Nassau Lawyer

DECEMBER 2016 | VOL. 66 | NO. 4 | WWW.NASSAUBAR.ORG

Beat the Clock: 1031 Exchange Replacement Property Identification

Internal Revenue Code § 1031 permits a property owner to defer recognizing the capital gain from the sale of his property by "exchanging" it for other "like kind" property. By deferring the recognition of the capital gain, the property owner also defers the taxation on the capital gain, thereby allowing him to utilize all of the sale proceeds to purchase a new property, rather than having to set aside a portion to pay the various levels of government. Known as a 1031 exchange, IRC Section 1031 has long been a favorite of savvy real estate investors.

Michael S. Brady

However, time constraints are part and parcel of every 1031 exchange. While the property being sold by the investor ("Relinquished Property") and the property being acquired by the investor ("Replacement Property") do not need to be exchanged simultaneously, the 45-day identification deadline and the 180-day maximum exchange period can be daunting to the unprepared taxpayer. Sure, the benefits of doing an exchange are clear—tax savings of 20-30% or more—but the Internal Revenue Code requires quick action.

The identification deadline tends to be the most troublesome: from the closing of the Relinquished Property, an investor must identify his potential replacement property within 45 calendar days.[1] This includes weekends and holidays, so even if the 45th day is on the Fourth of July or Thanksgiving, the property still must be identified by midnight, fireworks and turkey be damned. In even the best seller's market, a month and a half is not much time to find a suitable investment property, and the identification process may not be as easy as it seems.

Written Identification

The Treasury Regulations are very particular about how Replacement Property must be identified. Any Replacement Property that is received by the taxpayer before the 45th day is deemed to be satisfactorily identified.[2]

Replacement Property that will be received after the 45th day must be identified in the written document, that is signed by the taxpayer, and delivered to either the Qualified Intermediary[3] that is facilitating the exchange, the seller of the Replacement Property, or "any other person involved in the exchange other than the taxpayer or a disqualified person." The escrow agent or title company involved in the purchase might be acceptable parties to receive the identification.[4]

A "disqualified person" would include an agent of the taxpayer, such as any person who has acted as the taxpayer's employee, attorney, accountant, investment banker or broker, or real estate agent or broker within the two years prior to the sale of the Relinquished Property. Additionally, any entity in which the taxpayer or other disqualified person owns more than a 10% interest would likewise be a disqualified person and could not act as the taxpayer's qualified intermediary.[5]

Describing the Replacement Property

The written identification must unambiguously describe the Replacement Property.[6] It is not sufficient to list the property as "a commercial condominium in SoHo." A street address, legal description or distinguishable name, such as The Empire State Building, should be included, as should the city and state where the property is located. For a condominium, cooperative, or other property located within a larger property complex, the unit number, apartment number, or other more precise information should be stated as well.

Since the taxpayer must receive "substantially the same property" that he identified, fractional interests in a larger property, such as tenant in common interests and beneficial interests in a Delaware statutory trust, should also be described in detail, including the percentage interest or dollar value of the interest being acquired.

An example in the Treasury Regulations indicates that if only a portion of an identified property is received, it is considered substantially the same as the identified property, if it does not "differ from the basic nature or character" of the identified real property as a whole, *and* it is at least 75% of the fair market value of the identified property.[7] So if a taxpayer identified 201 Park Avenue, New York, New York as a Replacement Property, but only acquired a 2% tenant in common interest in that property, the IRS could disallow the exchange on the basis that the acquired interest is not substantially the same property as the property that was identified.

Likewise, if the identified replacement property will be substantially changed between the time it is identified and the time of closing, such as by new construction or substantial renovations, the taxpayer should also include "as much detail regarding the construction of the improvements as is practicable at the time the identification is made."[8]

Identifying Multiple Properties

Once the 45-day identification period has expired, the taxpayer may only acquire a Replacement Property that has been properly identified. He may not switch or add additional properties for any reason, even if an identified Replacement Property has been sold to someone else or the property has become less desirable after the taxpayer completes his due diligence. While the taxpayer is not required to have a contract of sale for a Replacement Property within the 45-day Identification Period, doing so will certainly reduce the risk of losing the property.

