Why is it Necessary to Identify Replacement Property?

In a typical Internal Revenue Code (IRC) §1031 delayed exchange, a taxpayer has 45 days from the date of sale of the relinquished property to identify potential replacement property. This 45-day window is known as the identification period. The taxpayer has 180-days from their sale closing date to acquire one or more of the identified properties, which is known as the exchange period. Property(ies) acquired within the 45-day identification period do not have to be listed on the identification form, however they do count toward the 3-property and/or 200 percent rules discussed below.

The timing deadlines of the 45-day identification deadline and 180-day completion deadline are strict and other than in the case of Presidentially declared natural disasters, such as hurricanes, there are no extensions. These rules are a direct result of the Starker case where for the first time a taxpayer was able to sell relinquished property on one day and acquire replacement property at a different point in time. These time limitations were a compromise between allowing an exchange to be non-simultaneous while at the same time having some temporal continuity between the sale and the purchase.

What is expected under the Identification and Receipt Rules?

The 1031 guidelines require that the taxpayer identify replacement property before the end of the 45th day after the relinquished property is closed. There are three rules the taxpayer must be aware of:

- The 3-Property Rule
- The 200-Percent Rule
- The 95-Percent Rule

45-DAY IDENTIFICATION PERIOD

The exchange regulations provide "The identification period begins on the date the taxpayer transfers the relinquished property and ends at midnight on the 45th day thereafter". The identification must (i) appear in a written document, (ii) signed by the taxpayer and (iii) be delivered to the replacement property seller or any other person that is not a disqualified person who is involved in the exchange. The custom and practice is for the identification to be delivered to the qualified intermediary.

Disqualified persons generally are those who have an agency relationship with the taxpayer. They include the taxpayer's employee, attorney, accountant, investment banker and real estate agent if any of those parties' provided services during the two-year period prior to the transfer of the relinquished property. Property identifications made within the 45-day period can be revoked and replaced with a new
Identification form, but only if done so prior to midnight of the 45-day identification deadline.

THE 3 PROPERTY RULE

A taxpayer may identify up to three properties of any value and may acquire any one or all the properties without restriction. If during the 45-day period the taxpayer wishes to amend the identification document, the original can be revoked and a new form listing different properties may be submitted. This must be done in writing.

THE 200% RULE

A taxpayer may exceed three properties and identify any number of properties provided the aggregate fair market value of the identified properties does not exceed 200 percent (double) of the fair market value of all relinquished properties. The fair market value of the relinquished property is established on the date it is transferred to a buyer. The fair market value of the aggregate replacement properties is determined at the end of the identification period (the 45th day).

THE 95% RULE

If both the 3-property rule and the 200% rule are exceeded, the taxpayer must acquire at least 95 percent of the aggregate fair market value of all property identified before the end of the replacement period (180 days from the transfer of the relinquished property). For purposes of the 95% rule, the fair market value is determined on the date a property is received or on the 180th day for those properties not received.

Exception: Any property received during the 45-day identification period will be considered valid replacement property.

DESCRIPTION OF REPLACEMENT PROPERTY IN IRS 1031 EXCHANGE

The description of replacement property must be unambiguous and specific. For instance, the identification of "a condominium unit at 123 Main Street, Chicago, IL" would fail due to the specific unit not having been identified.

The actual rules are as follows:

- Replacement property is identified only if it is unambiguously described in a written document or purchase agreement, signed and dated by the taxpayer and submitted prior to the 45-day.
- Real property generally is unambiguously described if it is described by a legal description, full street address, or distinguishable name (e.g., the Mayfair Apartment Building).
- Real property to be improved during the exchange must be unambiguously described including as much detail as practical about the intended improvements.

RELEASE OF FUNDS

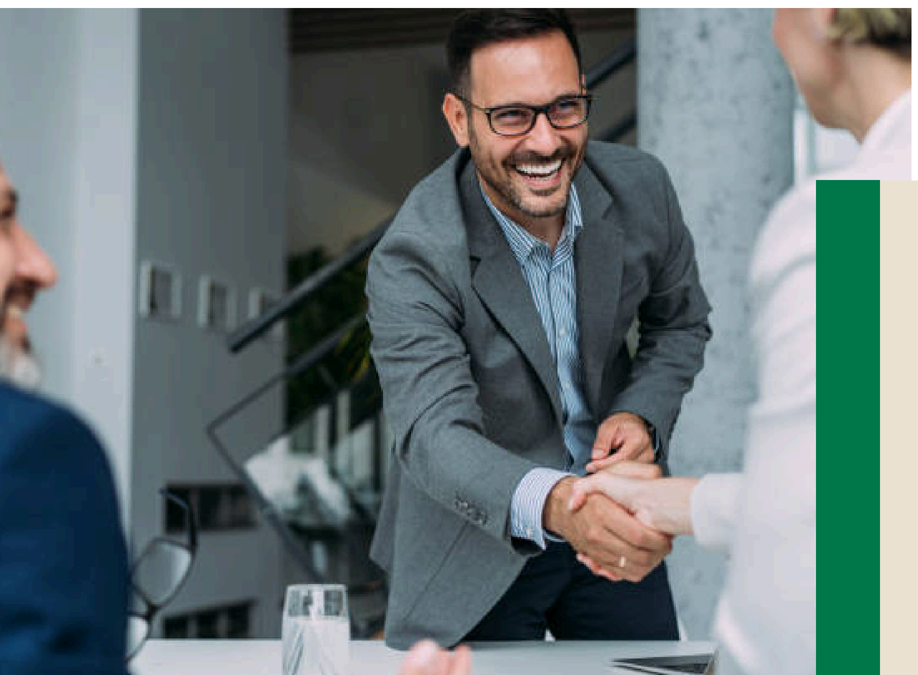
In April of 2000, the IRS issued a private letter ruling in response to a request by a Qualified Intermediary ("QI") regarding the release of exchange proceeds to a taxpayer during an exchange. The QI was concerned with clients who cancel their exchange and demand release of the funds prior to the expiration of the 180-day replacement period. The QI asked the IRS for permission to amend its exchange agreement and release the proceeds if, after good faith negotiations with a prospective seller or sellers, the exchangor is unable to reach a binding purchase agreement. The issue was whether failure to reach an agreement with a seller constituted a 'material and substantial contingency' beyond the control of the taxpayer which would allow the QI to release the funds. Unfortunately, the IRS' response was that it did not consider a mere failure to reach an agreement with a seller as material and substantial thereby permitting the release of funds by the QI. As a result, if a taxpayer identifies one or more replacement property(s) and either: 1) fails to purchase any of the properties identified; or, 2) acquires some but not all of the identified property and has funds remaining, then those funds must be held by the QI until the 181st day.

To avoid this problem, when identifying multiple replacement property(s) the exchangor should specify in writing whether they intend to purchase multiple property(s) or they are identifying multiple property(s) but intend to purchase only one of the choices. If the intent is to purchase only one, and this is made clear at the time of identification, then they may receive any residual funds after they complete the purchase, and the 45-day identification period has ended.

1031 Identification Rules

SUMMARY

The ability to defer taxes through a §1031 exchange is a valuable benefit to taxpayers. However, to receive this benefit, all the exchange rules must be strictly adhered to. The rules pertaining to identification and receipt of replacement property must be understood and met to comply with the technical requirements of this IRC §1031. In fact, the property identification rules are so germane to a proper exchange that there is a question asked of the taxpayer on the exchange reporting form 8824 about compliance with these rules.



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