be exchanged, and the taxpayer may purchase a fractional interest in the replacement property as well. These types of transactions are becoming very popular among investors who would like to invest together with other investors. However, the interests of partnerships or other entities cannot be exchanged.

**Can I sell or buy several properties when exchanging?**

Many exchangors would like to sell several properties to acquire one (or more) replacement property (ies), or many want to sell one property to acquire several replacement properties. A multiple leg exchange is allowed, however, the identification and acquisition period begins when the first relinquished property is exchanged. This may limit the exchangor if they intend to perform one exchange transaction. As a result, it may sometimes be best to structure the exchange as several transactions rather than one.

**Do I receive a cost basis in my replacement property?**

The tax basis from the relinquished property is carried over to the replacement property when performing an exchange. The tax basis in the replacement property is increased by additional cash or by the increase in debt used to acquire it.



### **Does my accommodator report my exchange to the IRS?**

The role of the accommodator is to hold funds during the exchange period, not to file a tax return for the exchanger. At the close of escrow, the IRS form 1099S will show that the exchanger will receive property as consideration for the sale of the relinquished property. The IRS form 8824 must be completed with the taxpayer's annual federal tax return. This form determines the realized gain, recognized gain and basis of the like-kind property received. It also asks for the description of the property sold and purchased, and the dates of identification and acquisition of exchange property. In addition to form 8824, the taxpayer must also report the exchange on their state return. In Oregon, form 24 is used to report the exchange of property.

### **How should I take title to the replacement property?**

Many taxpayers will sell as one individual or entity and will attempt to acquire title to the replacement property in the name of another individual or entity. When performing an exchange, the title to the replacement property should be the same name in which the relinquished property was held.

### **If I don't spend all of my sale proceeds, when can receive the remaining funds?**

If the taxpayer acquires all identified properties, the remaining exchange funds can be released to the exchanger at that time. However, if the exchanger does not acquire all identified properties, then the unused funds cannot be released until the end of the 180- day exchange period.

### **Can I take a note on the sale of the relinquished property?**

If a relinquished property is sold and the exchanger takes a note and trust deed as part of the consideration, the note would be taxable. To avoid this taxable event, the note and trust deed can be made in the name of the QI.

- The replacement property can be acquired by assigning the interest of the note and trust deed to the seller for part of the equity in the new property.
- The QI can sell the note and trust deed to a third party. This will allow the exchanger to have all cash from the note and trust deed to acquire the replacement property.
- The note and trust deed can held by the QI until the end of the exchange period, and then assigned back to the exchanger. The will result in boot, however, the exchanger will only have to pay tax on the amount received each year.

### **If I have already signed a contract or opened escrow, is it too late for me to treat my sale as an exchange?**

As long as the sale is not closed, the exchange can still be completed. Contacting an accommodator as early as possible is a good idea. This will help insure that all escrow paperwork is correct and the exchange papers are prepared in time. Once the sale is closed, it would be too late to perform a 1031 exchange.

### **How should items such as rents and deposit be handled when performing an exchange?**

Any sale proceeds used to transfer rents and security deposits to the buyer would be considered boot, resulting in a



taxable event. These items should be handled outside of escrow, or these non-transaction costs should be paid for by making a separate deposit into the escrow.

**Can I exchange if the property is partially a residence and partially an investment property?**

Many exchangers may sell or buy a property that is used for personal and investment purposes. In this situation, an allocation must be made to determine the percentage of value that can be exchanged.

**Can I convert the replacement property into a principal residence?**

Oftentimes taxpayers will change the use of the replacement property, and may like to use it as a principal residence. Although there are no specific regulations on how long a property should be used as an investment property, it is generally recommended that the property be held for at least two tax returns before converting its use. Please discuss this option with a tax professional, as gains may be applicable if the property is later sold as a principal residence.

**What is a 'reverse exchange'?**

A reverse exchange, sometimes called a 'parking arrangement', occurs when a taxpayer acquires replacement property before selling their relinquished property. A 'pure' reverse exchange where the Taxpayer owns both the relinquished property and the replacement property at the same time is not allowed. The actual acquisition of the 'parked' property is done by an Exchange Accommodation Titleholder, or parking entity.

**Can proceeds from the relinquished property be used to make improvements on the replacement property?**

Yes – this is known as a Build-to-Suit or Construction or Improvement Exchange. When performing an exchange the taxpayer is not permitted to build on the property they already own. Therefore, an unrelated party or parking entity must take title to the replacement property, make the improvements, and convey title to the taxpayer before the end of the exchange period.

**Are IRC 1031 Exchanges limited to just real estate?**

No – any property that is held for productive use in a trade or business, or for investment, may qualify for tax-deferred exchange under IRC 1031. In fact, many exchanges are 'multi-asset' exchanges involving both real estate and personal property.