The regulations do permit a taxpayer to identify multiple potential replacement properties, but there are limits:

Three Property Rule: The taxpayer may identify up to three properties regardless of the fair market value of the properties;[9]

200 Percent Rule: The taxpayer may identify any number of properties provided the aggregate fair market value does not exceed 200 percent of the aggregate fair market value of all the relinquished properties;[10] and,

95 Percent Rule: If the taxpayer identifies more than three properties with an aggregate fair market value in excess of 200 percent of the fair market value of the Relinquished Properties, the taxpayer will be treated as having not identified *any* property, unless the taxpayer acquires at least 95% of the aggregate fair market value of all the properties identified before the end of the Exchange Period.[11]

The 95 Percent Rule seems to be designed for taxpayers who are purchasing a portfolio consisting of many properties, where the taxpayer will either acquire all of the properties listed, or none at all.

"Fair Market Value" is not well defined in the regulations ("the fair market value of property means the fair market value of the property without regard to any liabilities secured by the property"),[12] but since violating the 200 Percent Rule could result in the entire exchange being disallowed, a conservative approach will reduce that risk. Using the list price for the property is usually the safest alternative, rather than using an aggressive below market offer price that the taxpayer believes the seller will accept.

Dobrich v. Commissioner

Attempting to complete an exchange without abiding by the identification rules could result in the 1031 exchange being disallowed if the transaction is audited, resulting in the taxpayer being required to pay the taxes they sought to defer, as well as accrued interest on the amount due. Depending on the circumstances, accuracy related underpayment penalties could also be assessed.[13]

Additionally, as one unfortunate taxpayer discovered, backdating an identification form could also result in significant fraud penalties. In *Dobrich v. Commissioner*, upon finding that the taxpayer had submitted false and backdated identification documents to the IRS, the Tax Court imposed a 75% fraud penalty, which amounted to $1.6 million![14]

Given the strictness and complexity of the identification rules, attorneys should consult with their clients early in the process to review their clients' intentions. Discuss partial identifications, whether the property will be improved prior to the closing, and if the client wishes to identify multiple properties. Perhaps most importantly, the taxpayer should begin shopping for his Replacement Property well before the closing of his Relinquished Property. Doing so will help him avoid the last minute rush, making it more likely that he will make a sound investment decision, rather than a hasty tax decision.

Michael S. Brady is Executive Vice President of KV 1031 Exchange LLC, a national Qualified Intermediary for 1031 Exchanges, and an affiliate of Kensington Vanguard National Land Services. Mr. Brady has earned the Certified Exchange Specialist® designation from the Federation of Exchange Accommodators. He can be reached at (646)518-3708 or mbrady@kv1031.com.

1. Treas. Reg.§ 1.1031(k)-1(b)(2)(i).
2. Treas. Reg.§ 1.1031(k)-1(c)(1).
3. Treas. Reg. § 1.1031(k)-1(g)(4). For tax purposes, the qualified intermediary "acquires the relinquished property from the taxpayer, transfers the relinquished property, acquires the replacement property, and transfers the replacement property to the taxpayer." Usually, the qualified intermediary will not actually acquire title to either property, but will instead just take assignment of the exchanger's rights under both contracts of sale, and then receive the net sales proceeds from the relinquished property closing and deliver them to the replacement property closing.
4. Treas. Reg. §1.1031(k)-1(c)(2).
5. Treas. Reg. § 1.1031(k)-1(k).
6. Treas. Reg. § 1.1031(k)-1(c)(3).
7. Treas. Reg. § 1.1031(k)-1(d)(2), Example 4.
8. Treas. Reg. § 1.1031(k)-1(e)(2).
9. Treas. Reg. § 1.1031(k)-1(4)(i)(A).
10. Treas. Reg. § 1.1031(k)-1(4)(i)(B).
11. Treas. Reg. § 1.1031(k)-1(4)(ii)(B).
12. Treas. Reg. § 1.1031(k)-1(m).
13. IRC § 6662.
14. *Dobrich v. Commissioner*, 74 T.C.M. 985 (1997), T.C. Memo. 1997-477.

KV 1031 EXCHANGE

Reprinted with permission by the Nassau County Bar Association